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2001 Ontario Budget

Corporate Income Tax

The Budget clarified that planned reductions in the Ontario corporate income tax rates are scheduled for January 1 of each of the next four years. This will result in the general Ontario corporate income tax rate and the manufacturing and processing tax rate being reduced from 14% and 12% respectively to 8% by 2005. The general rate will fall by 1½% per year and the manufacturing rate by 1% per year.

Capital Tax

The current Ontario capital tax system provides for an exemption from capital tax for corporations with taxable capital under $2 million and for reduced capital tax rates for corporations with taxable capital between $2 and $4 million. The Budget replaces as of January 1, 2002 both this exemption and the reduced rates with a new $5 million deduction from taxable capital.

Personal Tax

The Budget proposes to reduce slightly (with the reductions split between 2002 and 2003) the low and middle marginal rates from 6.2% and 9.24% to 6.05% and 9.15% for 2002 and to 5.65% and 8.85% for 2003 but does not propose to change the top Ontario marginal rate. A number of individual tax credits are also enhanced slightly. The Budget proposes to replace the current two tier surtax (20% and 36%) with a single surtax which applies at the same starting level at which the current second tier surtax begins to apply. This surtax change will represent a tax saving to middle and higher income individuals.

The element in the Budget which has received the largest degree of press attention is the announcement that between 2002 and 2006, the Ontario government plans to introduce progressively higher degrees of tax assistance for private school tuition. Effectively, a refundable tax credit will be available to parents for a portion (rising from 10% to 50%) of private school tuition up to $7,000 per child.

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Third Party Civil Penalties – The First Interpretive Views from the Canada Customs and Revenue Agency ("CCRA")

New sections 163.2 of the *Income Tax Act* (Canada) ("ITA") and 285.1 of the *Excise Tax Act* (Canada) ("ETA") introduce civil penalties which can be assessed against third parties involved in preparing, selling or promoting tax shelters or tax-shelter-like arrangements (the "Planner Penalty") and against third parties involved in providing tax return preparation and related services to taxpayers (the "Preparer Penalty"). These penalties apply to false statements made after June 29, 2000, the date of Royal Assent. This article will summarize the details of the legislation as enacted and outline various Principles of Application contained in draft CCRA Information Circular IC-01-1 dated January 12, 2001.

There is substantial overlap between the Planner Penalty and the Preparer Penalty, with a person being liable for the greater of the two penalties, if both are applicable. Subsection 163.2(2), the Planner Penalty, provides that:

> Every person who makes or furnishes, participates in the making of or causes another person to make or furnish a statement that the person knows, or would reasonably be expected to know but for circumstances amounting to culpable conduct, is a false statement that could be used by another person… for a purpose of this *Act*, is liable to a penalty in respect of the false statement.

Subsection 163.2(4), the Preparer Penalty, provides that:

> Every person who makes, or participates in, assents to or acquiesces in the making of, a statement to, or by or on behalf of, another person … that the person knows or would reasonably be expected to know but for circumstances amounting to culpable conduct is a false statement, that could be used by or on behalf of the other person for a purpose of this *Act*, is liable to a penalty in respect of the false statement.

There is potential for the imposition of very significant penalties under new Section 163.2. The amount of the Planner Penalty is the greater of $1,000 and the "gross entitlements" from the planning or valuation activity. The amount of the Preparer Penalty is the greater of (a) $1,000; and (b) the lesser of the Section 163(2) penalty on the taxpayer (which can be up to 50% of the full amount of the tax assessed) and $100,000 plus the "gross compensation" in respect of the false statement. The terms "gross entitlements" and "gross compensation" are for these purposes considered to be the person's fees charged, profit realized and any other potential income from being involved in making the false statement.

On January 12, 2001, the CCRA published in draft form Information Circular 01-1 – *Third Party Civil Penalties.* In IC-01-1, the CCRA has taken the unusual step of confirming what it refers to as "Principles of Application". This is confirmation that the CCRA recognizes that the new legislation has potentially broad application. Under the Principles of Application, the CCRA administratively takes the rare step of voluntarily narrowing its proposed application of the penalty provisions "…to ensure that the penalties are applied in a fair and reasonable way."

The Principles can be summarized as follows: (i) the legislation is intended to apply mainly to arrangements and plans that contain false statements, often without the knowledge of the client; (ii) tax-planning arrangements that comply with the law are not affected by these penalties; (iii) the legislation is intended to apply to those tax return preparers and advisors who counsel and assist others in making false statements when they file their returns; (iv) the legislation is not meant to impede regular day-to-day business activities and conventional tax-planning involving the application of the law to issues such as estate freezes, rollovers, reorganizations, amalgamations, and owner/manager remuneration; (v) the legislation is not intended to apply to honest mistakes, oversights and errors in judgement; (vi) the legislation is not intended to apply to differences of interpretation where a reasonable argument (an argument that is not obviously wrong) exists as to the application of the law; (vii) the legislation is not intended to create additional audit or verification work for accountants and lawyers who conduct their affairs in accordance with their professional standards; (viii) the legislation is not intended to apply to activities that are administratively acceptable to the CCRA as the correct application of the law. While these Principles provide some comfort to tax advisors, they are quite vague and subject to the interpretation of the CCRA.

Similar provisions have been added to the ETA for GST purposes. The above commentary also applies to those provisions.

These new penalties are onerous and may force the professional to be a watchdog for tax avoidance and evasion. We expect that there will be much discussion and possibly some amendment or further clarification to the provisions of the Information Circular with time.

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London Life Insurance Company v. The Queen GST Input Tax Credits – A Breakthrough

Tenants who are not normally eligible for full input tax credits in respect of GST paid in the course of operations and who are making leasehold improvements should take note of the recent Federal Court of Appeal decision in *London Life.* The decision suggests that input tax credits and possibly refunds could be available to such tenants in certain circumstances.

Generally, a business making GST taxable supplies is eligible for input tax credits in respect of the GST it pays. Input tax credits are generally not available, however, to a person in the business of making GST exempt supplies, such as financial services. In *London Life,* the taxpayer insurance company was the tenant of leased premises from which it generally made GST exempt supplies (insurance) and accordingly was not normally able to claim input tax credits. *London Life* claimed, however, that certain leasehold improvements made by it should be looked at as a separate commercial activity and that the leasehold improvements were a taxable supply made by it to the landlord for which it was entitled to a full input tax credit. The CCRA denied the input tax credit.

The salient facts were as follows. *London Life* made only GST exempt supplies out of the particular premises where the leasehold improvements were made. The landlord paid *London Life* a leasehold improvement allowance of $2.2 million plus GST of about $155,000. Under the lease agreement, *London Life* undertook to make leasehold improvements with this leasehold improvement allowance. *London Life* paid for leasehold improvements which cost approximately $2.1 million and paid GST thereon. Under the lease agreement, the leasehold improvements immediately became the property of the landlord. *London Life* also made an election under subsection 13(7.4) of the ITA. (A leasehold improvement allowance is generally added to a tenant's taxable income; an election under subsection 13(7.4) excludes the allowance from income and reduces the capital cost of the improvements to the tenant by that amount.)

There appear to be two important factors in the Court's analysis which led it to hold in favour of the taxpayer. Firstly, the leasehold improvements immediately became property of the landlord as provided in the lease agreement. Secondly, the leasehold improvements were found **not** to be "improvements" as defined under subsection 123(1) of the ETA since the leasehold improvement costs were not added to the capital cost of *London Life's* leasehold interest for purposes of the ITA due to the subsection 13(7.4) election.

The beneficial result for the taxpayer in this case should encourage tenants who make GST exempt supplies to consider whether such treatment is available for leasehold improvements in their circumstances. Readers are cautioned that there are time limitations in the ETA for claiming input tax credits or refunds and the potential availability of relief will depend on the tenant and its type of business.

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Term Preferred Shares – The *Citibank* Case

As a general proposition, the ITA is structured so that income is taxed once and only once at the corporate level. Therefore, subject to the exceptions referred to below, dividends paid by one corporation resident in Canada to another are tax free. That is, the dividend is included in the recipient corporation's income and a corresponding deduction is allowed in computing taxable income. On the other hand, section 55 of the ITA characterizes tax free intercorporate dividends as capital gains in certain situations where the dividend does not emanate from tax paid retained earnings in the dividend paying corporation (so called "safe income"). There are also a whole series of rules in the *Act* designed to prevent corporations which are not in a taxable position from using preferred shares as a substitute for debt with the result that the holder of the shares receives tax free dividends rather than taxable interest payments. These rules include the so called term preferred share, guaranteed share, collateralized preferred share, taxable preferred share and short term preferred share rules.

The oldest of these rules are the term preferred share rules. Subsection 112(2.1) denies the intercorporate dividend deduction where a "specified financial institution" receives a dividend on a term preferred share, other than a dividend paid on a share that was not acquired in the ordinary course of business carried on by the institution. In essence, the term preferred share rules were designed to prevent corporations that were not in a taxable position from issuing to financial institutions preferred shares with dividend rates set at slightly above what would be the after-tax cost of market rate interest to the payor if it were in a taxable position. Consider a very simple example where the market rate of interest is 10% and the corporate tax rate is 50%. If the corporation were in a taxable position and borrowed at market rates, its after-tax interest cost would be 5%. Where it is in a non-taxable position, however, its after-tax cost is 10%. Prior to the enactment of the term preferred share rules, therefore, corporations that were not in a taxable position (e.g. because of the availability loss carryforwards) would issue term preferred shares (which would

have debt like characteristics) bearing interest in the above example at 6%. This would result in substantially less cost to the corporation than the 10% cost if it had issued debt and would generate an after-tax yield to the financial institution of 6% since the dividend would be tax free, as opposed to an after tax interest yield of 5% if the financial institution had held debt. The Department of Finance considered this result to be inappropriate and hence the term preferred share rules were enacted.

The *Citibank* case is the first case to consider the definition of "term preferred shares". The definition of term preferred share is, to quote the judge in the *Citibank* case, "lengthy", "prolix in the extreme", "too long" and "represents the triumph of detailed, particularized, excessive drafting over common sense". *Citibank* had acquired preferred shares from two different corporations which were listed on a Canadian stock exchange. In each case, the critical attribute of the shares was that the holder had the right at the end of the initial 5-year term to convert the preferred shares into common shares of the issuer at a conversion rate obtained by dividing the issue price of the preferred share by the market price of a common share of the issuer at the date of conversion. Thus, if the financial institution held $1,000,000 of preferred shares, it would be assured of receiving on conversion $1,000,000 worth of common shares. This provided the financial institution with additional liquidity for its investment since the common shares were listed on a stock exchange.

The CCRA reassessed *Citibank* on the basis that the shares were caught by the term preferred share rules, and in particular that part of the definition which provided that a share is a term preferred share if under the terms or conditions of the share, the issuing corporation provides any form of "guarantee, security or similar indemnity or covenant" with respect to the share. The position of the CCRA was that the conversion formula amounted to a guarantee because *Citibank* would always receive full value for its preferred shares on the conversion.

In his reasons for judgment, Judge Mogan referred to the Supreme Court of Canada decision in *Stubart* which stated that:

> "the words of an Act are to be read in their entire context and in their grammatical and ordinary sense harmoniously with the scheme the Act, the object of the Act and the intention of Parliament."

Judge Mogan commented that the concept of a term preferred share applies to a relatively small community of sophisticated taxpayers and the words "guarantee, security, or similar indemnity or covenant" ought to have a more technical meaning derived from the law as it applies to commerce and public companies and therefore legal dictionary definitions were appropriate interpretative tools. Judge Mogan then went on to hold that a guarantee is given by a third party not the issuer, a mere promise to pay is not security and the shares in question did not involve any form of indemnity. Therefore, the shares in question were not term preferred shares.

The case is of particular interest because of Judge Mogan's criticism of Parliament's (in reality, the Department of Finance's) use of complex detailed statutory provisions to combat perceived tax abuses. In some ways, the effect of the judgment is to adopt the maxim: "Those who live by the sword, must die by the sword". As Judge Mogan put it:

> "The problem lies in the definition. It is so detailed; so particularized; so long and tedious and excessive in its use of language. The Respondent [Revenue Canada] has put forward the object and purpose argument to show that the subject shares go against the spirit of the legislation. When the definition is drafted with such care, why can the Appellant [*Citibank*] not argue that it is flowing with (and not against) the spirit of the legislation when it has, with equal care, drafted the terms and conditions of a share which is outside the forbidden area of the definition?"

It is to be hoped that this judicial approach will be applied in construing other complex and detailed anti-avoidance provisions of the *Act*.

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Tax Deferral for Exchanges of Employee Stock Options and Employee Stock Option Shares

When a corporation is acquired or reorganized, outstanding employee stock options are often exchanged for options to buy shares in the acquiror or the reorganized entity. Subsection 7(1.4) of the ITA defers the tax that would otherwise be payable on a disposition of the option by deeming the option acquired on the exchange to be the same option as, and a continuation of, the exchanged option. The deferral applies only when the

new option has the same intrinsic value as the old option **and** the holder of the option receives no consideration other than new options. Thus, options cannot be exchanged directly for shares and no non-share consideration can be paid for the old option.

If optionholders are to receive shares on an acquisition or reorganization, they will often be advised to exercise their options prior to the closing date in order to receive the benefit of the share exchange provisions in the ITA. Vesting and exercise dates may need to be accelerated to allow all employees to access the tax deferral. A cashless exercise procedure may be used to facilitate the conversion of existing options to shares.

The general rule is that employee stock option benefits are taxed when the option is exercised. For certain options granted by Canadian-controlled private corporations and for limited amounts of certain other options, the taxable event is deferred until the shares acquired under the option are sold. Also, for Canadian-controlled private corporation options, the taxable option benefit is generally reduced by 50% under paragraph 110(1)(d.1) if the shares are held for at least two years after exercise.

Where employee stock options have been exercised, whether in anticipation of an acquisition or reorganization or in the ordinary course, subsection 7(1.5) will, in certain circumstances, deem the shares acquired on exercise not to have been disposed of for purposes of the rules described in the preceding paragraph, thereby deferring the tax which would otherwise be payable. To qualify for this deferral, the exchanged shares must be shares of a Canadian corporation and the shareholder must receive no consideration for the exchanged shares other than new shares with no greater value than the exchanged shares.

The receipt of cash or other "boot" for employee stock options, or shares acquired through an employee stock option will prevent a taxpayer from taking advantage of the tax deferral provisions in subsections 7(1.4) and 7(1.5). The transaction can be structured, however, so that options are exchanged for options and shares for shares even if there is a cash component in the price. For example, a taxpayer may exchange a portion of his or her shares for shares (or options for options) and sell the balance for cash. This procedure is accepted by the CCRA to effect a share for share exchange under section 85.1 of the ITA, which also precludes the receipt of non-share consideration, so long as the taxpayer can differentiate between the shares which were sold for shares and those which were sold for cash.

When asked if this procedure could be used for exchanges under subsection 7(1.4) and 7(1.5), the CCRA indicated that it would consider a ruling request on the matter. Given the CCRA's position on exchanges under section 85.1, the CCRA would have difficulty refusing to apply the rollover provisions in section 7 if the taxpayer is able to identify the portion of shares or options disposed of for consideration other than shares or options.

Alternatively, where the shareholder or optionholder is disposing of other property in addition to the shares or options, the problematic consideration could be allocated entirely to that other property leaving the shares or options to be exchanged only for new shares or new options.

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Re Juliar – It is Finally Over

Readers will recall the discussion in previous issues of *Tax Notes* of the *Re Juliar* case regarding whether a rectification order made by the Ontario Courts was effective to correct the structure of a transaction which, because of an error, had resulted in a deemed dividend assessed against the taxpayer by the CCRA. The Ontario Court (General Division) had held that a rectification order should be granted in the circumstances. The effect of the rectification order was to restructure the transaction as at the date of the transaction so as to result in no tax liability. The CCRA appealed the decision, for some reason thinking that a windfall of tax to the CCRA was justified and that rectification orders were not appropriate in the circumstances. The Ontario Court of Appeal upheld the Ontario Court (General Division).

The Supreme Court of Canada has now denied the CCRA's application for leave to appeal to the Supreme Court. Rectification orders therefore continue to be a useful tool for taxpayers where the CCRA assesses in situations where clearly there has been an error on the part of the professional advisors or a misunderstanding of facts and no intent on the part of the taxpayers to avoid or evade the payment of tax.

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Publications and Seminars

Susan Manwaring of our Toronto office, **Mark Chartrand** of our Vancouver office and **Bill Fowlis** of our Calgary office spoke on *Third Party Civil Penalties* at the Canadian Corporate Counsel Association Conference in Victoria in April, 2001.

John Campbell of our Toronto office spoke on *Deductibility of Trips, Awards and Other Incentive Compensation* at a tax seminar of the Direct Sellers Association of Canada in Toronto on April 18, 2001.

Gerald Courage and **Robert Stewart** of our Toronto office were the authors of a paper on *Exchangeable Shares* published in the May issue of European Taxation, a publication of the International Bureau of Fiscal Documentation.

Bill Fowlis participated in the Institute of Chartered Accountants of Alberta and Canada Customs and Revenue Agency Round Table meeting on May 22, 2001.

Bill Fowlis is teaching a course entitled *Business Succession for the Entrepreneurial Client* in Edmonton in May and in Calgary in June.

Robert Hayhoe of our Toronto office spoke on *The Taxation of Non-Profit Organizations* at a CBAO Charities Section seminar on Non-Profit Organizations in May, 2001.

John Campbell will be speaking on *Tax Features of Shareholders Agreements* at an Atlas Information Seminar on Tax Planning for Business Agreements to be held in Toronto on September 10 - 11, 2001.

Susan M. Manwaring will be speaking on *Update on Canadian Tax* at the IBC Offshore Trust Summit 2001 to be held in Coral Gables, Florida on October 16 - 19, 2001.

Daniel Kiselbach of our Vancouver office, **John Campbell** and **Robert Hayhoe** presented Miller Thomson sponsored seminars on *How to Win Tax and Customs Disputes* in Vancouver on June 11 - 12, 2001.

Lawyer Exchange

As part of a short term lawyer exchange, **Jody Aldcorn,** of our Vancouver office, is working until the end of June in the Sao Paolo offices of our Brazilian affiliate, Mattos Filho. **Igor de Souza,** a tax lawyer from Mattos Filho, is working in our Vancouver office during the same period.

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Note:

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