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Cross Border Intercompany Management And Administration Charges

It is common for U.S. companies to charge management and administration fees to their Canadian subsidiaries. The U.S. head office will often provide services to the Canadian subsidiary in areas such as accounting, data processing, tax, legal, treasury, human resources, marketing, management, technical, systems, etc. It is often more cost efficient for the head office to provide these types of services than for each subsidiary to have separate staff and resources in these areas.

When structured and documented appropriately, management and administration charges of this nature can be quite tax efficient in relation to the Canadian subsidiary. The charges can be deductible to the Canadian subsidiary for Canadian income tax purposes and, in some cases, not subject to Canadian withholding tax, by virtue of the relief provided under a tax treaty.

Management and administration charges between a foreign parent company and a Canadian subsidiary are frequently reviewed by the Canada Customs and Revenue Agency ("CCRA"). A CCRA audit of intercompany management and administration charges often results in expensive reassessments for the Canadian subsidiary. Close scrutiny by CCRA is not surprising because of the negative impact of these intercompany charges on the Canadian tax base.

If CCRA is not satisfied that the management and administration charges are properly documented and that the amount of the charge is supportable, CCRA will disallow the Canadian subsidiary's deduction in whole or in part. The amount disallowed is usually also treated as a deemed dividend, i.e. a profit distribution, and Canadian withholding tax is also assessed. For a subsidiary, the applicable withholding tax rate under the *Canada-U.S. Income Tax Convention* (the "Treaty") is 5%.

CCRA's general views with respect to cross-border management and administration charges are set out in paragraphs 152 to 171 of CCRA Information Circular 87-2R on *International Transfer Pricing* ("IC 87-2R").

Intercompany management and administration charges are subject to Canada's transfer pricing rules. Accordingly, the charges to the Canadian subsidiary should be supported by contemporaneous documentation in order to avoid transfer pricing penalties on reassessment.

Appropriate documentation starts with a written agreement between the parent company and the subsidiary providing a general description of the services to be provided and the basis of the intercompany charges. Also essential is documentation showing and justifying how the intercompany charge is calculated.

CCRA generally expects these intercompany charges to provide no more than cost recovery for the parent company with respect to salary and other expenses incurred in the course of providing services for the benefit of the Canadian subsidiary. IC 87-2R does not entirely preclude the possibility of charging a mark up of parent company costs if a mark up is justifiable under the general transfer pricing rules, but an acceptable mark up will be unusual.

The manner in which the intercompany charges are calculated will be closely reviewed by CCRA on audit. It is essential to show a CCRA auditor that the parent company costs are incurred for services that benefit the Canadian subsidiary and do not duplicate services which the subsidiary already has through its own staff. CCRA prefers a direct charge method under which there are specific and separate charges for

separate services. This approach is usually impractical and the majority of taxpayers use the so-called indirect charge method whereby parent company costs are, in effect, allocated to the Canadian subsidiary.

Different approaches to allocation are possible. The most appropriate basis of allocation will depend on the nature of the cost being allocated. One should always consider whether the resulting charge is reasonable in light of the services actually provided to the Canadian subsidiary. General allocation keys such as sales or units produced may not be appropriate for allocating all types of costs. IC 87-2R notes that the number of employees may be the best measure for allocating human resource services costs. Arguably, the best basis for allocating parent company staff salaries is time spent on work that benefits the Canadian subsidiary. For example, if the parent company management spend 25% of their time dealing with Canadian subsidiary matters, then it is appropriate to charge 25% of their salaries to the Canadian subsidiary. This approach requires regular and fairly detailed record keeping by the staff involved. These records should note how much time was spent on work relating to the Canadian subsidiary and provide some description of the nature of the work. If these records are prepared by staff on a regular basis, they will constitute good contemporaneous evidence of what the intercompany charges are for. This type of record can be very helpful in responding to a CCRA auditor's questions, particularly where employees have left the company.

Parent company expenses relating to parent company legal, financial, tax and similar matters cannot be allocated to the Canadian subsidiary. An example would be the costs of shareholder meetings and stock exchange filings where the parent is a public company.

Information and submissions provided to the CCRA auditor are the taxpayer's best chance for an efficient resolution of any potential problems. A taxpayer can challenge a CCRA reassessment, if issued, but the process is potentially lengthy and complicated. If an adverse Canadian reassessment is issued, the company can file a Canadian notice of objection. This results in a review of the reassessment by the CCRA Appeals Division. If the company is not satisfied with the outcome of this review, the matter can be appealed to the Tax Court of Canada. The company should also consider how to obtain a compensating U.S. adjustment and may wish to initiate competent authority procedures pursuant to the Treaty. Under competent authority procedures, the CCRA and the IRS will jointly review the Canadian reassessment with a view to agreeing on a resolution which minimizes double taxation. In this case, the company should ensure that the relevant U.S. taxation years are kept open and be aware that notice must be given to the competent authority within six years after the end of the taxation year in issue.

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The *Penn Ventilator* Case - Interest Deductibility on a Share Buy Back

Thirty-two years after the *Trans-Prairie* case established that interest on borrowed money used to redeem a corporation's shares can be a deductible expense, the Tax Court of Canada decision in *Penn Ventilator* 2002 D.T.C. 1498 takes that decision one step further.

The facts in *Penn Ventilator* are straightforward. As part of a settlement with certain shareholders in an acrimonious oppression action, Penn Ventilator had to redeem some of its own shares against a threat from the shareholders that a partnership on whose existence Penn Ventilator relied would otherwise be dissolved. Penn Ventilator funded the redemption using $645,445 in cash and issued an interest bearing promissory note in the amount of $3,413,200 for the remainder. The Minister reassessed Penn Ventilator, disallowing the interest expense deduction taken on the interest payments pursuant to the promissory note.

Under paragraph 20(1)(c) of the *Income Tax Act* (Canada), in order for such interest to be deductible, it must either be characterized as "borrowed money used for the purpose of earning income from a business or property" or as "an amount payable for property acquired … for the purpose of gaining or producing income from the property or … from a business". The Minister's position was that no money had been borrowed and that no property had been acquired since the shares effectively disappeared on redemption.

In the course of the audit, the Canada Customs and Revenue Agency ("CCRA") auditor had noted that, had the promissory note been a borrowing, the interest expenses would have been deductible pursuant to *Trans-Prairie*. In *Trans-Prairie*, the taxpayer corporation was allowed a deduction for interest paid on money borrowed to redeem some of its shares. The deduction was allowed because the borrowed money was used to replace capital that was being used in the business and therefore had an income earning purpose. As a result of *Trans-Prairie*, it has been CCRA's administrative practice to allow deductions on borrowed money used to redeem shares to the extent the borrowed amount did not exceed the share capital and the retained earnings of the corporation. Arguably, allowing a deduction for a distribution of retained earnings, as well as for capital distributions, is more generous than *Trans-Prairie* contemplated.

While clearly no money had been borrowed, the Court was of the opinion that a redemption of a corporation's shares did amount to an acquisition of property. Therefore, if Penn Ventilator could point to authority for the proposition that a redemption of shares to replace capital and retained earnings (the amount of the promissory note exceeded the capital of the redeemed shares by $3,411,700) was an income earning purpose, the statu-

tory requirements for deductibility would be met. In this regard, the Court seemed to accept that *Trans-Prairie*, combined with CCRA's administrative practice described above, stood for just this proposition. The appeal of the taxpayer was allowed and the deductions for interest paid on the promissory note affirmed.

A note of caution: this decision does not mean that whenever debt is used to replace capital or retained earnings by redeeming shares of the corporation, a deduction will be allowed on the interest payments. In the 1987 Supreme Court of Canada decision in *Bronfman Trust*, it was affirmed that interest deductions are generally not allowed for transactions that only indirectly have an income earning purpose. However, exceptions to that general rule were contemplated and the Court indicated that *Trans-Prairie* was one of those exceptions. In *Trans-Prairie*, the redemption was to allow a debt financing placement to take place and in *Penn Ventilator*, the redemption was necessary to prevent a threat from shareholders to dissolve the partnership whose continued existence was much relied upon by *Penn Ventilator* in its business. In both *Trans-Prairie* and *Penn Ventilator*, the indirect purpose of the redemption itself was to earn income from a business. Nevertheless, it appears that a clear indirect income earning purpose must be established in order for interest deductions to be granted in cases where debt is used to redeem the shares of a corporation.

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The Alberta *Intestate Succession Act*

The Alberta *Intestate Succession Act* has recently been amended to give common law spouses the same rights as legally married spouses where there is no valid will. Continuous cohabitation for three years immediately before death, or simply a relationship of "some permanence" where there is a child, is sufficient to deem a non-married person to be a spouse for the purposes of intestate succession.

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Mortgage Investment Corporations

A mortgage investment corporation ("MIC") is a corporation entitled to special non-taxable status as a conduit for flowing interest income earned on residential mortgage loans to its shareholders under Section 130.1 of the *Income Tax Act* (Canada).

The shares of a MIC are an "eligible investment" for tax deferred plans, including registered retirement savings plans. Investment in a MIC is attractive for these types of plans as the MIC does not pay any tax when its income is flowed out as dividends, nor do the plans pay any tax when they receive the dividends.

Shares in a MIC will be disqualified as an investment for these tax deferred plans if at any time during the year the MIC holds, as part of its property, a mortgage or other indebtedness of a person who is an annuitant, beneficiary, employer or subscriber under the tax deferred plan, or any another person who does not deal at arm's length with such persons. In essence, this prevents a MIC from holding mortgages on homes of the shareholders of the MIC.

A MIC can be an attractive investment vehicle for tax deferred plans because Canadian tax rules usually prohibit such plans from borrowing funds. Plans are therefore restricted to earning income on funds contributed to them, whereas a MIC is entitled to borrow within prescribed limits. By holding shares of a MIC, plans can indirectly leverage their available capital. Also, by investing in a MIC, plans can have access to a diversified mortgage portfolio.

As with any investment undertaking that involves residential mortgages, there are risk factors. Many of these risk factors can be minimized by employing a mortgage portfolio manager and establishing strict lending parameters for mortgage loans, based on the underlying value of the security (e.g., restricting mortgages to 75% of value of the property).

Special rules allow a MIC to obtain tax deductions for dividends it pays. Taxable dividends will be fully taxable as interest income to the recipient. If the recipient is a tax exempt entity (e.g. an RRSP), the receipt will be tax deferred in the plan.

A MIC must have, at all times, at least 20 shareholders, none of whom may own or be deemed to own in excess of 25% of the issued shares of any class of the corporation. In the first taxation year of the MIC, these requirements are relaxed somewhat and will be considered to be met throughout the year to the extent they are met at the end of the taxation year. At all times, in excess of 50% of the cost amount of a MIC's assets must be invested in residential mortgages or bank and certain other deposits. Also, the tax cost of real property held by the MIC (other than property acquired by foreclosure) must not exceed 25% of the total cost amount of its assets. Certain debt/equity ratios must also be maintained by the MIC at all times with the maximum debt/equity ratio being 5:1.

Failure to satisfy any of the above requirements will result in a failure to qualify as a MIC for income tax purposes, and loss of the tax advantages of this particular status (causing difficulty for shareholders whose shares are held in registered plans). It is essential that MICs closely monitor these various criteria to ensure that they are met at all times.

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Ontario Budget 2002

The Ontario government delivered its budget on June 17, 2002. The most notable aspect of the Ontario budget was the decision to delay previously announced tax reductions for up to one year.

For individuals, the following previously announced tax cuts scheduled for January 1, 2003 will be delayed until January 1, 2004:

- the Ontario personal income tax rate reduction for the lower and middle tax brackets;
- the Ontario personal income tax surtax reduction;
- the phased-in increase of the Equity in Education tax credit for private school tuition; and
- the remaining 10% of the 20% education property tax reduction announced in 1999 (the first 10% was implemented in 1999).

For corporations, the schedule for general corporate income tax rate reductions and manufacturing and processing corporate income tax rate reductions was delayed for up to a year. However, the Ontario government maintained the timetable for the previously announced tax reductions for the small business corporations and for mining tax.

While the change in the timing of tax reductions was most notable, the Ontario Budget introduced certain specific tax measures effective as of the Budget date, including:

- a Retail Sales Tax (RST) rebate of up to $1,000 for alternative fuel and electric hybrid light trucks and SUVs;
- new RST exemptions for:
  (a) admission tickets donated by owners or operators of places of amusement to registered charities; and (b) ready-mixed concrete to make integral parts of production machinery in certain circumstances;
- for Ontario capital tax purposes, corporations prescribed as financial institutions for federal capital tax purposes no longer have to apply for such status and are deemed to be financial institutions for Ontario purposes; and
- Ontario will parallel Canada's income tax treaties for determining whether a non-resident corporation has a permanent establishment in Ontario.

On July 19, 2002, further to an announcement in the Budget, the Ontario Ministry of Finance released for public consultation draft RST legislation and administrative policies for computer software. The draft legislation proposes to refine the definition for taxable services in respect of software, clarify and possibly reduce the application of RST for modifications to pre-written software and introduce a *de minimis* standard where taxable and non-taxable software services are combined.

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Achievements, Publications and Seminars

Robert B. Hayhoe (Toronto) was recently re-elected as the 2002-2003 Vice-Chair (Taxation) of the Charities Section of the Ontario Bar Association.

Susan M. Manwaring (Toronto) made a presentation on *Charitable Giving Strategies* at a CIBC seminar for Private Banking Clients in Toronto.

John M. Campbell (Toronto) spoke on *Becoming a Non-resident* at the Society of Trusts and Estates Practitioners' (STEP) Fourth National Canadian Conference in Toronto.

Mark P. Chartrand (Vancouver) presented a paper on *Mechanics of and Recent Developments in Flow-through Share Financing* at the Red Flags in Tax Course sponsored by the British Columbia Continuing Legal Education in Vancouver.

Daniel L. Kiselbach (Vancouver) gave a presentation on *New Administrative Monetary Penalty Systems and Customs Law Development* at Khuene & Nagel, Customs Brokers.

Robert B. Hayhoe has prepared a case comment on *Canadian Committee for the Tel Aviv Foundation v. Canada* to be published by the International Journal of Not-for-Profit Law.

Robert B. Hayhoe has just published an article entitled *Keeping Records Key for Canadian Charities using Foreign Agents* in *The Lawyer's Weekly*.

Robert B. Hayhoe will republish an article entitled *Withholding Tax* on *the Elvis Stojko Show* in the *Canadian International Lawyer*.

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