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Tax Notes

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Good News for Importers: Supreme Court of Canada Limits when Royalty Payments can be Dutiable – the *Mattel Canada* Case

In *Canada (Deputy Minister of National Revenue B M.N.R.)* v. *Mattel Canada Inc.* (2001) 199 D.L.R. (4th) 598 ("*Mattel*"), the Supreme Court of Canada delivered a rare customs decision and limited the circumstances in which royalty payments will be included in the value for duty of goods imported into Canada.

Mattel Canada imported goods from offshore manufacturers owned by Mattel U.S. The manufacturers invoiced an intermediary, who invoiced Mattel U.S., who invoiced *Mattel Canada*. *Mattel Canada* paid royalties pursuant to a licence agreement between it and a trademark licensor. It also made periodic payments to Mattel U.S. on account of agreements Mattel U.S. had with other licensors. The Federal Court of Appeal held that the periodic payments should be included as part of the value for duty.

Mattel appealed the decision of the Federal Court of Appeal. The Supreme Court of Canada noted that the *Customs Act* provides that royalties and licence fees that are paid "as a condition of the sale of the goods" are part of the price paid or payable for goods imported into Canada (s.48(5)(a)(iv)). The Supreme Court reasoned that the meaning of the phrase "as a condition of the sale of the goods" was clear and unambiguous. The section requires there be an express provision in the sales contract between the parties. The express provision must give the vendor of the goods the right to refuse to sell the licensed imported goods or repudiate the contract of sale where the purchaser fails to pay royalties or licence fees. If that express provision is not in the parties' sales contract, the importer can avoid having royalty payments subject to duty.

The Supreme Court of Canada held that the sale agreement between Mattel U.S. and *Mattel Canada* was the relevant agreement for the purposes of determining duty. The Court found that licence fees that were paid to the licensor were not paid as a condition of sale. Therefore, if *Mattel Canada* refused to pay royalties to the licensor, Mattel U.S. could not refuse to sell licensed goods to *Mattel Canada* (as the contract of sale and royalty contracts were held to be separate agreements between different parties). For that reason, the licence fees could not be included in the price of the imported goods. In other words, *Mattel Canada's* obligation to pay these licence fees to various third party licensors was "distinct from its obligation to purchase goods from Mattel U.S."

While this decision is certainly good news for importers, it remains to be seen whether the Canada Customs and Revenue Agency will seek legislative change to reverse the Supreme Court of Canada decision.

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British Columbia's Economic and Fiscal Update

On July 30, 2001, the government of British Columbia issued an Economic and Fiscal Update. The Update implemented important tax cut initiatives.

Personal Taxes

Legislation was introduced to reduce personal income tax rates to the rates previously announced by the government on June 6, 2001. The changes for 2001 will be made retroactively to January 1. The new rates range from 7.3% to 16.7% for 2001 and 6.05% to 14.7% for 2002. By January, 2002, British Columbia's top marginal tax rate will be the second lowest in Canada, with the rate dropping from 48.7% to 43.7%. British Columbia will also have the lowest base personal income tax rate in Canada for the bottom two brackets.

Effective January 1, 2001, the British Columbia dividend tax credit rate is reduced to 5.9% from 6.6% of the taxable dividend. Effective January 1, 2002, this rate will be reduced to 5.1% of the taxable dividend. "Taxable Dividend" is the actual dividend paid plus the 25% gross up required under the *Income Tax Act (Canada)*.

Corporate Taxes

Effective January 1, 2002, the general corporate income tax rate will be reduced from 16.5% to 13.5%.

The corporate capital tax rate on non-financial institutions is cut in half, effective September 1, 2001. The tax rate for general corporations and investment dealers is reduced as follows:

Effective September 1, 2001 – 0.15%
Effective September 1, 2002 – 0.0%

For other corporations and investment dealers with taxation years commencing on or after September 1, 2002, the *Corporation Capital Tax Act* will no longer apply and all applicable sections will be removed effective September 1, 2003. Tax calculations must be prorated using the applicable rate for taxation year ends that straddle the September 1, 2001 and September 1, 2002 dates.

Previously, the Manufacturing and Processing Tax Credit program provided a 3% non-refundable tax credit to qualifying corporations for purchases of "qualified property" after March 31, 2000 and before July 31, 2001. This credit was claimed when filing the T2 Corporation Income Tax Return. This credit is being phased out; however, any unused credits may still be claimed under the carry forward or carry back provision.

The British Columbia Mining Flow-through Share Tax Credit program was introduced to allow individuals who invest in flow-through shares to claim a tax credit equal to 20% of their British Columbia flow-through mining expenditures. The credit is a non-refundable credit and any unused credit at the end of a taxation year may be carried back three years or forward ten years.

British Columbia flow-through mining expenditures are specific exploration expenses that are incurred after July 30, 2001 and before January 1, 2004 that are renounced by the corporation issuing the flow-through shares.

Effective July 31, 2001, certain production machinery and equipment bought by "eligible manufacturers" and by logging, mining and energy-sector businesses will be exempt from provincial sales tax.

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Non-Resident Trusts – New Draft Legislation

Revised draft legislation was released on August 2, 2001 with respect to non-resident trusts and foreign investment entities. This draft legislation implements changes first announced in the February, 1999 federal budget. An earlier version of draft legislation was released on June 22, 2000. Few changes have been made in relation to non-resident trusts.

The new rules for non-resident trusts apply for taxation years beginning after 2001.

The essence of the non-resident trust rules remains the same as in last year's draft legislation. A non-resident trust can be subject to Canadian income tax on its world income as a deemed resident of Canada in one of two ways.

1. If a Canadian resident has directly or indirectly transferred or loaned property to the non-resident trust. It is not necessary for a Canadian resident to be beneficially interested in the non-resident trust for the trust to be subject to Canadian tax. This was a key component of the old rules.
2. If a non-resident directly or indirectly transfers or loans property to the trust where the transferor or lender (the "contributor") was a Canadian resident within 5 years before the transfer or loan (18 months if before June 23, 2000 or if the contributor is an individual and the trust was created as a consequence of the death of the contributor) or becomes a Canadian resident within 5 years after the transfer or loan and there are any Canadian residents beneficially interested in the trust.

The new rules for non-resident trusts continue the long standing exemption for immigrant trusts. A non-resident trust will not be subject to Canadian tax under either of the above two bases of liability for a taxation year if, at the end of that taxation year, the contributor has not been a resident of Canada for more than 60 months.

There are extensive deeming rules to catch various types of indirect transfers. For example, providing services after June 22, 2000 is deemed to be a transfer of property equal to the value of the services. An exception for services rendered as an employee or agent is continued but now there is a requirement that the employee or agent be retained on arm's length terms and be paid accordingly. This fixes a gap in last year's draft legislation which appeared to except services provided by an employee even if the employee received below market salary.

Another rule deems shares issued by a corporation to be property transferred by the corporation to the recipient of the shares. This rule can apply where a non-resident trust receives common shares issued by a Canadian corporation after a freeze. This type of freeze was typically done with a trust resident in a low tax jurisdiction with which Canada had a tax treaty on the expectation that a subsequent sale of the common shares by the non-resident trust would be treaty protected from Canadian tax. The result now is that the non-resident trust is deemed to have received a transfer of property from a Canadian resident and is subject to Canadian tax. This deeming rule was in last year's draft legislation but did not apply to shares issued before June 23, 2000. This grandfathering has been eliminated in the August 2, 2001 draft legislation. Thus, even non-resident trust freezes completed before June 23, 2000 are caught by this deeming rule.

There is an exception from these new rules for an arm's length transfer or loan (as defined). This is an important exception. Most transfers or loans between parties dealing at arm's length should not, by themselves, cause a non-resident trust to become subject to Canadian tax. However, caution is required. For example, an arm's length transfer or loan includes ordinary course of business transactions done on arm's length terms but only where the transaction is in the ordinary course of business of the transferor/lender and it satisfies an arm's length standard based on looking only at the particular transaction. Non-resident trusts doing business in Canada directly or indirectly, may not always come within this. It is important for those dealing directly or indirectly with a non-resident trust to know if they are contributors to the trust. Contributors have joint and several liability for the trust's tax. On the positive side, an arm's length transfer or loan can include transactions between related parties in circumstances where the transaction is done on arm's length terms.

Beneficiaries and anyone who has transferred or loaned property to a non-resident trust (a "contributor") are jointly and severally liable for the trust's Canadian tax. This joint and several liability can be limited. The limit for beneficiaries is amounts received or receivable by the beneficiary or certain related parties from the trust as proceeds of disposition of an interest in the trust or as benefits from the trust. The limit for contributors is the aggregate contribution to the trust.

Unfortunately, there are severe restrictions on the limit to joint and several liability. Accordingly, we expect that, for contributors in particular, there will be many circumstances in which joint and several liability will be unlimited. The limit to joint and several liability will not be available to a contributor if his contributions exceed the greater of $10,000 and 10% of all contributions to the trust, if the contributor has not complied with the foreign reporting requirements under section 233.2 of the *Income Tax Act* on a timely basis (unless the contributor's contributions are $10,000 or less) or if any transactions were undertaken at the direction or with the acquiescence of the contributor to avoid the joint and several liability.

In light of the very broad net cast by these rules and the joint and several liability of beneficiaries and contributors, all existing non-resident trust arrangements should be reviewed. In particular, we urge those who have contributed or loaned property to a non-resident trust (or could be deemed to have done so under the new rules) to review their potential joint and several liability.

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Withholding Tax on the Elvis Stojko Show

Section 153 of the *Income Tax Act* requires a person paying fees for services to withhold from the payment and remit it to the Canada Customs and Revenue Agency ("CCRA") in accordance with Section 105 of the *Income Tax Regulations* which prescribes that "every person paying to a non-resident person a fee, commission or other amount in respect of services rendered in Canada, of any nature whatsoever, shall deduct or withhold 15% of such payment." The purpose of this withholding requirement is to assist the CCRA in collecting tax from non-residents who earn income from services in Canada. The amount withheld is deemed to have been paid by the non-resident, who can then apply to the CCRA for a refund if the amount earned was not taxable in the non-resident's hands. For example, pursuant to the *Canada-US Income Tax Convention*, a US resident taxpayer with no permanent establishment in Canada is not taxable on business income earned in Canada. It is also possible to apply for a waiver of the obligation to withhold on the ground that the non-resident recipient is not taxable in Canada.

The CCRA has begun to take an aggressive position on Regulation 105 compliance. Waivers are now only granted in limited cases and assessments are being issued against Canadians who have made payments to non-residents without withholding.

In 1996, Elvis Stojko performed in a number of Canadian cities as part of the 1996 Canon Elvis Tour of Champions. His show was produced by Marco Entertainment Inc. ("Marco"), a U.S. resident corporation. The arrangement between Marco and the venue in each city was that Marco obtained a licence to use the stadium for the performance day and arranged for the stadium to provide facilities services to Marco. The facility controlled ticket sales.

Prior to the performances, Marco had applied to the CCRA for a waiver of Regulation 105 withholding, but had been turned down (despite a waiver having been granted in the previous year). After each show, the facility's owner remitted the ticket proceeds less the agreed upon fees to Marco, without any Regulation 105 withholding. The CCRA assessed the facility providers (Ogden Palladium) for failure to withhold and Ogden Palladium appealed to the Tax Court.

Ogden Palladium argued that since Marco did not provide services to them, they had no withholding obligation. The CCRA argued that Ogden Palladium received ticket revenue from audience members for the provision of entertainment services. As a result, the payments to Marco were payments *in respect of* services.

The Tax Court confirmed that the obligation to withhold arises whether or not the non-resident payee has any tax liability (the non-resident can always obtain a refund from the CCRA). Since the payment to Marco was *in respect of* a service (even if it was not a payment for a service provided to the payor facility provider), it was caught by Regulation 105 and withholding was required. The Court relied upon previous tax decisions which had held that "in respect of" connoted the broadest possible relationship between two things.

The Tax Court upheld the penalties applied to Ogden Palladium on the ground that there was no evidence that it had been duly diligent in not withholding. Since Ogden Palladium had never sought professional advice on its withholding obligations, it was liable for penalties. This case points out how insidious the application of Regulation 105 can be. In making a payment to a non-resident, it is important to consider whether it is *in respect of* a service (even if it is not a payment *for* a service). This is especially important given the CCRA's increased enforcement activity.

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Publications and Seminars

Greg P. Shannon of our Calgary office spoke at Alberta Venture Magazine's *Go for the Money Financing Symposium* in Calgary on September 19, 2001.

Robert B. Hayhoe of our Toronto office spoke on *Surviving a CCRA Charities Audit* at the Canadian Council of Christian Charities 2001 Annual Conference on September 26, 2001.

Clarke D. Barnes of our Calgary office made a presentation on *Corporate Reorganizations and Rollovers – Sections 85, 86, 87 and 88* to the Canadian Bar Association (Alberta), Taxation Non-specialist Section on October 4, 2001.

Susan M. Manwaring of our Toronto office was a panelist on *Update on Canadian Tax* at the Offshore Trust Summit 2001 held in Coral Gables, Florida from October 17 to 19, 2001.

Robert B. Hayhoe and **Susan M. Manwaring** will both be speaking on *Cross-Border Gifting Issues* to the Canadian Association of Gift Planners Conference on October 25, 2001.

William Fowlis of our Calgary office will be teaching tax courses for the Institute of Chartered Accountants of Alberta in October, 2001and January, 2002.

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