CANADIAN TAXATION
OF BUSINESS AND INVESTMENT INCOME
OF NON - RESIDENTS

by

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a thesis submitted in partial fulfilment of

the requirements for the degree of

MASTER OF LAWS

in the Department of

LAW

We accept this thesis as conforming

to the required standard

The University of British Columbia

May, 1972

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ABSTRACT

Canadian Taxation of Business and Investment Income of Non-Residents

The new Income Tax Act (S.C. 1970-71, c.63), formely known as Bill C-259, has introduced important changes and many new rules into Canadian legislation, which affect taxation of non-residents.
This thesis is a study of the tax treatment which the new law imposes on non-residents and an examination of the differences from the previous system. However, taxation of non-residents depends not only on statutes but also on case law. Therefore, attention is devoted to judicial decisions to ascertain whether they conflict with the new statutory provisions. This thesis studies non-residents earning income from a business they carry on in Canada, and deriving income from investments they make in Canada. The comparatively simple situations of persons holding employments in Canada, or receiving pension payments from Canadian sources are not analyzed. The study is limited to the law normally applicable without modifications dependent on international treaties.

The thesis is organized in seven main chapters and a short conclusion. The first chapter summarizes the reasons making taxation of non-residents a complexe matter, and the rules governing it. The second chapter is devoted to the definition of residence as well as to a brief comparison with certain other countries. The tax consequences of non-residents

carrying on business in Canada and the methods available are examined in the third chapter. The taxation of the different forms of investment income which non-residents may derive from Canada is the object of the fourth chapter. The non-resident-owned investment corporation, that is to say the special vehicle afforded to foreign investors, is analyzed in the fifth chapter. The sixth chapter explains the technical provisions aimed at counteracting thin capitalization. The taxation of capital gains realized by non-residents is studied in the chapter seven. Finally, some conclusions are drawn in the eighth and last chapter.

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TABLE OF CONTENTS

I. A SUMMARY OF CANADIAN TAXATION OF NON-RESIDENTS

One of the fundamental rules of the federal INCOME TAX ACT is the division of taxpayers into two categories: residents and non-residents. These two classes are subject to different treatment depending upon their different situations. The principle is that resident taxpayers pay an income tax on their world income -- s.2(1) and s.3 I.T.A.-- whereas, generally speaking, non-residents are liable to pay taxes on the income earned in --s.2(3) I.T.A.-- and derived from Canada -- Part XIII I.T.A.--.

The general justification for taxing non-residents earning income inside a country seems to be that they find themselves in a position similar to that of residents. As they benefit, even if to a smaller extent than people residing in that country, from the general public expenditures, they have to contribute to the country's maintenance by remitting an income tax on the revenue they obtain from employment or business in that country, just as other residents. It is more difficult to find an explanation for the taxes levied on the income that non-residents receive from a country. The reason is probably that (except particular cases) countries do not want to be tax-havens nor do they want to miss the opportunity to collect wherever they can the monies they need.

In every country the taxation of non-residents is a delicate matter because of related international problems, because of the necessity to reach a fair balance between residents' and non-residents' tax burden and because such taxation may be considered and used as an instrument of economic policy. A too generous treatment of non-residents would attract large investments from foreign sources. That could have undesirable consequences: first,much of the economic activity would be controlled by people residing in other countries; second, the profit of such businesses and investments would not remain in the country but would flow to the foreign investors; finally, the residents being assessed more severely would be discouraged from carrying on businesses and making savings for investment purposes in their own country. Conversely, too heavy a tax burden imposed upon non-residents could prevent them from investing in the country and might leave it without the capital necessary for the development of its economy. Although a state may also relate on other means to keep under control the growth of foreign investments in order to avoid an excessive dependence upon decisions taken abroad, there is no doubt that tax legislation is one of the most effective means and one of the most frequently used.

The Canadian situation illustrates the complexity of the problem and of the difficulty in reaching a satisfactory compromise. With its extensive territory and its great potential of natural resources Canada may welcome, up to a certain level, the inflow of foreign capital which it needs to set up the structures permitting the exploitation of resources and, consequently, making industrial production possible. The foreign investors

are attracted to Canada because of both the high yields they can obtain and the political stability of the country. The result is, however, that some sections of the Canadian economy are largely in foreign hands. When one says foreign hands one really thinks of American hands, as there is no secrecy about the overwhelming predominance of Americans among non--resident investors and corporations in Canada.

The situation may be better illustrated with the support of some figures to be found in the Watkins Report on Foreign Property of 1968[1].

In 1964 foreigners owned $ 33 billion of assets in Canada. The foreign long-term investments amounted to $ 27 billion, 60 % of which ($ 15.9 billion) was constituted by foreign direct investments : the U.S. part of these direct investments accounted for 80 %. As to portfolio investments non-residents owned 19 % of all Canadian funded debt : 16 points of this belonged to the U.S.. In 1963, foreigners controlled 97 % of the capital employed in the automobiles and parts, 97 % in rubber, 78 % in chemicals and 77 % in electrical apparatus; the corresponding figures for U.S. control were 97 %, 90 %, 54 % and 66 %.

Another author wrote in 1969 that the United States accounted for over 80 % of foreign direct investment in Canada and about 70 % of foreign portfolio. In 1967 the U.S. investments in Canada amounted to $ 29.4 billion. Roughly estimating, about 45 % to 50 % of corporate equity in Canada was owned by U.S. citizens[1a].

Through its international provisions the new income tax legislation purports to preserve the integrity of the tax system and at the same time to accomo-

date it to the foreign systems. This is crucial because of the openness of the Canadian economy and the necessity for it to attract foreign investments. The legislators sought to create a system which would treat foreign investors fairly without allowing opportunities for abuse.[1b]

The new federal INCOME TAX ACT (S.C. 1970-71, c.63), formerly known as Bill C-259, which came into force on January 1,1972 increases the taxation of revenues earned by non-residents from investments made in Canada (withholding tax). It maintains the taxation of income earned in Canada by non-residents and, like the old system, applies to them the same method of computation as to residents. Moreover, non-residents will suffer for the first time, together with Canadians, an income tax levied on capital gains realized when disposing of Canadian property.
But the new system as provided in the Act will not always apply as such, for Canadian international taxation largely depends on bilateral fiscal conventions which generally establish for residents of one country (party to the convention) earning any revenues in the other country a more favourable treatment than that provided in the Act. At present Canada is bound by double taxation treaties to some sixteen countries[2]. The government has plans to renegotiate and to enlarge the treaties' framework by 1975. For this reason some provisions in the Act concerning non-residents are temporarily modified until 1976 by the 1971 Income Tax Application Rules (transitional provisions) in order to avoid some of the conflicts with existing treaties

Very briefly summarized Canadian taxation of non-residents may be explained as follows.

Every non-resident person pays tax upon his taxable income earned in Canada. The new element, in contrast with the old legislation, is that the income need not to be earned in the taxation year but may have been earned in any previous year [s.2(3)I.T.A.]. This income may be obtained from employment or offices performed in Canada or from carrying on business in Canada. The taxable income also includes one half of the capital gains realized on the disposition of taxable Canadian property, one half of the capital losses being deductible according to the provisions relating to this matter. The general rule applies to both individuals and corporations, s.248 I.T.A. defining the expression "person" as including "any body corporate and politic". The computation of income, the allowance of deductions and exemptions and the determination of taxable income are made in the same way as for resident taxpayers except for a few particular adjustments; the rates of tax calculation are the same also.

If the business is carried on by a non-Canadian corporation (the old Act read "non-resident" corporation), which is surely the case with a non-resident corporation, an additional tax of 25%, reduced to 15% until the end of 1975, is levied on the after-tax profits (Part XIV I.T.A.).

Non-residents pay an income tax on the returns of their investments and property, returns paid or credited to them by debtors or payers residing in Canada. This income tax as in the provisions of Part XIII I.T.A. applies to interest, dividends, rent, income from trusts or estates, royalties and similar payments and management fees. It may be noticed that the same tax

is imposed on alimony payments and, since the new system has started, on pension plan benefits as well as annuity and retirement savings plan payments. Such income tax is a merely proportionate but not progressive one, being computed at a flat rate of 25%, reduced until 1976 to 15%, of the gross income (without any deduction) received by the non-residents. The rate applied on dividends may be lower than the normal one if the paying company has a degree of Canadian ownership, a complicated notion related to the equity and the directorship.

This tax is a withholding tax as the debtor generally has, if he wants to avoid any personal liability, to withhold the tax amount on what he pays to the non-resident creditor. A special alternative is offered in the case of rental of real property, in order to allow the non-resident to determine his income from property as his profit therefrom.

If the non-resident disposes of the asset, the possible yield of which has been subject to withholding tax, he of course falls under s.2(3)I.T.A. as having disposed of a taxable Canadian property.

Non-resident persons have a wide choice as to the way of earning income in or from Canada. Individuals may do it themselves or through an agent and so be taxed like residents, the tax burden being more or less heavy according to the bracket applying to their taxable revenue. They also can incorporate a company resident in Canada, which pays income tax at the ordinary fixed corporate rate, and they then remit the withholding tax to be levied on the dividends distributed by the company.

Foreign corporations may act themselves and be subject to the corporate tax upon their income; if they run a business, the additional tax is imposed on the after-tax profits. Otherwise, they are able to incorporate a subsi-

diary which is normally taxed as being resident in Canada, and then to pay the withholding tax on dividends received from that subsidiary.

When non-residents want to make financial investments alone in Canada they have the opportunity,instead of investing directly, of setting up a non-resident-owned investment corporation , incorporated in Canada, which deals with the investments in its own name. The company's income tax is then calculated at a special low rate of 25 % respectively 15 %. This institution already existed under the old legislation, but it is now more difficult to qualify as such a corporation. There are several new concepts , owing to the fact that the dividends paid out are no longer exempt from the withholding tax and that the company may claim a refund on its tax payment. Generally speaking, however,the main purpose of creating a non-resident-owned investment corporation is to have the investments' income as though it flows directly to the non-resident shareholders. Non-residents may wish, rather than use this particular form of corporation, to make their investments through the same investment corporations, mutual fund corporations and mutual fund trusts, which are available to resident investors.

The non-resident shareholder of a resident corporation carrying on business might favour lending money to this company rather than subscribing for more shares. Such a solution is penalized by the new Bill,which does not allow an excessive thin capitalization of companies in which a substantial part of the shares -- at least 25 % -- are owned

by non-residents. The penalization consists in prohibiting the corporate taxpayer from deducting a proportion of otherwise deductible interest when determining income. The interest paid to the non-resident shareholder, whether or not deductible, is still liable for withholding tax.

II. RESIDENCE IN CANADA

As pointed out at the beginning of the first chapter, an essential distinction between resident and non-resident taxpayers must be made. It is impossible of course to try to define the concept of non-resident; s.248 I.T.A. simply explains that non-resident means non resident in Canada. Therefore the only way to determine whether a taxpayer is a non-resident seems to be to examine the rules and the criteria governing the determination of "resident in Canada". It being established that one does not reside in Canada it follows that one is a non-resident for the purposes of the income tax legislation.
In fact in Canada the general taxation liability, implying that a tax is levied on the world income, is based upon residence. Domicile and citizenship are irrelevant , whereas in the U.S. American citizenship is a tax basis in case of non-residence (s.911 International Revenue Code). The justification of the choice of residence as a general basis for taxation is the recognition of the economic allegiance existing between a person and the country where he has his prevailing economic interests. For Canada one of the reasons of choosing the residence has probably been the British precedent.[3]
The concept of residence will be looked at separately for individuals and corporations under both common law and statutory rules.

1. INDIVIDUALS

A. Common Law

The first test was that of the "settled or usual abode" used in the English cases of Levene v. I.R.C.[4] and of C.I.R. v. Lysaght[4a]. Both decisions pointed out that there was some difference between "resident" and "ordinarily resident"; such distinction, if any, was necessary for the words of the British Act, but it seems then to have been rejected by Canadian jurisprudence although the statutory rule still employs both terms.

The decisions which have been rendered in Canada appear to be sometimes in contradiction and difficult to reconcile except on the point that the question of residence is a question of fact to be determined in accordance with the circumstances of each particular case. The fundamental decision was laid down in Thomson v. M.N.R.[5]. A Canadian who had left the country with the declared intention of settling his domicile elsewhere,but who returned to Canada for some months in each year and maintained a large home there, was held to be a resident by the Supreme Court of Canada, which added that if the term resident is given its fullest signification the qualification of "ordinary" becomes superfluous.

The fact of owning a house does not always creat residence. In Russel v. M.N.R.[6] the Exchequer Court found that if one maintains a home in Canada during his absence from this country, there are high probabilities that he is considered to be a resident. On the other

hand, a sea captain living in the U.S., making voyages between that country and Canada, owning in Canada a house occupied by his married daughter in which he used to spend two weeks vacation a year with his wife, was held to be a visitor because of the lack of the degree of permanence and substance which must be present to create residence (Meldrum v. M.N.R.)[7]. And an obiter dictum in Thomson v. M.N.R. noted that it would be difficult to hold that a national of the U.S., residing there but occupying for 4-5 months of the year a summer house he owns in Canada, is a resident. This clearly refuses to apply the contrary old principle asserted in the English decision of Cooper v. Cadwalader[8]. Confronting such as these cases one reader might say that they contradict each other, while another could contend that the distinctions lie only in subtle differencies (e.g. home and house).

Cases of absence from Canada because of military service have led to conclusions frankly contradictory. The Tax Appeal Board pronounced that an air force officer living abroad in rented quarters and not keeping a home in Canada was ordinarily resident in Canada (Avent v. M.N.R.)[9]. Two years later in the well-known case of Beament v. M.N.R.[10] the Supreme Court of Canada decided, reversing the decision of the Exchequer Court, that the appellant, a non-active partner of an Ottawa law firm during his military service in England, was not resident in Canada because of his firm intention to leave this country.

An individual who, because of his work is not present in Canada, may yet be declared resident in Canada. This has been pointed out in two recent

decisions in which the Tax Appeal Board continued to show a preference for the dual concept of residence and ordinary residence, which is apparently in conflict with the ratio decidendi of the Thomson case. In favour of the Board's judgments it may be argued that this distinction still appears in the statute and that the case law ought to be in harmony with the codified rules. In Holly Recker v. M.N.R.[11] it was said that the appellant,whenever on a job outside Canada, always returned, never setting up residence elsewhere.And in Korican v. M.N.R.[12] a civil servant posted by the government to Japan, where he spent three years, was held ordinarily resident in Canada since the nature of his appointment indicated that he would return to Canada eventually, such appointments being necessarily limited. Support was found in the early English precedent of Lysaght v. C.I.R.

Those taxpayers who leave Canada intending to settle themselves in another country are not residents at least during the time they live elsewhere. A salesman living in Canada decided to sell his house and to move with his family to the U.S. to engage in his own new business venture. After four months, during which he sustained losses, he chose to come back to Canada, where he sought to deduct those losses from his income. The Tax Appeal Board, following the ratio of Beament v. M.N.R. decided that the taxpayer was not resident in Canada during those four months because of his firm intention to leave the country. Consequently, it disallowed the deduction of the losses suffered in the U.S. (N. 416 v.M.N.R)[13]. Reversing an unfortunate decision of the Board, the Exchequer Court

judged that the executive of an American company, who had resided for three years in Canada and who, being recalled to the U.S., left his wife and his son in Toronto in order to sell their house, was not resident in Canada. In fact, the Court said, he had completely divorced himself from his Canadian residence. The presence of his family was only to facilitate the sale of the house. The car and bank accounts they had were simply the consequence of the steps taken to dispose of the house (Schujahn v. M.N.R.)[14].

The task of summarizing the principles and criteria used to ascertain whether one is resident at a given place is not a simple one at all, some cases being difficult to reconcile with others. As already mentioned, the question of residence is a problem of fact and the term "resident" is to be interpreted in accordance with its usual meaning. It is important to stress that , for the purposes of tax legislation, an individual must at all times have a place of residence (Thomson v. M.N.R.)and that he may be resident in more than one place at the same time. It is almost impossible to enumerate all the facts which may be relevant as a means of establishing residence.However, these may include : the time spent in a place, the manner in which it is spent, the property owned and the manner in which it is maintained, the family contacts, the business and social relations, the mode of life related to a place. Their significance may change from case to case,for careful consideration of the circumstances is necessary. The general principle which synthesizes the different criteria is still that stated by the Supreme Court of Canada

in Thomson v. M.N.R. :

> "It is important only to ascertain the spatial bounds within which he spends his life or to which his ordered or customary living is related... ... that quality is chiefly a matter of degree to which a person in mind and fact settles into or maintains or centralizes his ordinary mode of living with its accessories in social relations, interests and conveniences at or in the place in question".

Finally, it may be noticed that loss of residence is more difficult to prove than acquisition. Once residence has been clearly established, it may be impossible to convince a court that it has been removed. It is relatively easy to persuade a court that residence has been acquired in Canada. This may explain the rule that an individual may be resident of more than one place at the same moment[14a].

B. Statute

(i) In General

The term "resident in Canada" appears at first in s.2(1)I.T.A. whereby it creates general tax liability. It is acknowledged that this provision refers to both the common law residence and the statutory residence. Under s.250 the new Income Tax Act attributes to the concept of resident an extended meaning by prescribing when a person shall be deemed to have been resident in Canada.

According to s.250(1)(a) the person shall be considered resident who has sojourned in Canada in the year for one or several periods totaling at least 183 days. As the deemed residence counts throughout a taxation year the taxpayer has to remit the income tax on his world income for the whole taxation year. As under the old legislation, this rule might conflict with the "split-residence" provision of s.114 I.T.A. (s.29 old Act) concerning individuals who, arriving in or leaving Canada during the year, pay only an income tax apportionate to the period of residence in Canada in the year. It has, however, been suggested[15] that the 183 days rule only applies to a sojourner who is not a resident but who, because of his intermittent presence in Canada, is deemed to reside there, whereas the residents in the usual sense are subjected to s.29 old Act (s.114 I.T.A.) when they change their situation in the course of the year.

Another class of deemed residents is constituted by members of the Canadian Forces, by diplomats, civil officers and servants working for the federal government, by provincial officers or servants who were residents in Canada immediately prior to appointment. Also included are persons who perform services in a foreign country under a prescribed international development assistance program of the Canadian government, and who have been resident in Canada at any time in the 3 months' period preceding the beginning of the services [s.250(1)(b) to (d) I.T.A.]. So, under the old system, a construction engineer working in Burma on a Colombo Plan project was held to fall within s.139(3)(ca)old Act and consequently deemed to be a resident (Petersen v. M.N.R.)[16]. One may wonder why in the recent case of Korican already cited the Tax Appeal Board conside-

red it necessary to go back to the idea of ordinary resident rather than simply apply s.139(3)(c)old Act, as the appellant was a customs officer.

In the last category are grouped the spouses of or the persons living with the deemed residents of ss. (b) to (d). However, persons in this category must themselves have been resident in Canada in any previous year, as must the children of the same deemed residents [s.250(1)(e) and (f) I.T.A.].

The provisions concerning constructive residence enable one to understand why the Tax Appeal Board, following the line of English case law, quite recently placed emphasis on the notion of ordinary residence. In fact s.250(3)I.T.A. [s.139(4)old Act] reads that a reference to residents includes persons ordinarily residing in Canada. Such provision, however, appears superfluous after the judgment of the Supreme Court of Canada in Thomson v. M.N.R.

(ii) Split-residence

S.114 I.T.A., similar to s.29 old Act, provides that individuals who have been resident in Canada only during part of the year are to be treated as residents for only that part of the taxation year. Their taxable income for the year is the amount of income earned during that portion of the year spent in Canada; and it is subject to the normal tax rates. This provision is mainly intended to offer relief to immi-

grants arriving in and emigrants leaving Canada. As already seen, the possible conflict with the 183 days rule for sojourners could be avoided by applying the part-time residence provision only for those who are resident in the usual sense.
It is submitted that s.114 I.T.A. also applies to the deemed residents of s.250(1), except the sojourners, s.250(2)I.T.A. reading that the deemed residents ceasing to be such during the year shall be considered residents in Canada for the part of the year preceding that time.

There are some differencies between s.114 I.T.A. and s.29 old Act as to the computation of income, especially because of the inclusion in the taxpayers' income of some new items such as capital gains. According to the new Act the taxpayer's income comprises: any income for the period during which he was resident; taxable capital gains (exceeding $ 2,500) from dispositions of property, other than taxable Canadian property, which are deemed to have taken place when the individual leaves Canada --which constitutes a new provision [s.48(1)I.T.A.]--; amounts taxable as income earned in Canada if he had not been resident at all and if he had fallen within s.2(3) and s. 115 I.T.A.(such as deferred business profits, deferred capital gains, grants and remuneration while on leave) --equally new--. S.29 old Act prescribed that payments listed in s.31A. i.e. superannuations - pensions - retirement allowances - amounts from deferred profit sharing plan, be included in the part year's income. This is no longer necessary, for such payments are now subject to the withholding tax provided by Part XIII I.T.A. collected on revenue received

by non-residents.

The calculation of deductions to be made in order to determine taxable income continues to be as it was under the old Act. Some deductions may reasonably be considered wholly applicable, whereas other deductions especially personal exemptions, may be allowed only in part. The assessment depends upon ministerial discretion. The Tax Appeal Board affirmed an assessment allowing only ten twelfths of the personal exemptions(marital status and dependent person) in the case of a taxpayer who resided in Canada for only ten months (Gray v. M.N.R.)[17]

It may be noticed that the cases N.416 v. M.N.R. and Schujahn v. M.N.R.[18] in which the taxpayers were recognized as being non-residents for a part of the year, were in fact both connected with s.29 old Act insofar as their residence in Canada was limited to the other part of the year.

2. CORPORATIONS

A. Common Law

English case law is even more important for establishing the residence of companies than it is for individuals. In the early case De Beers Consolidated Mines Ltd. v. Howe[19] the House of Lords reasoned that the question of residence of a company is to be solved by drawing an analogy with the residence of an individual, although a company cannot eat or sleep. Thus it was decided that the test of residence has to be not where the company is registered but where "it keeps house and does its real business", the real business being carried on where the central management and control actually abides. Being a mere question of fact, it is to be determined upon a scrutiny of the course of the business and

trading and not according to regulations or by-laws. The place of central management and control is generally where the directors and the company hold theirs meetings and the conduct of the affairs is decided. This fundamental criterion was confirmed in Egyptian Delta Land & Investment Co. Ltd. v. Todd[20], where it was judged that the residence of a company, whether British or not, is preponderantly if not exclusively established by its real business' location. This criterion was then followed in all future decisions regarding the residence of companies.

Reasserting the analogy between individuals and companies, the House of Lords held in Swedish Central Railway Co. Ltd. v. Thompson[21] that a company may have residence for tax purposes in two jurisdictions when, as in this case, the management of a company at its highest level is in fact divided . However, the High Court of Australia warned that a finding on possible dual residence of a corporation should not be made unless the control of its general affairs is really divided among two countries or more (Koitaki Para Rubber Estates Ltd. v. Federal Commissioner for Taxation[22]). But the principle of a possible dual residence was strengthened in Union Corporation Ltd. v. I.R.C.[23] where, after appreciating the precaution suggested by the Australian Court, it was held that the central management and control may be divided, and that such division, being a matter of fact and degree in each case, is not denied by the circumstance that the supreme command, the power of final arbitrament, may be found to be, or to be predominantly, in one place.

This principle was applied in the Canadian decision of Crossley Carpets (Canada) Ltd. v. M.N.R.[24]. The company, incorporated in England,which had taken over a business established in Canada, managed its affairs in Canada, and merely had held formal meetings in the U.K..Crossley Carpets was held to have at least two residences. One was Canada, the actual place of management, in which were the manager's residence, bank accounts, auditors and solicitors. England was only the place of the de jure control.

The various elements related to company residence were again examined by the House of Lords in Unit Construction Co.Ltd. v. Bullock.[25] While admitting doubts about the analogy between residence imputed to individuals and residence imputed to companies (Lord Radcliffe), the House put emphasis on the factual and concrete acts of management as means of establishing the location of central management and control, whether such acts are irregular or unauthorized or unlawful according to the corporation's constitution. This test was followed in Canada , just as in the case of Crossley Carpets Ltd. cited above, in Yamaska Steamship Co. Ltd. v. M.N.R..[26] Yamaska, incorporated in Canada before 1948, was found not to be resident in Canada. Although the directors lived in Canda, all decisions were made by the controlling shareholders in London.

A more legalistic solution was reached in the case of Bedford Overseas Freighters Ltd. v. M.N.R..[27] The Exchequer Court considered that a company incorporated in Canada and largely owned by a non-resident in which, however, the directors abiding in Canada "negotiated" and signed agreements and cheques for the company, was resident in Canada. After stressing that the directors are not the agents of the sharehclders the Exchequer Court ex-

plained that the management and controlling power of Bedford was exercised by the persons in whom it was legally vested, albeit in large measure to carry out the owner's instructions and the policy decisions made by him elsewhere.

According to very recent Canadian jurisprudence the existence of a "head office" in this country does not necessarily imply that the company will be judged to be resident in Canada. Take the case of Tara Exploration, incorporated in Canada, but whose sole business was exploring for minerals in Ireland and whose directors were living and acting there. Tara had a "head office", kept books and held some meetings in Toronto (as consequence of the incorporation in Canada), had raised capital on the Canadian market, and had even embarked on a business adventure in Canada. Notwithstanding all this, the seat of its central and actual management was held to be in Ireland, and Tara, therefore, as being neither resident nor dually resident in Canada (Tara Exploration & Development Co. Ltd. v. M.N.R.).[28]

Before closing this review of English and Canadian decisions it may be useful to note the Canadian case of The King v. B.C. Electric Railway Co. Ltd.[29] ultimately examined by the Privy Council. The Exchequer Court asserted that the term nationality insofar as it is applicable to companies, is determined by the country of incorporation. Apart from this issue the case established that the expression "Canadian debtor" of the Income War Tax Act, with reference to withholding tax, meant debtor residing in Canada.

B. Statute

As in the case of individuals, the notion of residence of companies is widely extended by some statutory definitions.

Any company incorporated in Canada after April 26, 1965 shall be deemed to be resident in Canada. The simple and formal aspect of the incorporation creates residence [s.250(4)(a)I.T.A.] regardless of where the real business is done or where the directors act.

If the company has been incorporated in Canada before April 27, 1965 then the company is considered to reside in Canada if at any time in the taxation year or in any preceding year (ending after April 26, 1965) it has been resident in Canada or has carried on business in Canada [s.250(4)(c)I.T.A.]. When reading resident the Act obviously means common law resident. It is submitted that there is not any requirement that the company carries out all its business in Canada and, therefore, it suffices that some business be done there in order to establish Canadian corporate residence.

Both provisions exactly correspond to the old Act [s.139(4a)]. But the new legislation also creates a new class of deemed resident corporations. This class is constituted by foreign business corporations (s.71 old Act) which were such on June 18, 1971. During the ten years preceding that date they must have carried on business in a country other than Canada; must also have been incorporated in Canada before April 9, 1959 [see s.71(5)old Act] and have been resident or doing business in Canada [s.250(4)(b)I.T.A.].

The deemed residence of s.250(4)I.T.A. applies throughout an entire taxation year and the company is assessed on its world income according to s.2(1) and s.3 I.T.A..

It was very recently judged (The Deltona Co. v. M.N.R.)[30] that a corporation amalgamated after April 26, 1965, whose central management and control was in the U.S. and which had not carried on any business in Canada, was a company deemed to reside in Canada, for the amalgamation itself constituted an incorporation within the meaning of s.139(4a)(a)old Act.

Canadian corporation

The Bill introduces a new concept of Canadian corporation which, in connection with the topic of this paper, is of central concern when dealing with the additional 25 % (or, until 1975, 15 %) branch tax. According to s.89(1)(a)I.T.A. there are two classes of companies complying with this term. First, any company incorporated in Canada, no matter when, and resident in Canada at the relevant time. Second, any corporation resident in Canada throughout the period starting June 18, 1971, and ending at the relevant time. However, for the purposes of tax-free distribution of dividends out of tax-paid undistributed surplus or 1971 capital surplus [s.83(1)I.T.A.], a company that was incorporated in Canada before April 27, 1965 [see s.250(4)(c)I.T.A.] and was not resident there at the end of 1971 may not be considered a Canadian corporation.

3. CONCEPTUAL COMPARISON WITH CERTAIN OTHER COUNTRIES

Taxpayers who(for Canadian tax purposes) are non-residents in Canada must be considered to reside in some other country. The concept of residence is not necessarily used in every country, for general tax liability may rest on other bases. Taxation systems and kinds of taxes levied vary greatly from one country to another. When used, the term of residence may apply to notions other than that of residence in the sense used by Canadian and English law. Differencies exist not only between common law and civil law countries but also among civil law jurisdictions, because of different tax structures and national codifications.

Therefore it will be of interest to give a brief summary of the situation as it exists in a few other countries.

Western Germany

German tax legislation distinguishes between taxpayers with "unlimited" tax liability who pay tax on the whole income from German and foreign sources, and taxpayers with "limited" liability only taxed on income from German sources.

For individuals the unlimited taxability is determined by : a) "domicile" (Wohnsitz), which is the place where individuals occupy a residence in a manner indicating that they will use and retain it on a non-temporary basis; b) "costumary place of abode" (gevoehnlicher Aufenthalt), which is the location where they are physically present under circumstances showing that the presence is not merely temporary, place of abode also being created by staying in Germany over six months.

For corporations or other entities : a) the seat or statutory office (Sitz), which is the place where the corporate body is listed in the official register (necessarily in Germany if the company is organized under German law); b) the "place of management" or centre from which its activities are directed.

France

Individuals having their "domicile" (domicile) in France are taxed on income from both French and foreign sources; an exemption for their foreign income is granted to individuals who are nationals of a country taxing its citizens abroad (the typical example being the U.S.). Domicile is determined through : i) centre of interests, i.e. location of the taxpayer's major economic activities with a character of permanence and stability, or the location of the major portion of their wealth: ii) principal residence (séjour principal) for more than five years and personal presence in France during most of that time (even without permanent dwelling).

Non-resident individuals are taxable on income from sources within France defined in the Tax Code. Individuals may belong to a third class if, without being domiciled, they maintain a "secondary residence" and so are liable to tax on the actual income from certain French sources or to an amount equal to five times the rental value of the residence.

Residence of a corporation is established by the location of the head office (siège social), generally corresponding to that designated in the charter of incorporation (siège statutaire). If the latter is only fictitious then the head office is located where the actual management

is centered and carried on (siège effectif). Resident companies and other organizations are taxable on their world income except the income from active business done abroad.

Non-resident entities are taxed on their French income, and must also remit a tax on dividends distributed by them and derived from the earnings obtained from business in France.

Italy

The concepts of residence or domicile are practically useless in Italian taxation as the legislation has attempted to create a system taxing all the new wealth produced in the country in the year (the "national product"). The place of taxability is the place where an income producing factor (source of income) is used: this principle is called territoriality. To determine the location of a source of income several criteria are employed: location of property, place of exercise of activity, domicile or residence of payor and place of creation of obligation to pay income.

For individuals the objective taxes (imposte reali), composed by four different taxes, and the personal taxes (imposte complementari) are levied, regardless of residence, on income from Italian sources, with some restrictions concerning foreigners in Italy and Italians abroad.

Companies pay the corporate tax constituted by a tax on the assets of the entity (paid-up capital + reserves) -- a true wealth tax -- and a tax on the income exceeding the "normal profit" (6% of the assets value), with the restriction on foreign companies to assets devoted to operations in Italy and income referable to those assets.

Sweden

Sweden levies two income taxes: a national one and a municipal one. Residents pay both taxes on their world-wide income. Non-resident taxpayers suffer taxes on income from both real property and business in Sweden; they also suffer withholding taxes.

Individuals do reside in Sweden when they make there their "real dwelling and home", when they intend to become residents, or when they make their "permanent sojourn" in the country.

For companies the only test is the incorporation; if incorporated elsewhere the entity is non-resident.

Belgium

Taxpayers who are "inhabitants of the Kingdom" (both individuals and legal entities) are taxable on their world income, while those who are not inhabitants only pay on income from Belgium and on income received in Belgium.

A taxpayer is an "inhabitant" if he has there his"fiscal domicile" or his "seat of affairs", the latter being specially important for corporations. The fiscal domicile is a concepte considering the residence but attaching more importance to circumstances than to an individual's intentions. The seat of affairs is the place of the principal administrative establishment; but incorporation in Belgium suffices to have a company domiciled there.

Switzerland

The tax system of Switzerland is organized at three levels -- federal,

cantonal (the states of the Swiss Confederation are called cantons) and municipal -- and all three political entities levy income and net wealth taxes. The cantonal taxes are the most important. Therefore, it is impossible to define a Swiss system as such for any cantons legislate according to their own needs. Some general criteria apply, however, in almost every jurisdiction.

Taxpayers with unlimited tax liability (assujettissement général) suffer taxes on their world income, while those with limited liability (assujettissement limité) pay on their income from Swiss sources (often through the anticipatory tax, which is a federal withholding tax).

General taxability for individuals results from permanent residence (domicile fiscal), which is the centre of life interests and relations; temporary residence for more than six months (or more than three months if they own a residence); temporary residence, even for less than six months, if the individuals engage in a gainful activity (activité lucrative). It should be added that temporary residence creates taxability retroactively.

Corporations are unlimitedly liable on the basis of incorporation in Switzerland together with location of the centre of management and, especially, on the basis of permanent establishment in the country. Foreign companies having a permanent establishment in Switzerland (broadly defined) are liable to taxes on the income and assets of it with an apportionement of such elements to the whole undertaking of the entity. The same is valid for Swiss companies having a permanent establishment abroad, with some limitations. Special treatment is generally granted to special companies, such as holding or service corporations.

III. ACTIVE BUSINESS INCOME EARNED IN CANADA BY NON-RESIDENTS

As stated at the beginning of this paper non-residents are liable to taxes on their income earned in Canada --s.2(3)I.T.A.--. One of the most important sources of income for non-residents is carrying on business in Canada. S.2(3)(b)I.T.A. effectively reads that when a person carries on business in Canada he has to pay Canadian income tax.

1. CARRYING ON BUSINESS IN CANADA

A. Business

Business is a very widely used word often appearing in the tax legislation and covering various gain producing activities. In the old English case of Smith v. Anderson[31] the Chancery Division decided that anything occupying the time, the attention, the labour of a man for the purpose of earning a profit is included in the concept of business. A few years later it was also held that "business" is a much larger word than "trade" (Rolls v. Miller)[32]. A similar position appeared in the Canadian jurisprudence, where the emphasis was put on the prospect of gain or profit (Samson v. M.N.R.)[33].

In the present Canadian tax law the word "business" has a very broad meaning and some assistance can be found in s.248 I.T.A. [s.139(1)(e)old Act which reads:

> "Business includes a profession,calling,trade manufacture and undertaking of any kind whatever and includes an adventure or concern in the nature of trade but does not include an office or employment".

B. Carrying on Business in Canada

In Erichsen v. Last[34] it was held that when a person habitually does a thing capable of producing a profit then he is carrying on a trade or business. In the same case it was then said that the question of knowing whether a person carries on business is essentially a question of fact to be answered in accordance with the circumstances of each case as"carrying on of a trade is a compound fact made up of a variety of things".

As to carrying on business in Canada by non-residents some assistance can be found by reading s.253 I.T.A. [s.139(7)old Act] which provides:

> "When, in a taxation year, a non-resident person
>
> a) produced, grew, mined, created, manufactured, fabricated, improved, packed, preserved or constructed, in whole or in part, anything in Canada whether or not he exported that thing without selling it prior to exportation,
>
> b) solicited orders or offered anything for sale in Canada through an agent or servant whether the contract or transaction was to be completed inside or outsied Canada or partly in and partly outside Canada
>
> he shall be deemed, for the purposes of this act, to have been carrying on business in Canada in the year".

The common law courts have not really established a clear test permitting one to say when business is done in a country. They have, in varying cases,given emphasis to the place where profit producing contracts are concluded (Grainger & Son v. Gough [35]; Firestone Tire & Rubber Co. of Canada Ltd. v. C.I.T.[36]), where the work is done or the goods are delivered (Smidth & Co. v. Greenwood[37]; Belfour v. Mace[38]), where payments are made, where the principal objects of transactions but not the ancillary activities are performed.

All these principles have been superseded or overruled by the statutory provisions, the result of which is to classify a wide range of activities as deemed to be carrying on business in Canada. The interpretation of these provisions offered the Canadian courts the opportunity to give some illustrations of the bear of these provisions. As most of the cases deal with the problem of carrying on business in Canada, either through an agent or in real estate investments, they will be examined under the paragraphes related to those questions. However, the important case of United Geophysical Co. of Canada v. M.N.R.[39] should be looked at immediately. An american corporation which used to conduct a business in both the U.S. and Canada incorporated a wholly-owned subsidiary . The subsidiary assumed the Canadian part of the business by acquiring and "renting" the parent's equipment. The parent corporation had nothing more in Canada but the "rented" assets. It effected servicing and repairing. and provided supplementary equipment, all that at cost. The Exchequer Court decided that either the

"rental" only constituted an income from property, in which case it is immaterial whether the parent did business in Canada; or, in a more correct view, the parent company was effectively carrying on business in Canada (as defined in s.139(7)old Act). Moreover, the "rental" it received was income from the business carried out in the U.S. and not from that part of its business done in Canada, for the equipment was delivered in the U.S. and the payments were determined and received in the U.S.. They did not result in any proximate sense from rendering services in Canada. The "rental" flowed to the parent from the hiring of the equipment and was, therefore, in its nature liable to withholding tax.

In 1962 an author made an attempt to enumerate the principal indicia of "carrying on business in Canada"[40]:

1. the maintenance in Canada of a physical establishment such as a branch office or factory;
2. the maintenance of a stock of goods in Canada, from which deliveries to customers are regurarly made;
3. the habitual making of contracts in Canada by the non-resident, or an agent or servant of the non-resident;
4. the production, growing, mining, manufacture, fabrication, improvement, packing, preserving or construction of anything in the whole or in part in Canada;
5. the rendering of services in Canada.

He also suggested that a non-resident can be said to be "carrying on business" not only if he trades in Canada in the ordinary way but also if he engages in an adventure in the nature of trade. This position seemed to

find a judicial confirmation in Thea Co. v. M.N.R.[41] in which an individual non-resident was held to be carrying on business in Canada because a company, that was considered as his agent, had engaged in an adventure in the nature of trade. The position also seemed to find confirmation in Ann Neuberger v. M.N.R.[42] where it was said that "the carrying on of a business comprises even a single adventure in the nature of trade". But the Exchequer Court decided the contrary in Tara Exploration & Development Co. Ltd. v. M.N.R.[43], tentatively holding that an adventure in the nature of trade did not in itself constitute "carrying on business", as it was not part of a larger activity and as it has never been said that an isolated transaction falls within s.139(7)old Act. It also asserted that s.139(1)(e)old Act did not operate a substitution of "adventure in the nature of trade" for "business" in the provisions (particularly s.2(2)old Act) creating the tax liability of non-residents. Probably in consideration of such decision, the Tax Appeal Board held that a non-resident who had participated in a number of real estate transactions had carried on business in Canada, pointing out that he was engaged in a series of adventures in the nature of trade which constitutes a business activity quite distinct from a single or isolated venture involving one purchase and sale.(Heskel Abed v. M.N.R.)[43a]

Both last cases could imply the consequence that the gains arising from the sale of capital assets would be treated as capital gains when concerning a non-resident, whereas they may be considered as income(as revenue from an adventure in the nature of trade) when concerning a resident.

The meaning "in Canada" is defined in s. 255 I.T.A.[43b].

C. Carrying on Business through an Agent

Non-residents can carry on business in Canada through an agent(or an employee) acting on their behalf. This was already recognized in some old British cases where non-residents of the U.K. were held to exercise their trade in the U.K. through their agents and representatives acting there (Watson v. Sandie Hull[44]; Turner (Leicester) Ltd. v. Rickman[45]; Wilcock v. Pinto & Co[46]; Belfour v. Mace[47]) and there performing on behalf of their foreign principals one or some of the essential activities necessary to their principals' businesses.
In the present Canadian legislation, however, s.253(b)I.T.A. [s.139(7)(b)old Act] establishes a much broader tax basis, since mere solicitation of orders or offering goods for sale through an agent or servant suffices to have business carried out in Canada by non-residents.

One of the major problems is in knowing whether the representative is an agent of a non-resident principal or an indipendent contractor doing his own business. The question is very important because only in the first case will there be taxability of the non-resident under s.253(b). The answer will depend on the degree of control that non-resident exercises on his representative's activities (Standard Fashion Co. v. McLeod)[48]. Anyway the mere fact that the relationship between the Canadian representative and the non-resident is referred to as one of agency is not determinant and the issue is to be solved by means of general legal principles[49]. The facts of each case are to be considered carefully. Some criteria to deter-

mine whether or not there is agency are reported by LaBrie: whether the alleged agent conducts the business in the name of the principal or in his own name; whether the representative acts for only one principal or for several persons.[50]

The problem is far from being an easy one and the judicial solutions are somewhat difficult to reconcile. In a sales tax case -- Palmolive Manufacturing Ltd. v. The King[51]-- a Canadian manufacturing company that was the wholly dependent subsidiary of an American corporation, which also owned a Canadian distributing company, and which sold its products to the second Canadian company exclusively; was held merely to act as agent of the second company. But short time later the Exchequer Court asserted in another sales tax case that the fact that the two corporations had business relations with each other alone did not constitute the first one agent of the second (The King v. B.C. Brick & Tile Co. Ltd.)[52]

The question mainly arises in cases in which a non-resident sells his goods in Canada through the services of a Canadian distributor. The "distributor's warehouse contract" may be one of simple purchase and resale rather than agency, as it was decided by the Supreme Court of Canada (two judges dissenting) in the case of an extra-provincial company. This company delivered its products to its B.C. distributor. Had there been an agency the company ought to have paid provincial income tax (Firestone Tire & Rubber Co. of Canada Ltd. v. C.I.T.)[53]. Again, some tests to determine whether the agreement is one as between vendor and purchaser or as between principal and agent are suggested by LaBrie[54]: the occasion and

time of passing of property from the alleged principal; his legal rights against goods in the possession of the agent; his control over reselling contracts, prices and methods; the risk supported by the distributor.

Some jurisprudence exist in direct relation to s.139(7)(b)old Act. In some cases the judges held that there was an agent acting on behalf of a non--resident principal who was, therefore, carrying on business in Canada. In Ross & Co. Ltd. v. M.N.R.[55] a stockbroker of the Bahamas bought and resold with the cooperation of Toronto securities dealers shares of an American corporation. The Exchequer Court held that the Canadian dealers were his agents because they realized such a small profit percentage, which was a commision rather than a profit from dealing on their own account, and because they bought shares sometimes below and sometimes above the market price, according to his instructions. In the already mentioned case of Thea Co. v. M.N.R.[56] a company was considered to be the agent of a non-resident as the latter was the brother of its only shareholder and he himself owned 75% of the interest in a land parcel whose title had been transferred to the company. The company, the Tax Appeal Board said, had been intruded into the matter just to serve as a vehicle and to simplify a number of things. See also with particular reference to real estate investments the cases of Ann Neuberger v. M.N.R.[57] and of Heskel Abed v. M.N.R.[58]

Judgments have also been rendered in which the existence of an agency relationship has been denied. Thus a Canadian wholly-owned subsidiary, entirely assuming the previous Canadian venture of its parent, was not recognized

to be the agent of the American parent, for there had been a clear intention to transfer that business to another legal identity and because the mere ownership of all the shares does not make the company's business that of the shareholder. (United Geophysical Co. of Canada v. M.N.R.)[59] In an earlier case the Tax Appeal Board decided that the activity of the agent of a foreign corporation who merely disposed of the crop-shares payment, which the corporation received for rented farmland, was not sufficient to constitute a business carried out on behalf of the non-resident (D.H. Peery Estate Inc. v. M.N.R.).[60]

Summarizing, one can say that a non-resident carries on business in Canada -- the solicitation of orders and offering of goods for sale -- through an agent when he exercises a certain control over his agent, the degree of control being ascertained by means of the criteria outlined at page 35, and when the agent's activity may be qualified as carrying on of a business which would require in harmony with the most recent jurisprudence more than an adventure in the nature of trade. This latter point is probably still open to discussion.

Another difficult question is that of determining whether a sale, which would be a capital sale and create taxable capital gain (1/2 of the gain) when concerning a resident, becomes a business operation creating income when effected by the agent of a non-resident. The problem may be rather usual with the realization of land investments.[61] One author expressed

the opinion that the application of s.139(7)(b) old Act should lead to the conclusion that the revenue of such a sale should be treated as income, although to assess tax would seem unfair and strict, the tax statutes not being open to argument of equity and fairness.[62] The last jurisprudence considering that an adventure in the nature of trade does not corrispond to carrying on of a business, however, might permit one to argue that a capital sale which is not a business for a resident is a fortiori not carrying on business for non-residents.

D. Carrying on Business by Owning Real Estate

Frequently the issue whether a non-resident does business or not in Canada is raised in relation with the ownership of realty and its disposition. Real estate is in fact the most traditional and one of the surest forms of investment and its return is a typical kind of property return. In some circumstances one may reach the point where the landownership becomes commercial enterprise. The tax position of the real property owner completely depends on the answer given to this question. If he carries on business he is taxable under Part I of the Act, whereas if he simply receives income from property he is liable to the withholding tax --Part XIII I.T.A.-- on the gross revenue unless he chooses the alternative election. It is understood that in the case of taxability under Part I because of doing business no election is necessary.

It seems that when non-residents lease farmland they own in Canada they are not deemed to carry on business, even if they participate in the farming profits and these are collected by an agent. In Peery Estate Inc. v. M.N.R.[63] the crop-shares payments, which an American corporation received from farmland it had rented for over twenty years to the same tenant, were said to be rental income and not business profit, although the corporation had a local agent disposing of the crop-shares and remitting the proceeds. Likely in C.A. Graf von Westphalen v. M.N.R.[64] where the farmland parcel of a non-resident was rented by his brother-in-law (acting as his attorney) to a lessee who agreed to pay a rental plus a share of the net profits, the Board held that the income was only the result of a landlord-tenant relationship as the land was not exploited on behalf of the owner.

Non-residents owning an apartment building leased for them by a local manager who also collects the rentals are probably not in business yet. But non-residents having two buildings with numerous flats, stores and even a manufacturing place , looked after for them by a real estate broker and an accountant spending a good part of their working time on this task, were considered to carry on business (Rubinstein v. M.N.R.)[65]. In the case of non-residents transferring money to Canada where the money is used for continuous dealing in land and for speculative repeated purchasing and reselling of realty, there is no doubt that they do business in this country (Ann Neuberger v. M.N.R.; Heskel Abed v. M.N.R.)[66].

It so appears that in extreme situations it is not too difficult to solve the problem, whereas in other cases the solution will depend on the following facts : kind and number of properties, kind and number of rental contracts, type and amount of agents'work, exceptionnality or frequency of transactions.

E. Income from Carrying on Business

According to s.2(3)(b)I.T.A. [s.2(2)old Act] non-residents carrying on business in Canada suffer the Part I income tax on their taxable income earned in this country. The income from business is the profit therefrom [s.9(1)I.T.A.]. The computation of taxable income is made in the same way as for residents, some supplementary rules beeing laid down in s.115 I.T.A.. From s.115(1) - ss.(a)(ii) for the business income -- it follows that the income of such taxpayers is their income for the year as it would be determined under s.3 so modified by s.115 itself. The section contains provisions related to the taxable capital gains and to the allowable deductions, as will be seen later on.

Taxability is established not only when non-residents do business in the year but also when they have done it in a previous year. The timing extention introduced by the new Bill -- s.2(3) -- affects employment income generally computed on a cash basis rather than business revenues to which the accrual method is applied. The new provision will, however, also concern some forms of business income which might be not included in Part I income until a year after the business is discontinued.

Examples are reserves for future proceeds on the sale of property in the course of business, or recapture of capital cost allowances on the sale in a later year of depreciable property used in the business.[67]

Computation of income from sources completely within one territory is based on assumption that the taxpayer has no income from any other territory and that the admitted deductions are only the deductions which are reasonably applicable, either in whole or in part, to those sources : s.4(1)(a)I.T.A. [s.139(1a)(a)old Act]. If the business is carried on partly in one place and partly in another the same assumptions are made with particular reference to any particular place : s.4(1)(b)I.T.A. [s.139(1a)(b)]. This rules is completed when applying to non-residents --s.115-- by s.4(3)I.T.A. [s.139(1b)old Act] which reads that in such case of computing income on territorial basis all deductions allowed shall be deemed to be applicable either wholly or in part to sources in a particular place.

Under the old system the computation of territorial --for non-residents Canadian income as long as it was in the same territory-- from all sources in one territory could be done all together,with losses offsetting gains[68]. That is no longer possible under the new Bill, which prescribes [s.4(4)I.T.A.] separate determination of income or loss from each source of business (or property) income. It is not clear how effective the practical separation of different businesses will be.[69]

As the only business income is that from Canadian business operations, so the only business losses are those from businesses carried out in Canada[s.115(1)(c)I.T.A.]. This provision replaces in a simpler form s.31(3)old Act. In Ross & Co. Ltd v. M.N.R.[70] a non resident stock-broker, who was considered carrying on business by dealing in securities, was disallowed the deduction of a loss suffered in relation with other securities as the latter ones were not comprised in the trade exercised in Canada.

S.115(1) [s.31(1)(b)old Act] also provides that the only deductions permitted are those which may reasonably be considered wholly applicable; and also such part of any other deductions as may reasonably be considered applicable. The actual basis for an apportionment may depend on the nature of deduction which the taxpayer claims, the main factor in the calculation being reasonableness. There is an obvious similarity with s.114 (s.29old Act) applying to part-time residents, the practical effect of which is left to the Department's discretion. It was decided that a non-resident doing business during a whole year was entitled to full personal exemptions (Rubinstein v. M.N.R.)[71]. Probably the text to fix the allowable portion of deduction is a combination of location and duration of the taxpayer's Canadian sources of revenue.

Finally it may be noticed that the general (income) averaging formula is available to individual non-residents in the year of averaging (taxation year) and the immediately preceding year if they carry on business in

Canada [s.118(2)I.T.A.], whereas they are denied the relief of an income averaging annuity contract (forward averaging) in respect of which residence in Canada is a condition sine qua non [s.61(1)I.T.A.].

F. Ship and Aircraft Operations

An exception to the principle that non-residents pay an income tax on the income earned from carrying on business in Canada is provided by s.81(1)(c)I.T.A. [s.10(1)(c)old Act]. This section prescribes that the earnings from the operation of a ship or an aircraft in international traffic shall not be included in the income, the condition being that the country of residence of the said taxpayers offers a substantially similar privilege to Canadian residents. Such exemption is not peculiar to Canada[71a] and it is repeated in general tax conventions as well as in particular tax treaties related to this matter (e.g. with Switzerland). The words "operated by the taxpayer" have been interpreted in a case where an English company owning ships had branch offices in Canada which provided various services not only to their own ships but also to subsidiaries'and other (independent) companies' ships, when they were in Canadian waters. The Exchequer Court, subsequently affirmed by the Supreme Court of Canada, held that in computing its Canadian income the company could deduct (as exempt) the part corresponding to the services rendered by the branches to the company's ships, as such earnings arose from the operation of ships owned (or chartered) by the taxpayer.

But the exemption did not cover the profit from the services performed for the subsidiaries' or the other corporations' ships (Furness Withy & Co. Ltd. v. M.N.R.)[71b].

2. COMPARISON OF METHODS

A. Individuals

Non-resident individuals can carry on business in Canada either directly themselves, or through their agents acting in Canada on their behalf. According to s.2(2) and s.115(1)I.T.A. they pay taxes on their taxable income from their Canadian business. Except in those few cases already pointed out, they are in the same situation as the resident businessmen. The new Bill greatly simplifies the calculation of the income tax payable by substituting a single schedule for the combination of an income tax rates schedule together with various special taxes (old age security, social development, foreign investment, temporary surtax).
For the provincial tax the new system simply creates a percentage calculation of the federal tax instead of an abatement from the "basic tax" (s.33 old Act) and a new calculation. By assuming a new standard rate of provincial tax at 30 % (of the federal tax) the total income tax will vary from a minimum of 22.1 % (reduced to 7.8 % until 1976) for amounts up to $ 500 to a maximum of 61.1 % for amounts over $ 60,000 of the taxable income in the taxation year (s.117 I.T.A.).As some provinces will probably introduce a percentage higner than 30 % their taxpayers

will suffer total taxes somewhat higher than the figures above.

If the non-residents doing business in Canada also own shares of Canadian corporations they will not benefit from the dividend tax credit provided by s.121 I.T.A.. As in the old legislation --s.108(9)-- the new Bill [s.214(13)] allows the Governor in Council to make general or special regulations about the (withholding) tax --Part XIII I.T.A.-- to be remitted by a non-resident carrying on business in Canada. S.805 (1) old Income Tax Regulations read that a non-resident doing business in Canada was taxable under Part III old Act (withholding tax) on all amounts paid or credited to him and normally subject to that tax, but not for those amounts that may reasonably be attributed to his enterprise in Canada. It is quite probable that the new Regulations will contain a similar provision. Thus, unless the shares are held in relation with or for the purpose of the business activity, dividends will be taxed on the gross amount at the flat withholding rate. But if the shares are not so held, dividends are grossed up by 1/3 and included in the taxpayer's income --s.82(1)I.T.A.--. The computed federal tax is then reduced by a deductible dividend tax credit of 4/5 of the gross-up; it is to be hoped that the provincies will allow the deduction of the remaining 1/5.

Individuals may prefer another solution. They may incorporate, either alone or in cooperation with Canadian residents, any company which does business in this country. In general the company pays income tax on its taxable income at a fixed rate of 50 % (declining to 46 % until

1976) --s.123 I.T.A.-- a provincial tax credit of 10 % of the taxable income being deducted from the federal corporation tax (s.124). When the company resident in Canada distributes or is deemed to have distributed dividends to its non-resident shareholders these will pay an income tax of 25 % (reduced to 15 % until 1976 by the Income Tax Application Rules). This tax is withheld, under Part XIII I.T.A., by the payer corporation resident in Canada. If through the participation of Canadian residents the corporation reaches the legally defined degree of Canadian ownership, the withholding tax will be only 20 % (i.e. 10 % until 1976) of the dividend amount. The different payments and appropriations deemed to be dividends [see s.15 and s.56(2)I.T.A.] are subject to the withholding tax by virtue of s.214(3)I.T.A..

Under the old Act there was not any practical difference between a company incorporated in Canada and a company incorporated elsewhere but having its common law residence in Canada because of the location of its central management and control. What was relevant was the residence in Canada. All corporations in such a situation were equally treated, the total tax burden being constituted by the normal corporate tax plus the withholding tax retained on dividends distributed by them. Since the enforcement of the new Bill incorporation in Canada will probably be advantageous, except where a company which has been created in some other country already had residence in Canada on the Budget Day (June 18) 1971. In any other case, in fact, the company will not be a Canadian corporation as defined in s.89(1)(a)I.T.A.. Therefore it will have to pay

the additional tax of Part XIV I.T.A..

Whereas the branch earnings tax of s.110B old Act was levied only upon non-resident companies the new Bill makes any corporation, other than a continuous Canadian corporation, liable for it. The company being resident in Canada, the non-resident shareholders will also suffer the withholding tax of Part XIII. The new legislation, however, provides some relief in order to reduce the additional tax burden when the resident company pays out dividends.

But as the tax on after-tax benefits may not be completely neutralized, it might be better for a company incorporated outside Canada to keep its residence in another country and simply to do business in Canada. Then it would be liable for the additional tax, but no withholding tax would be retained on dividends flowing down to shareholders.

Another argument in favour of incorporation in Canada is that,where individual shareholders resident in Canada participate in the company, they are entitled to the dividend tax credit of s.121 only when the debtor corporation is a Canadian corporation. According to s.121 I.T.A., the dividend tax credit consists of 4/5 of the gross-up prescribed in s.82(1)(b) which applies only to taxable Canadian corporations, which is to say, Canadian corporations not exempted --s.89(1)(j)I.T.A.--. So if the company is only resident without being Canadian, the Canadian shareholders would not include any gross-up in their income but would be denied any credit to be claimed against their tax amount. In other words,Canadians will be discouraged from participating in companies incorporated outside Canada, even if they acquire resident status in

Canada.

If he is willing to be effectively a minority shareholder, the non-resident may, by agreeing to substantial participation of resident individuals or private corporations in that company [s.89(1)(f)I.T.A.], be shareholder of a company incorporated in Canada and benefiting by the new small business incentive --s.125--. Roughly speaking, the small business deduction affects the first $ 50,000 of net income from Canadian active business, reducing the tax related to this amount to 25 %. This tax incentive only applies to Canadian-controlled private corporations. S.125(6)(a) defines such corporations as being private corporations --s.89(1)(f)-- which are Canadian corporations --s.89 (1)(a)-- and which are not controlled, directly or indirectly in any manner whatever, by one or more non-resident persons or one or more public corporations [s.89(1)(g)I.T.A.]. The term "controlled corporation" is not explained in regard to this matter, but by analogy with the constant definitions of corporations controlled by other corporations [s.112(6)(b); s.186(2); s.192(4); s.194(3)I.T.A.] it may be thought that a shareholder controls a corporation when he owns,--either himself or through persons with whom he does not deal at arm's length--, over 50 % of its issued share capital (having full voting rights under all circumstances).

Thus, the non-resident shareholder must have a shareholding lower than 50 % and must not enter into any agreement with other shareholders enabling him to determine their conduct inside the company. Moreover, if the non-resident takes over the control of the company which, as a result, becomes a non-Canadian-controlled corporation while remaining

private,it must remit the Part VI Tax (s.190 I.T.A.) which approximately corresponds to the previously obtained small business tax reduction.

B. Companies

(i) Branch

Non-resident companies can do business in Canada directly or through an agent. As in the case of individuals, the use of an agent makes no difference for tax purposes. In both situations companies have, as commonly said (in a somewhat misleading and imprecise expression), a "branch office" in Canada. Such companies are neither private --s.89 (1)(f)-- nor public corporations [s.89(1)(g)I.T.A.] as they do not reside in Canada. According to s.2(3) and s.115(1)I.T.A. they pay corporate income tax at the same rate as any corporation (s.123 and s.124) without any particular advantage.

As they do not have their residence in Canada(and so cannot be Canadian corporations) they also suffer the 25 % (reduced to 15 % until 1976) additional tax of Part XIV I.T.A. levied on the after-tax profits, without of course any relief for distribution of dividends (this relief being only for resident non-Canadian corporations). This tax, a "branch earning tax", already existed by virtue of s.110B old Act.

The ownership by non-resident companies of shares of Canadian or resident corporations may raise some questions. If companies own shares without

any connection with the business they run in Canada, the dividends from such shares are probably not included in their income. So the withholding tax of Part XIII is normally levied, a provision like s.805 old Regulations being expected (see page 45). If, on the contrary, the shareholding is in relation to the branch operations then such dividends are computed as a part of the companies' income.

It is submitted that the new Bill shows at this point a major difference with the old system, a difference which, surprisingly enough, has not been mentioned in any commentary. It is primarily that such intercorporate dividends are no longer tax-free when received by a non-resident corporation doing business in Canada. Whereas s.28(1)old Act concerned any company paying Part I tax, even if it was not resident[72](as long as s.805 Regulations was complied with),the new provision [s.112(1) I.T.A.] on tax-free intercorporate dividends only applies to resident corporations. As the marginal note refers to "dividends received by corporation resident..." it seems to be clear that such rule is intended only for recipient corporations residing in Canada. Thus it will now be better for non-resident companies carrying on business in Canada to have the dividends they receive caught under Part XIII(25 % withholding tax on gross amount) rather than under Part I through s.2(3) (50 % of the net amount).

Canadian individuals who are shareholders of such foreign corporations are not personally affected by the companies' business in Canada. They will simply include the dividends in their income and they will neither

add any gross-up (s.82(1) only applies when dividends are paid by Canadian corporations) nor be entitled to deduct any dividend tax credit (cf. s.121 I.T.A.) from their own tax amount.
This is again a difference from the old system, which allowed [s.38 (2)old Act] resident individuals to claim credit for dividends they received from certain non-resident companies doing business in Canada, and which so offered an incentive for acquisition of shares in foreign controlled companies operating in Canada[73].

For Canadian resident corporate shareholders(other than private corporations --s.186 I.T.A.--)of such non-resident companies it will be more difficult than under the old legislation to receive this kind of inter-corporate dividend partly tax-free. The amount of dividend free of tax has to be, as before, apportioned to the taxable income that the paying corporation earned in Canada in the year preceding the taxation year [s.112(2)I.T.A. ; s.28(10)old Act].
But the new Bill also requires that the Canadian income be earned through a Canadian permanent establishment of the non-resident corporation . Carrying on business no longer suffices. The Act does not give any definition of permanent establishment and s.112(2) anticipates that it will be defined in the new Regulations. It is interesting to note that it is the first time that this concept appears in the federal Income Tax Act. Until now it was employed only in the Regulations[74] (for interprovincial purposes), in some provincial statute[74a] and, mainly,in tax treaties. Therefore it may be thought that the definition

will be similar to those of tax conventions[74b].

The advantages of the "Canadian Branch" solution are that no new incorporation expenses are incurred and, especially, that the branch's losses, being deductible for the non-resident (main) company, can be absorbed more easily, so making the branch particularly attractive for speculative ventures in Canada[75]. Probably the additional tax (Part XIV) is easier to avoid than the withholding tax on dividends distributed by a resident subsidiary[76].

The disadvantages result from the difficulty of determining the profits allocable to the branch and from the differences between the Canadian income computation method and sources qualification, and the foreign methods and qualifications. Moreover, provincial licenses will be necessary to do business in Canada.

(ii) Subsidiary

Non-resident companies can incorporate subsidiaries resident in Canada to carry on business in this country. The subsidiaries pay the ordinary corporate income tax, and the non-resident parent companies then remit the 25 % (respectively 15 % until 1976) withholding tax on dividends, this last rate being reduced by 5 % in the case of subsidiaries having a degree of Canadian ownership.

To escape the Part XIV additional tax, subsidiaries have to be incorporated in Canada unless they were resident on June 18, 1971 because

qualification as Canadian corporation is required. When resident, but non-Canadian, corporations pay out dividends (subject to the withholding tax in the case of foreign parents' subsidiaries) a partial relief is provided by the Act.
The observations made about the participation of non-resident individuals in Canadian-controlled private corporations [s.125(6)(a)I.T.A.] are valid here for subsidiaries incorporated in Canada.

The qualification of the subsidiary as a Canadian corporation is necessary in order that individual shareholders residing in Canada may benefit from the dividend tax credit [s.82(1)(b) and s.121 I.T.A.]. It would be denied them in the event that the company incorporated elsewhere has acquired common law residence after the Budget Day 1971.

Again, that qualification is required in order to have dividends flowing tax-free to corporate shareholders resident in Canada [s.112(1)(a) I.T.A.]. The residence in Canada of the subsidiary is not sufficient except where there is control (i.e. over 50 % of the voting shares) --s.112(1)(b)--.
Even if all provisions based on the concept of Canadian corporation have been enacted for the purpose of discouraging incorporation outside Canada, the application of the principle in s.112(1)I.T.A. leads to an apparently contradictory and overly severe tax treatment. In fact resident corporate shareholders may receive dividends at least partly tax-free from non-resident companies having a permanent establishment

in Canada --s.112(2)--, but they are not entitled to any tax relief for dividends paid to them by resident companies which do not qualify as Canadian corporations. After distribution to their own shareholders such earnings will have been taxed three times.

If the Canadian subsidiary is established for the purpose of purchasing a company residing in Canada, problems arise as to losses and designated surpluses. Any loss connected with any particular business cannot be carried forward where persons (corporations e.g.) which were not carrying on that business acquire the control of the company : s.111(5)I.T.A. [s.27(5)and (5a) old Act]. The same rule applies now to capital losses [s.111(4)I.T.A.].

Dividends out of designated surpluses flowing to non-resident controlling corporate shareholders are subject to the 15 % Part VIII tax to be suffered by the payor corporation : s.194(1)I.T.A. [s.105 B(1)(a) old Act]. The normal withholding tax will also be retained, for such dividends are taxable dividends (see s.192(1)I.T.A.).

Under the old system there was some tax incentive for the sale of a Canadian company, which had an important undistributed income, to a non - resident corporation rather than to another Canadian one, as the total burden in the first event was only 30 % (instead of 50 %)[77]. That will now be ended,for, although the tax paid by residents on dividends out of designated surpluses --Part VII tax-- is 25 % [s.192(1)I.T.A.], such tax constitutes the total tax, these dividends being now deductible when computing the taxable income of the recipient. In fact s.112 I.T.A. does not provide any prohibition similar to s.28(2) old Act. For the

non-resident the total tax will be 40 % (or 30 % until 1976).

If the subsidiary is incorporated outside Canada after June 18,71 then it is better that it keeps its residence in another country so that no withholding tax will be paid on its dividends. The subsidiary will remit the additional tax which even in the case of residence in Canada is not completely avoidable.

It has been suggested[78] that the solution of the non-resident subsidiary only doing business in Canada may become attractive for the distribution of accumulated income, when the company discontinues the business and then winds up. S.81(7)old Act excluded the application of s.81 when more than 50 % of the shares belonged to non-residents. That appears still to be true under the new law, for s.84(2)I.T.A., which creates deemed dividends when funds or properties of a company are distributed upon winding up, only concerns resident companies.

The advantages of the subsidiary (qualifying as Canadian corporation) are facility in accounting and in financial control, easier compliance with Canadian regulations as the accounts are separate, no necessity for licences and a better (political)position in Canada (for excise and customs duties and for incentives[79]. The disadvantages are application of the withholding tax on dividends to non-residents, incorporation fees and impossibility for the parent company to absorb the subsidiary's losses.

3. ADDITIONAL BRANCH TAX

Part XIV I.T.A. provides that corporations, other than Canadian corporations, pay an additional tax on their after-tax profits when they carry on business in Canada. This tax, commonly called "branch office" tax, existed in the old legislation. The new Bill, however, introduces some changes extending the application of this tax and rendering its calculation more complicated.

Under the old system this tax (Part III A) concerned only non-resident companies carrying on business in Canada and their income earned through such business[s.110 B (1)old Act].
The tax basis was obtained by deducting from the taxable income earned in Canada [ss(a)] the (federal) Part I income tax, the provincial income taxes (for the part not deductible under Part I in computing the income) and an allowance for net increases in their capital investment in property in Canada [ss(b)]. The tax rate was 15 %.
The allowance was, according to s.808 Regulations, the difference between the taxpayer's capital investment in property(undepreciated capital cost of depreciable property and cost of land less unpaid portions of purchase price and amounts borrowed for the purpose) at the end of the taxation year and the sum of the allowances for previous years after 1960 plus the Canadian capital investment when starting to suffer the branch tax.
The additional tax was not applied to some kinds of companies, listed in s.110 B (2), and was substituted for by two special additional taxes

for non-resident insurers [s.110B(4) and (5)old Act].
Until 1961 the 15 % branch tax did not exist, so non-resident corporations doing business in Canada directly were in a better position than were non-resident companies which had incorporated a subsidiary residing in the country. The additional tax was, therefore, intended to avoid differencies of tax treatment between branches and Canadian subsidiaries and was levied on the after-tax earnings available for transfer to the main company. The branch tax has been considered as a tax on the current undistributed profits[80].

In the new legislation the Part XIV additional tax applies to any company carrying on business in Canada and which is not a Canadian corporation [s.219(1)I.T.A.].
As the Canadian corporation is defined as a company which was either incorporated in Canada or continuously resident in Canada since June 18, 1971 [s.89(1)(a)] it follows, as already mentioned, that a company created in another country and which acquired common law residence after that date will now be taxed despite its residence in Canada. Since for resident companies which distribute (taxable) dividends (subject to the withholding tax when paid to non-residents) the tax burden would become too heavy, s.219(1)(i) offers some relief.
The tax rate is 25 % [s.219(1)I.T.A.] but it is reduced by the Application Rule 11 (1) to 15 % until the end of 1975. As there are some differencies in establishing the tax basis for resident and non-resident companies, it seems wise to deal separately with them.

a)Non-resident corporations

The basis for the additional tax will be : the year's corporation's taxable income --s.219(1)(a)-- plus the allowance for investment in property in Canada which was claimed in the preceding year --219(1)(b)-- minus the aggregate of :

- net taxable capital gains on taxable Canadian property or net taxable capital gains on taxable Canadian property other than Canadian business property, whichever is the less --219(1)(d)--
- federal Part I tax less the proportion of this tax attributable to the above capital gains --219(1)(e)--
- provincial income taxes, to the extent that they were not deductible in computing the income, less the proportion of these taxes attributable to the above capital gains --219(1)(f)--
- prescribed allowances for investment in property in Canada --219(1)(h)--

b)Resident corporations

In this case the basis for the additional tax will be : the corporation's taxable income for the year --219(1)(a)-- plus the allowance for investment in property in Canada claimed in the preceding year --219(1)(b)-- plus the dividends deduction claimed in the preceding year --219(1)(c)-- minus the aggregate of:

- federal Part I(income)tax --219(1)(e)--
- provincial income taxes, as long as not deductible in computing the income --219(1)(f)--

- foreign tax credit deduct under s.126 I.T.A. from the tax plus 1/2 of the corporation's tax income or of the foreign income and taxable capital gains, whichever is the less --219(1)(g)--
- prescribed allowance for investment in property in Canada --219(1)(h)--
- dividends paid less 1/2 of the foreign income and taxable capital gains.

The result of these somewhat complicated computations is that in both situations the additional tax will be levied on after-tax Canadian source income[81]. The government has anticipated that the allowance for increase in Canadian assets will be extended to working capital and will be subject to recapture if investment is reduced[82]. The new Regulations will probably provide no deduction of previous years' allowance, unlike old Regulations 808(1)(a), in calculating the allowance --219 (1)(h)--, as such allowances of the preceding years will now be included in the income (for additional tax purposes) every year [s.219(1)(b)I.T.A.].

The jurisprudence on this matter is very limited. In Union Oil Co. of California v. M.N.R.[83] it was decided that a corporation which had compensated its income tax with certain tax credits could make no deduction under s.110B(b)old Act from its taxable income of tax payable. The taxable income, therefore, was entirely subject to the additional tax. In a case, then affirmed by the Supreme Court, the Exchequer Court held that a non-resident was entitled when computing the income of its Canadian branch to deduct the portion of the foreign head office's administration costs attributable to the Canadian operations(Furness Withy & Co. Ltd. v. M.N.R.)[84].

Some corporations are exempted from the additional tax : banks, transportation and communications, mining iron ore in Canada, organizations exempted from any income tax under s.149 (non-profit, charity, housing, scientific research)[s.219(2)I.T.A.]. The only change is the exclusion of certain old companies exempted by virtue of s.110B(2)old Act.

Non-resident insurers do not pay, as they did under the old legislation, the branch tax of s.219(1). However when they elect to compute their Canadian investment fund in order to deduct the difference between this fund and certain liabilities incurred in the course of their Canadian operations, they then must pay an additional tax of 25 % of that deduction --219(4)I.T.A.--. Secondly they also suffer a special tax of 25 % of the difference between their Canadian investment fund and the value of their Canadian assets. S.11(1) Application Rules reduces both rates to 15 % from 1972 to the end 1975.

IV. INVESTMENT INCOME EARNED FROM CANADA BY NON - RESIDENTS

1. IN GENERAL

Non-residents receiving payments from Canada are subject on such amounts to a special tax provided by Part XIII of the Income Tax Act.
The person who owes the tax (the taxpayer) is the non-resident payee, but as the tax is to be withheld by the resident payor and remitted by him on behalf of the non-resident person the tax is generally called withholding tax.
According to the Act the tax is levied only on itemized types of revenue flowing to non-residents, but the list is so complete and the terms are so broad that practically no kind of revenue from investments which non-residents make in Canada escapes the withholding tax.

In the Act the tax is designated as an income tax although it is quite different from the ordinary Part I income tax. In fact for the purposes of Part I income tax the taxpayer has to find out his net income by deducting his expenses from the gross income. Then he must compute his taxable income by making the allowable deductions and personal exemptions. In the case of payments to non-residents subject to the withholding tax, however, s.214(1)I.T.A. prohibits any deduction[85] so that the tax is levied on the gross amount of the payment. Probably the reason why it is designated as income tax is that all payments imposed under this part of the legislation are of an income nature[85a]. When non-residents

whose investment incomes are taxable within Part XIII I.T.A. realize capital gain on the disposition of taxable Canadian property (perhaps the investment asset itself) then they become non-residents taxable on such gain under Part I by virtue of s.2(3)(c)I.T.A..

The tax is due not only when the non-resident taxpayer receives the amount paid to him but when the payment is made. S.212(1) reads that the tax shall be paid when the resident debtor pays or credits, or is deemed by Part I to pay or credit, to the non-resident creditor an amount on account or in lieu of payment of, or in satisfaction of one of the various listed items of income. When the non-resident creditor receives in lieu of payment a security or other right, a certificate or other evidence of indebtedness, the value of the security shall be deemed to have been paid to him in relation to the debt in respect of which he received it [s.214(4) and s.76(1)I.T.A.].

The withholding tax is levied on the gross amounts regardless of the taxpayer's hability to pay. The tax rate of 25 % --s.212(1) and (2)-- is generally the same for everybody and for every kind of payment. Until the end of 1975, however, the rate will remain at 15 % [s.10 (2) (a) Income Tax Application Rules] as it was under the old system. The period ending in 1976 is also the period indicated by the government for renegotiation of existing tax treaties and entering into new conventions with other countries.

In the case of dividends distributed by corporations having a degree

of Canadian ownership the withholding tax will be only 20 %, but,once again, 10 % until the end of 1975.

The tax is imposed on payments made to non-residents. The question of residence (or of non-residence) is answered by the criteria presented in chapter II above. It is notable that s.214(13) empowers the Governor in Council to make general or special regulations prescribing who is or has been resident in Canada. Where non-residents carry on business in Canada investment income continues to be caught under Part XIII, except for those amounts which may reasonably be attributed to the business carried on in Canada, if a provision such as s.805 old Regulations is enacted. This may be expected because of s.214(13)(c)I.T.A. which allows the establishment of regulations in this regard.

Collection of tax

Part XIII income tax is, as noted above, a withholding tax. The system was the same under the old Act.

The resident payor shall withhold or deduct from the payment he makes to the non-resident the appropriate amount of tax and immediately remit it to the Receiver General on behalf of the non-resident taxpayer[s.215 (1)I.T.A.]. Where the Canadian debtor acts through an agent paying the non-resident on his behalf, particularly in the case of redemption of bearer coupons or warrants, s.215(2) imposes the obligation of withholding upon the agent. Where the payment is made to an agent of the

non-resident creditor without the tax having been retained, the non - resident's agent shall himself withhold the tax --215(3)--.
The obligation for the resident debtor to withhold and remit the tax exists notwithstanding any agreement or any law providing the contrary [s.215(1)I.T.A.]. The non-resident cannot complain and he is not entitled to sue the payor who has deducted the tax amount : s.227(1). Where the debtor has not regularly or has not at all withheld the amounts of tax he ought to have retained,the debtor is liable to pay as Part XIII tax the whole of such amounts and he is allowed to deduct them from any payment to the non-resident [s.215(6)I.T.A.].

The responsibility of the resident payor is very heavy ; if he does not withhold the tax he is liable to pay its totality plus an interest at a prescribed rate per annum [s.227(8)I.T.A.]. Under the old Act --s.123(8)-- the interest rate was 10 % ; it will now be fixed in the Regulations. A penalty is also provided for a resident who withholds the tax but fails to remit it : 227(9)I.T.A..

S.215(4)I.T.A. reads that Regulations may be enacted in order to except the application of the withholding rule for payments made to non-residents carrying on business in Canada. These would have to file a special return and then pay Part XIII tax themselves. It is important to notice that their investment income would then continue to be caught under Part XIII. The opportunity perhaps afforded by s.215(4) is not to be confused with the possibility (s.214(13)(c) and Regulations) of having part of such investment income included in the business income earned

in Canada. S.215(4)I.T.A. in fact deals only with the deduction of the tax amounts and refers to the payment of the tax "imposed by this(XIII) Part".

2. INTEREST

Interest payments made by residents to non-residents constitute a fairly simple class of investment income subject to the withholding tax: s.212 (1)(b)I.T.A. [s.106(1)(b)old Act]. Any interest except that specifically exempted is liable to this tax. Where a payment is partly capital and partly interest that part which can reasonably regarded as interest is submitted to tax : s.214(2) simply extends the bear of s.16(1)I.T.A.

The Bill extends the withholding tax to two other kinds of interest: accrued bond interest and discount on sale of obligations. The old Act contained in its Part I some provisions [s.7(2) and 19A] to which,however, no reference was made under Part III (withholding tax). Although the law was not very clear,accrued interest was probably not considered as income[86] and non-residents could easily avoid the withholding tax by selling securities to residents prior to maturity at a price which included the accrued interest. The new rule about Part XIII tax on accrued interest and discount apply to short-term securities (bonds,debentures,bills, notes, mortgages, hypothecs or similar obligations) issued after June18,1971. Withholding tax is levied on accrued interest when a non-resident (transfe-

ror) transfers to a resident (transferee) an obligation,whose interest is not due yet and a part of which would be, if s.20(14) were applicable, included in the transferor's income. According to s.214(6) such an amount is deemed to be an interest payment by the transferee to the non-resident transferor and it is, therefore, liable to the withholding tax, provided that the transferred debt is : neither a government bond, other public obligation or debt whose interest is payable in foreign currency ; nor an obligation whose issuer has less than five years to reimburse more than 25 % of the borrowed sum ; nor a public issue security [214 (8)(a)(i) to (iii)I.T.A]. If the resident acquiring the obligation (transferee) is a non-resident-owned investment corporation, the normal exemption of s.212(1)(b)(i) does not apply and the tax must be paid. The rule imposing the accrued interest is also applicable when the transferee is a non-resident carrying on business in Canada and entitled to the corresponding deduction of s.20(14)(b) [s.214(9)I.T.A.].

When a resident issues or sells to a non-resident an obligation at discount, i.e. for a price less than the principal amount, then 4/3 of the discount is deemed to be an interest payment to the non-resident at the time of the transaction and it suffers withholding tax [s.214 (7)I.T.A.]. Until the end of 1975 the deemed interest will be 100/85 (instead of 4/3) of the discount amount, as prescribed by s.10(2)(b) Application Rules. The withholding tax on discount is escaped by "excluded obligations, which are obligations whose accrued interest is not taxed [s.214(8)(a)(i) to (iii)], and obligations whose original issue discount is not greater than 3 % and whose actual annual yield does not exceed 4/3 of the stated interest rate [s.214(8)(a)I.T.A.].

Again, should the issuer or seller be a non-resident-owned investment corporation the ordinary exemption does not apply --s.214(11)--. If the non-resident who subscribed or acquired the debt sells it before maturity to a resident, he then is entitled to a proportional refund [s.214(7) and 227(6)]. At this moment, however, he will pay the tax on the accrued interest by virtue of s.214(6)I.T.A.. The prescription taxing the discount also applies where the person issuing or selling the obligation is a non-resident doing business in Canada [214(10) I.T.A.]. Finally the rule concerning combined capital and income payments is not applicable in respect of discount obligations[214(12) I.T.A.] ; otherwise there would be a danger of double taxation.
It is notable that these provisions regarding accrued bond interest and discount obligation have been made applicable by s.76(2)Applications Rules from June 19,1971 s.76(1)Rules having amended the old Act by adding to it the new s.108(4a) to (4g).

The withholding tax rate of 25 % [212(1)(a)I.T.A.] is reduced to 15 % until end 1975 through s.10(2)(a)Rules. After 1976 the rate will be maintained at 15 % in favour of non-residents, living in countries probably to be prescribed by Regulations, if the obligations have been issued before 1976 and the residents paying the interest have dealt with them at arm's length : s.10(4)Rules. A special rate of 5 % is provided by s.212(6)I.T.A. (whose misleading marginal note has not been corrected) for interest from provincial bonds issued before December 20,1960 --212(7)-- or after that date but in exchange of bonds which had been themselves issued before [s.212(8)].

Exempted Interest

As in the old legislation, the new Bill exempts a certain number of interest payments from the withholding tax ; changes are not numerous and introduce only minor restrictions.

Interests payable by non-resident-owned investment corporations continue to be tax-free [s.212(1)(b)(i)I.T.A.]. These interests are not deductible as expenses when computing the income of such companies. The fact that the withholding tax exemption of interest payments made by such corporations has not been affected by the legislative revision is to be underlined, for the whole treatment of non-resident-owned investment corporations has been modified. In particular, their dividends flowing to non-residents are no longer tax-free.

Another class of exempt payments comprises interest from bonds issued before December 20,1960 or guaranteed by the Canadian government ; similar bonds, issued before April 16,1966, whose yield is paid to the governments or central banks of foreign countries or to international organizations listed in s.806 old Regulations; obligations of the federal government, of provincial governments, of municipalities, of local organizations with a 90 % financial Crown participation; of educational institutions or hospitals when they are supported in such transactions by a provincial government. The time condition for such securities is issuance after April 15,1966 and, as newly enacted, before 1976 [s.212(1)(b)(ii)(A) to (C)I.T.A.].

The law exempts interest payable in a foreign currency on the following: obligations issued or stipulated in writing before December 20,1960; debts owed by banks subject to the Bank Act; and indebtedness entered into in the course of carrying on business in a foreign country, provided (this being added by the new Bill) that the Canadian taxpayer is allowed to deduct the payment in computing his income [s.212(1)(b)(iii)(A) to(F)I.T.A.].

An essential condition for exemption is that the resident debtor and the non-resident creditor deal at arm's length. The facts indicating that the parties to the transaction are not dealing at arm's length have to be clearly ascertainable because the presumption of non-arm's length, even when justified by the situation, is a rebuttable one[88]

In a recent case Swiss Bank Co. and Swiss Credit Bank v. M.N.R.[89] both banks controlled a company which was the manager of an investment fund that owned all shares of a Canadian corporation. The banks lent to the Canadian corporation money raised for the fund and they contended that the interest on the loan paid to them in Swiss francs was exempt from withholding tax. The Exchequer Court held that the recipients and the debtor were not dealing at arm's length, the bank and the management company acting in concert and having all voting power inside the Canadian corporation, to which they could dictate what to do and so could exert their influence.

Finally, the interest is to be effectively paid in a foreign currency and not simply stipulated payable. Thus it was decided that the debentureholders of a resident company, whose securities' interest was payable in U.S. $ and which paid it for a certain time by issuing

common shares to them, were denied the statutory exemption(Manitour Beaune Mines Ltd. v. M.N.R.)[90].

The last group of exempt interests is that of payments made on obligations issued after June 13,1963 to persons holding a certificate of exemption: s.212(1)(b)(iv). As under the old system, such a certificate is issued, upon application to the Minister, to persons who reside in a country imposing an income tax and who are tax-exempt in that country. S.212 (14)I.T.A. enacts a severe supplementary restriction : the certificate is granted only to persons who either would be tax-exempt within s.149, if they were resident in Canada, or are trusts or corporations created solely for employees' superannuation or pension funds or plans. The restrictive new qualification will lead to the exclusion of certain non-resident entities, e. g. foreign holding corporations of jurisdictions such as Luxembourg, which formely benefited by the exemption[91]. Some concern had been expressed about the fact that the government had not certified what would happen with the existing certificates whose validity lasts over 1971 and whose holders do not meet the new requirements[92]. When the new Bill was amended a prescription was incorporated in the Application Rules --s.10(5)-- providing that the exemption certificates issued under the old Act are deemed to be in force until end 1974, except that if the bearer has ceased to be an exempt person (in his own country) before that time, the certificate ceases to be in force either on January 1,1972 or on the day of the end of the exemption, whichever is later.

Loans to Wholly-Owned Subsidiaries

S.110 A old Act recited that under certain circumstances the interest paid on loans granted by non-resident companies to Canadian subsidiaries may be exempted from the withholding tax; this has been reprinted in s.218 I.T.A.. The Act deals with non-resident parent corporations, which are indebted to a Canadian resident or to a non-resident insurance company doing business in Canada (creditors) and which must pay interest in Canadian currency. If these corporations have re-lent the same money at the same rate to their wholly-owned subsidiaries residing in Canada, whose principal business is the making of loans, then the amounts so lent by the parents are deemed to have been borrowed by them as agents of their subsidiaries and the interest paid by the latter to the parent is considered to have been paid directly to the creditors. So, no Part XIII tax is suffered by the non-resident parents : s.218(1). To obtain the benefit a joint election has to be filed, within 12 months after any payment, by the parent company and the creditor [s.218(3) and (4) I.T.A.]. The relief is extended by s.218(2) to the case in which the money has been lent to a subsidiary whose principal business is not loaning, and then re-lent by it to a wholly-owned subsidiary conducting such business. The explanation of these special rules is that the money paid on account of interest by the subsidiary never leaves Canada[93].

3. DIVIDENDS

Dividends distributed by resident corporations to non-resident shareholders

are subject to the withholding tax by virtue of s.212(2)I.T.A.. Within the provision come those taxable dividends, other than special capital gains dividends, which are defined by s.89(1)(j)as any dividend in respect of which no election was made in accordance with s.83.. The dividends which may be covered by an election under s.83(1) are those out of the tax-paid undistributed income and 1971 capital surplus. As they are not taxable dividends no withholding tax will be imposed. Also caught are capital dividends which are dividends distributed out of the capital dividend account [s.89(1)(b)]. This account is roughly 1/2 of the net capital gains accumulated and distributable tax-free by private corporations to their resident shareholders [s.83(2)]. The withholding tax is levied on "effective" dividends as well as on deemed dividends (s.84: increases of capital; distributions on winding-up; redemptions; reduction of capital). The latter also include --s.214 (3)-- the payments which according to s.15 are computed in the income of shareholders and considered to be received by them as dividends (appropriations of the corporations'properties to shareholders[94]; loans made by corporations to shareholders[95] except in particular cases; interest on income bonds; or use of a car).
Also included are payments which according to s.56(2) are indirect payments.

It is to be noticed that since the new Bill has been enforced the term "dividend" includes (s.248) a stock dividend other than one that was paid before 1972, whereas s.139(1)(k)old Act read that stock-dividends

were not dividends. In this regard it is interesting to observe that in relation to the withholding tax the Exchequer Court had earlier decided, under the Income War Tax Act, that a stock dividend was a dividend regardless of the fact that no "payment" and no "currency" was actually involved in a transaction (The King v. Johnson Matthey & Co. Ltd.)[96].

Two kinds of dividends exempted from the withholding tax under s.106 (1a)old Act will now suffer Part XIII tax. These are dividends formerly paid off by personal corporations --but the concept of personal corporations has disappeared with the legislative revision-- and those flowing from non-resident-owned investment corporations.

On the other hand, capital gains dividends distributed by non-resident -owned investment corporations and mutual fund corporations [s.212(2) I.T.A.] are not subject to withholding tax.

Dividends which may still be free of withholding tax are those distributed by foreign business corporations. However,at least 90 % of the income of such corporations must be earned by operating public utilities or by mining, transporting or processing ore in the same country in which reside either non-resident individual shareholders or individuals owning more than 50 % of non-resident companies, which companies are themselves shareholders, of the foreign business corporations.-- S.213(1)I.T.A. [s.107(1)old Act][96a]. As the concept of a foreign business corporation is going to be phased out within four years (s.60 Application Rules), s.213(3) prescribes that for the purpose of exemption a company will be considered a foreign business corporation if it would have been considered

such under s.71 of the old Act.

The tax rate of 25 % [s.212(2)I.T.A.] will be only 15 % until the end of 1975 by virtue of s.10(2)(a) Application Rules. As already mentioned, when the paying corporation has a degree of Canadian ownership the tax rate is the normal percentage minus 5 % , in other words 10 % until the end of 1975 and afterwards 20 %.

Degree of Canadian Ownership

The statutory definition of the "degree of Canadian ownership" enabling the non-resident shareholders of corporations reaching it to receive dividends taxed at a reduced withholding tax is contained in s.257 I.T.A. (s.139 A old Act). It is extremely complicated[97].

When establishing the main criteria of such a definition one can say that a company has a degree of Canadian ownership where [s.257(1)I.T.A.] :

a) it is resident in Canada;
b) in any year after 1964 not less than 25 % of the directors reside in Canada;
c) the corporation is
   1) a corporation in which not less than 25 % of issued and outstanding shares , having full voting rights, and equity shares representing not less than 25 % of that part of the paid-up capital represented by all issued and outstanding equity shares, belong to individuals resident in Canada or corporations controlled in Canada; or

2) a corporation, having a class or classes of shares listed on a prescribed stock exchange in Canada, and in which no one non-resident owns more than 75 % of the issued and outstanding shares (having full voting rights), and more than 75 % of that part of the paid-up capital represented by all the issued and outstanding equity shares; or

3) a subsidiary controlled corporation of which equity shares representing at least 75 % of that part of the paid-up capital, represented by all the issued and outstanding equity shares, belong to the parent company, to a corporation controlled in Canada, or to an individual residing in Canada; or

4)a wholly-owned subsidiary of a corporation as defined under n.1) to 3).

The different concepts used in s.257(1) are in turn defined in the other subsections of s.257,whose peculiar details are not to be examined in this paper. It will only be noticed that s.257(2)(e) defines an equity share as a share other than a non-participating share [s.257 (2)(f)]. According to s.257(2)(a) a corporation is controlled in Canada when it is resident in Canada and when more than 50 % of the shares (shares representing more than 50 % of its paid-up capital, equity shares representing more than 50 % of that part of the paid-up capital represented by all the equity shares) belong to individuals resident in Canada or to corporations being themselves controlled in Canada.

Under the old legislation, the qualification of a company as one having

a degree of Canadian ownership entitled it to accelerated capital cost allowances --class19-- for its assets [s.1100(1)(n)old Regulations).

4. RENT

Although in the Income Tax Act rents, royalties and similar payments are treated as the same type of income for the purposes of withholding Part XIII tax, rentals and royalties will be dealt with separately herein for practical reasons and without presumption of establishing distinctions.

Rent or similar payments which residents make to non-residents for the use of or the right to use any property in Canada suffer withholding tax: s.212(1)(d)(i)I.T.A.. This provision concerns any kind of property which can be used by residents, except railway rolling stock used by railway companies and corporeal properties used outside Canada [s.212(1)(d)(vii) and (ix)I.T.A.].
The new Bill provides another exemption covering payments from a resident carrying on business outside Canada if he deals at arm's length with the non-resident payee. Moreover in order for the non-resident to benefit from the exemption the resident payor must be able to deduct the amount paid when computing his income [s.212(1)(d)(x)].

The withholding tax may also be levied on rentals paid to non-residents by other non-residents when the rent is due for property used in Canada:

s.212(13)I.T.A.. The tax rate amounts to 25 % --s.212(1)-- reduced to 15 % until 1976 [s.10(2)(a)Rules].

It may be difficult to determine whether a certain payment should be considered similar to a rent and, therefore,be caught under the taxing provision. In S. I. Burland Properties Ltd. v. M.N.R.[98] the non-resident owner of a real property had leased it to a resident and had covenanted with the lessee that the latter would pay not only the rental but also the taxes on the property. Following a contention of the Revenue the question arose whether the land tax amounts ought to have been deemed part of the rental price and so taxed. The Exchequer Court held that, notwithstanding the amount was fixed and paid for a certain time, the property tax payment could be considered neither as a rent nor a similar payment for the use of property, for tax amounts are not usually reserved to the landlord.Moreover, under the relevant provincial statute, the obligation of remitting that tax was imposed with joint liability to landlord and tenant, so that when the tenant agreed with the lessor to pay tax he was not discharging a lessor's obligation but only assuming his statutory duty. However, the judgment was reversed by the Supreme Court, which decided,without giving any written reason, that the land tax amounts paid by the tenant in pursuance of a covenant in the lease were payments similar to rent according to s.106(1)(d)old Act and, therefore,subject to the withholding tax.

If the non-resident prefers to hold the property through a company a change in the tax situation does not necessarily result. Where a company

does not reside in Canada but owns a property which it rents to Canadians, without reaching the point where it carries on business in the country, no corporate income tax will be levied and no withholding will be imposed on the dividends, as the corporation is not resident in Canada. The only tax suffered will be the withholding on rentals exactly as if the non -resident individual owned the property himself.

An Alternative for Rents from Real Property

Like s.110 old Act the new legislation affords a special alternative permitting non-resident landowners to be taxed on the net income from rented real properties instead of suffering the withholding tax on gross revenues.

S.216(1)I.T.A. reads that if he chooses to file a return as a normal resident and does it within two years from the end of the taxation year, the non-resident will be liable to pay income tax under Part I. He will be treated as though he resided in Canada, his interest in real property in Canada were his only source of income --ss.(b)-- and he were not entitled to any deduction from income for the purpose of computing income --ss.(c)--. Both subsections should be considered with care. Ss.(b), reading that the realty is the only income source, enables the non-resident , who is liable to pay Part I tax as if he were a resident, to avoid the world income rule [s.3(a)I.T.A.] and so to be taxed only on his Canadian rental income. Being taxable on income from property he will be imposed according to s.9(1) on the profit (net income) therefrom. In other words he is allowed to deduct from the gross rental the expenses

he has incurred in order to earn it and in particular to deduct the capital cost allowances for depreciation of the property authorized by s.20(1)(a) and Regulations. The profit so determined will itself constitute the taxable income, the taxpayer being deprived by ss.(c) of the right to claim personal exemptions and deductions.

The consequence of being allowed to deduct capital cost allowances is that, when the property is disposed of, the excess of the proceeds over the undepreciated capital cost (up to the capital cost) is to be included in the income (s.13 I.T.A.,recapture) reported in the return for that taxation year (to be filed within the normal time,s.150) [s.216 (5)I.T.A.]. The rule applies only if there is some recapture [s.216(6) I.T.A.].

The old Act afforded the relief of an averaging provision only in the event that the non-resident had used that alternative for the last five years without interruption. Under the new law, s.216(7) simply provides that the non-resident, although imposed as a resident, is not allowed to resort to the forward averaging provision (s.61) normally restricted to residents. The taxpayer is entitled to average the income of the year of disposition of the property by means of the general formula (s.118).

For the non-resident having chosen the alternative of being imposed under Part I it does not follow that the resident payor or tenant is discharged from the obligation of deducting and remitting the amount

of the withholding tax. According to s.216(2)I.T.A. the remittance on behalf of the non-resident is simply deemed to have been made on account of Part I (rather than Part XIII) income tax. If there is any overpayment the amount in excess will be refunded to the non-resident.
A particular option of withholding the tax amount is granted to the agent of the non-resident if the latter undertakes to file the return within six months (instead of two years) of the end of the taxation year [s.216(4)].

The non-resident might be interested in employing a trustee resident in Canada to hold the real property on his behalf. Such an arrangement, however, may imply some undesirable consequences. If the using of a trustee created a trust (subdiv. k I.T.A.) the non-resident would no longer be entitled to the s.216 election nor to the benefit of a capital cost allowance.
In fact the non-resident would be a beneficiary from a trust residing in Canada and would suffer withholding tax on income from the trust [s.212(1)(c)I.T.A.]. The amounts received by him would not be paid to him on account of rent on real property and therefore s.216 would not be applicable[99].

The alternative of s.216(s.110 old Act) is provided only for real property as the statute clearly prescribes. This was pointed out, if the Act required, by the Exchequer Court in Lea-Don Canada Ltd. v. M.N.R.[100].
It was held that a non-resident leasing an aircraft to a resident could not have elected under s.110 old Act.

5. ROYALTIES

A. In General

As was said under paragraph 4, royalties are dealt with separately only for the practical purpose of organization, it being clearly impossible to draw a clear distinction with rental payments.

The taxing provisions [s.212(1)(d)(i) to (v)I.T.A.] are the same as under the old statute after s.106(1)(d) was revised in 1968-69. The main purpose of that revision was removal of any doubt about taxation of payments flowing to non-resident persons for technical assistance and know-how services. That explains why the statutory rule contains such a detailed list of taxable payments.

More simply, it appears that withholding tax is levied on royalties or similar payments which residents pay or credit to non-residents :

1) for the use of or the right to use in Canada any property --invention, patent,trade mark, secret process-- or other thing whatever, or payments which are dependent upon use of or production from property (whether or not such payments are instalments on the sale price);
2) for industrial,commercial and scientific information and services the consideration for which depends on use,production,sale or benefit therefrom;
3) for abstaining from use of such things or information.

To be added are timber royalties [s.212(1)(e)I.T.A.] provided in a special rule, because the common law concept of timber royalty is different

from that for taxation purposes[101]. The payees of such royalties are offered, as are non-residents receiving rents, the choice of electing for the alternative of s.216 I.T.A. and so of being liable for Part I tax on the net income.

The statute exempts from Part XIII tax payments in pursuance of bona fide reasonable cost share arrangements for research and development expenses in exchange for an interest in properties resulting therefrom.
It also exempts payments from a resident dealing at arm's length with the recipients if the payor may deduct the amount when computing the profit from a business carried out in another country.
The most important exemption is of royalties paid on copyright [s.212 (1)(d)(vi),(viii),(x)I.T.A.

The tax rate of 25 % [s.212(1)] will be only 15 % up to the end of 1975 [s.10(2)(a)Rules].

B. Know-how Payments

Even without employing the term "know-how" the courts had to deal with the problem of payments for technical assistance, as in Warsh & Co. Ltd. v. M.N.R.[102] A Canadian company had obtained the exclusive Canadian rights to the dress designs of a non-resident for a yearly base payment plus a percentage of the sale proceeds. The agreement provided that the "lessor" would also furnish some information, help and advice. The

Tax Appeal Board decided that the services were indivisible from the rights licensed, were a parcel of such rights and that the full payments, i.e. the fixed base plus the percentage, were royalties or similar payments.

The problem, however, became more complex when the judicial authorities were faced with know-how licensing agreements and know-how sales. To determine whether the payments based upon a know-how licensing agreement are royalties (or similar) and as such subject to the withholding tax, when flowing to non-residents, one had to examine the nature of "know -how", the nature of the royalties and whether know-how constituted a property.

About the nature of know-how the House of Lords observed in Rolls-Royce Ltd. v. Jeffrey[103] that it is " an ambience that pervades a highly specialized production organization". Giving concrete examples one of the speakers at the 1964 International Corporate Tax Conference[104] explained that "know-how may take the form of management skill, technical ability, financial means, patent protection, a well developed trade mark or trade name, or whatever else contributes to the success of an enterprise".

The second issue concerned the nature of royalties. As mentioned, royalty is not easily distinguishable from rent. Royalty has not a precise technical or legal meaning so there must be recourse to meanings established by industrial and commercial usage. Royalty may be described as compensation dependent upon use, production, or benefit,and rental described as a fixed payment related to a time measurement[105]. Payments for know -how,although generally computed by reference to production therefrom,

have not always been considered royalties.

The Rolls Royce case appears to suggest that payments for know-how based on production or use may be like royalties"in the sense that the measure of these recurrent payments is taken to be so many pounds sterling per engine manufactured and a fixed percentage of the commercial selling price". But they were not concluded to be royalties, perhaps because they were not payments made for the rendering of services. That was the conclusion of one Lord in English Electric Co. v. Musker[106], who suggested that in making know-how available these companies were teaching for reward and that the payments constituted remuneration for a service.

The result of both British decisions has been the drawing of a distinction between payments related to services and so entering the income from trade or business, and payments related to the use of property, so being the return from investment or mere passive ownership. The distinction is similar to that already established in the U.K. regarding revenue from patents[107].

In Canadian jurisprudence the principle of the Rolls Royce case was followed in Technical Tape Corp. v. M.N.R.[108]. A Canadian company had obtained know-how --technical and engineering assistance-- from an American corporation. The Canadian company paid a contractually fixed amount in some years and a percentage of the sales in others. After stating, without indicating any reason, that the fixed amounts were not in the nature of a rent or royalty as they had been arrived at by negotiation and mutual agreement, the Tax Appeal Board held that the other payments (percentage on sales) were in the nature of royalties because they were

calculated on the extent of the use made by the resident of the know-how supplied to him.

In the analysis of the character of royalties one thing seemed to be beyond dispute : the term was ordinarily used to describe compensation for the use of, or the right to use property. To constitute a royalty a payment had to flow from property (still cf. s.212(1)(d)(i)I.T.A.) and property in this sense may be tangible or intangible and includes proprietory rights[109]. Thus, in order to determine whether payments for know-how were royalties or similar to royalties, the final and essential question was that of determining whether the know-how was a property.

In Evans Medical Supplies Ltd.v. Moriarty[110], a know-how sale case in which the issue was whether a lump sum constituted capital or income receipt, the House of Lords held that secret processes and information composed a valuable property or business asset of the taxpayer. In Rolls Royce Ltd. v. Jeffrey again it was asserted that the know-how is undoubtedly an asset, even though it may be an intangible one which never becomes depleted.

Relying on the support of such an authority the Board stated in Technical Tape Corp. v. M.N.R. that without doubt the know-how was to be regarded as "property" in accordance with the definition of s.139(1)(ag)old Act [s.248(1)I.T.A.] which reads :

> "property" means property of any kind whatever whether real or personal or corporeal or incorporeal and, without restricting the generality of

> the foregoing, includes a right of any kind whatever, a share or a chose in action.

So the payments (found to be in the nature of royalties) were held to be royalties or similar payments falling within s.106(1)(d)old Act. Thereafter it seemed that knowledge, expertise, information would beyond any doubt be declared to be property.

In a later case the Exchequer Court rendered a decision along the same line : the confidential technical information (which was highly valuable, jealously guarded proprietary information), supplied by a non-resident to a resident corporation in return of fees at specified rates based on sales, was said to form trade secrets (analogous to secret processes) and could be classified as "other like property" -- the term being contained in the Canadian-American Reciprocal Tax Convention - and, therefore, the fees were royalties for the use of technical information, taxable under s.106(1)(d)old Act (Western Electric Co. Inc. v. M.N.R.)[111].

It was difficult,however, to say whether such a conclusion could be considered an absolute one. Two years earlier the same Court, judging a case similar to the earlier, above, where the members of an American coop-association by paying dues,fees and mechanical charges were allowed to use the trade-name and to receive different types of assistance (on production, quality control, advertising, marketing and organization of seminars), rejected the distinction operative in English jurisprudence between know-how as property and know-how as service. The Court held that the know-how provided had to be categorized in any event not as "property" or "other thing". The consequence was that no withholding

was to be retained (Quality Chekd Dairy Products Ass'n v. M.N.R.)[112]. Obviously the incertainty about the state of the law was great and it was difficult to foresee the courts' decisions[113].

The replacement of s.106(1)(d)old Act in 1968-69 with a new detailed list of situations in which payments flowing to non-residents are considered to be royalties or similar payments (corresponding to s.212(1)(d)I.T.A.) should avoid any doubt as to the application of the withholding tax to know-how supplies. The statutory provision expressly describes as royalties or similar payments those fees computed on a proportional basis for technical information and services.

C. Motion Picture Films

Like the old legislation,the new Act contains a special section providing that the withholding tax shall be levied on royalties paid to a non-resident for a right in or the use of motion picture films or films or video tapes related to television and used or reproduced in Canada [s.212(5)I.T.A.].

It is interesting to note that all payments made for a right in or the use of films that are to be reproduced in the country are comprised within the meaning of the statutory provision, whether or not such rights are derived from an outright purchase, as the Exchequer Court

decided in N.664 v. M.N.R.[114]

According to s.106(2)old Act the tax withheld on such royalties amounted to 10 %, which means that it was lower than the normal 15 % withholding rate. The transitional provisions of the new Bill will maintain the preferred rate of 10 % until the end of 1975 [s.10(2)(c)I.T.A.]. After that date the tax will increase to 25 %,so being equal to the withholding retained on other non-residents'incomes from Canada.

6. MANAGEMENT FEES

The withholding tax applies to management administration fees or charges paid or credited by resident persons to non-residents [s.212(1)(a)I.T.A.]. This rule was introduced in the old Act in 1963 with the main objective of checking the possible abuses consisting in the charging of excessive management fees by foreign parent companies to Canadian subsidiaries. Payments are taxed in those circumstances under which the label of management expense is used as a facade to withdraw profits which would otherwise be taxable [115].

What are management and administration services ? The expression refers to the kind of services related to management consultants --systems

development, organization studies, production planning, market research--as well as to services furnished by corporations' head offices to branches or by parent companies to subsidiaries : advertising, insurance, data processing equipment, special technical departments (legal,engineering, research, internal audit, credit and collecting, personnel relations, public relations, libraries, cost accounting, printing) and other group expenses on behalf of the operating divisions. This very large grouping includes services which sometimes can only be performed, because of the necessary facilities, by head offices.

It would, in other words, comprise all business facilities available from the head office[116].

It soon appears that such an extensive definition, proper and justified when the provision was enacted, could lead to an overlapping and confusion with the rule (as amended in 1968-69) prescribing the taxation of royalties or similar payments for industrial-commercial-scientific information and services [s.212(1)(d)I.T.A.]. Certainly it could be contended that a distinction would probably lie in the method of calculation of the fees, the royalties for know-how depending upon the production or profit therefrom and the management charges being generally more fixed. But that is not necessarily true. A case like that of Technical Tape Corp.[117] shows that know-how consideration may be fixed and, on the other hand, administration charges could also be computed in a proportionate way.

So a more restricted conception would seem appropriate it having been stated in Parliament that the government intended to impose amounts paid for advice or direction pertaining to the operation or administration of a company, not including those paid for identifiable services(transpor-

tation, insurance, advertising, accounting and research)[118]. In support of a narrower view it has been suggested that the provision will only apply, as a matter of law, to payments for the kind of thing or activity that a board of directors and the top executive management of a corporation would themselves perform in the current business operations[119].

The withholding is theoretically not levied on all management fees paid to non-residents, as s.212(4)I.T.A. avoids taxability :

- of services performed by a non-resident in the ordinary course of a business, including such services for consideration, provided that he deals at arm's length with the payor :
- of specific expenses reimbursed to a non-resident who incurred them in rendering a service that was for the payor's benefit.

The general condition is,moreover, that the amount was reasonable in the circumstances.

But the effectiveness of s.212(4) is limited because it requires arm's length relationships but primarily applies to transactions that usually occur between parent companies and their subsidiaries. It is understandable that Canadian subsidiaries of foreign corporations may find it useful to "pay" the parent companies high management fees and administrative charges, so minimizing their own corporate income tax and the withholding tax suffered by the parent companies on subsidiaries'dividends.

It has been suggested, with some tentativeness,that the provision taxing the management fees, being particularly intended to prevent abuses in inter-company pricing, was perhaps dispensable. Legislation has other means of counteracting such abuses. In fact administration charges

in excess of a reasonable amount are not deductible [s.67 I.T.A.; s.12 (2)old Act],only the reasonable portion being allowed [s.69(2)I.T.A.] [s.17 old Act]. The excess is treated as a dividend flowing to non-resident shareholders according to s.214(3) [s.108(5)old Act] if it is an indirect payment or transfer or appropriation of funds[120].

It is interesting to notice that the law excludes taxability of management fees using two different criteria.

In one situation, which could only exist between independent parties because an arm's length relationship is required, the exemption [s.214 (3)(a)I.T.A.] concerns the whole reasonable amount paid for management services to a non-resident dealing at arm's length. The concept of arm's length value is the same as that one employed in s.69(2) to limit the price which the resident is entitled to deduct as an expense. On the arm's length value basis[120] underlying costs are almost ignored and the fees are determined according either to an estimated market value of the services furnished or to the value of the benefits received.

The other situation is one particularly useful for inter-company services, as no arm's length is required. The statute [s.214(3)(b)] exempts from withholding tax the portion of the charge that corresponds to specific costs incurred by the non-resident performing the services. But such costs must be reasonable. The criterion of cost level appears to conflict with the arm's length value prescribed in s.69(2) as to the deductibility of the payment (not only the costs) for the payor. On the cost basis[120] actual expense constitutes total charge and the payee --usually the company or the head office-- does not realize any profit or incur any loss.

In the event that management services are performed in favour of Canadian residents outside Canada, the withholding tax of s.212(1)(a) becomes a protectionist duty much more than an income tax, as the statute reads.

And what if the services are rendered in Canada ? Before the 1968-69 amendment of s.106(1)(d)old Act it was suggested[121], by reference to United Geophysical Co. of Canada v. M.N.R.[122](relating to technical service more than management), that such services would constitute carrying on business in Canada. In this event non-residents would have been caught under s.2(2) and 31 old Act and exempted from withholding tax by s.805 old Regulations. It now may be contended, especially when accepting a restricted conception of management services as distinguished from technical services and information (covered by s.212(1)(d)I.T.A.), that management and administration activity does not constitute carrying on business in Canada even if performed in the country: it is not covered by the extended meaning of carrying on business in Canada given in s.253. The same thought may be extended to technical information and know-how services as referred to in the Act after the 1968-69 amendment. In such case there would not be any reason for imposing profit under Part I I.T.A.. The imposition could only be through withholding tax.

7. TRUST AND ESTATE INCOME

Income flowing from a trust or estate to non-resident persons are

subject to the withholding tax [s.212(1)(c)I.T.A.].
The taxing provision applies to all payments made by a trust to beneficiaries or other persons beneficially interested (otherwise than on capital distribution) regardless of the source from which the trust derives the gain [s.212(II)I.T.A.]. Thus it has been mentioned under paragraph 4 that a non-resident owning real estate or timber right may be at a disadvantage if he chooses to hold it through a Canadian trustee, for he will be deprived of the alternative of s.216.

Beneficiaries residing in other countries and suffering the withholding tax on the gross amounts of their receipts [s.214(1)I.T.A.] may not benefit at all by capital cost allowances and depletion allowances to which resident beneficiaries are entitled according to s.104(16) and (17). With particular reference to depletion deduction which a trustee desired in computing the trust's income from royalties on oil wells before distributing income to non-resident beneficiaries, it was held that no depletion allowance --a mere deduction from income-- could be claimed according to the withholding tax rule (National Trust Co Ltd., trustee of S.Gorman v. M.N.R.)[123].

The withholding tax is not imposed in some cases. One exemption concerns trusts created before 1949 all the beneficiaries of which reside in the same foreign country from which the trust itself receives the whole of its income: s.212(10).
Another exemption applies to situations in which the trust is only an

intermediate, the effect of which would be to deny the beneficiaries some privileges granted to them if they acted personally.So if non -resident beneficiaries' income from a trust may reasonably be regarded as royalties which the trust earned on copyright (normally non-taxable, s.212(1)(d)(vi)), no Part XIII tax will be withheld, according to s.212 (9)(b)I.T.A. The same is provided for those interests and dividends, other than taxable or capital dividends, which a non-resident-owned investment corporation distributes to a trustee --s.212(9)(a)---. The condition is the reasonableness of the amount then paid on this basis to the beneficiaries. This rule makes the exemption applicable only to dividends given out of tax-paid undistributed income and 1971 capital surplus [s.83(1)I.T.A.]. However, the corporation must have complied with the prescribed election, for if it does not elect then such dividends are taxable [s.89(1)(j)I.T.A.]. In contrast to s.106(4) old Act the restriction regarding such dividends is owing to the fact that now dividends distributed by non-resident-owned investment corporations are no longer tax-free.

According to s.212(1)(c) income from trusts does not include beneficiaries' designated capital gain. According to s.104(21) a trust may designate a portion of its net capital gain, that can reasonably be considered to have been part of the trust income (paid or payable) of a beneficiary, as being taxable capital gain of that beneficiary from disposition of capital property.Because of the designation such portions of capital gain could be deducted in computing the income of the trust and included in the income of the designated beneficiary.

In the event that the particular beneficiary is a non-resident person, s.104(9) prohibits the trust from claiming any deduction. For that reason no withholding tax will be levied on that part of the beneficiary's income.

If no designation is made by the trust under s.104(21) the non-resident beneficiary will suffer the withholding tax on all his trust income.

It is noticeable that property, in respect of which the trust may allocate a portion of taxable capital gains to a beneficiary, must only be a capital property. S.54(b) defines as capital property any depreciable property of the taxpayer and any other property on disposition of which the taxpayer would pay capital gain taxes (or claim capital losses).

If the non-resident owned directly (instead of through the trust) he would according to s.2(3)(c) be taxed only on capital gains realized on taxable Canadian property, which comprises a certain number of items listed in s.115(1)(b)I.T.A. (realty, business property, shares, capital interest in trusts).

When a trust makes payments to its beneficiaries the amounts so paid are deductible in calculating the trust income [s.104(6)I.T.A.]. If the payable beneficiaries are non-residents no deduction is allowed unless the trust itself is resident in Canada [s.104(7)I.T.A.].

However, when all the property is owned by the trustee for the exclusive benefit of non-resident beneficiaries or their unborn issue, dividends and interest which the trust receives from non-resident-owned investment corporations are deductible by the trust even though they are not

payable to the non-resident beneficiaries in the year [s.104(10)]. The Act provides, moreover, that such dividends shall be deemed transferred as trust income to the beneficiaries --s.104(11)-- and so submitted to the withholding tax [s.212(1)(c)I.T.A.].

Finally, when the non-resident is beneficiary of an inter vivos trust doing business in Canada the trust is disallowed by s.104(8) any deduction for amounts it pays to the beneficiary. Such amounts suffer Part XIII tax.

V. THE NON-RESIDENT-OWNED INVESTMENT CORPORATION

The non-resident-owned investment corporation (NRO) provided by s.133 I.T.A. (s.70 old Act) constitutes an useful vehicle for non-residents who wish to invest in Canada or to make their international investment operations from a Canadian basis and prefer to do that through a company. The effect of the rules relating to NROs is ultimately to tax the non-resident shareholders of such companies in the same manner as they would have been taxed if they had invested directly. The concept of NRO is essentially the same as under the old legislation, the NRO being a company whose shareholding substantially belongs to non-residents and whose activities and earning sources are listed in the statutes.

The new law, however, is somewhat more restrictive. In order to qualify as an NRO, a company has to meet some supplementary requirements as to the shareholding and as to the continuity of the NRO qualification.

A mayor change is that dividends flowing to non-resident shareholders are now subject to the withholding tax, except in the case of special dividends. This does not imply that NROs are taxed twice, as both company's profit and dividends. The new Bill introduces,as in other matters, a system refunding the prepaid corporate special income tax when the NROs distribute taxable dividends. The refund is not total, only applying to tax paid on income, not on capital gains. Moreover,

the tax rates have increased. Therefore NROs and their shareholders now suffer a heavier tax burden. The new provisions are complicated and they contain new concepts based on highly technical definitions.

A. Definition

To qualify as a NRO a company has to meet all requirements set out in s.70(4)old Act.

The incorporation has to take place in Canada so that the company will necessarily be resident in this country. The company must have been continuously an NRO from June 18,71. until the end of the relevant taxation year. If it has been created later, the corporation must always have been an NRO. This condition of continuity was non-existent under the old Act.

Another new prescription is that if the corporation results from an amalgamation after the Budget Day 1971 the merging companies had themselves to be NROs.

All companies' bonds,debentures and other funded indebteness must be beneficially owned by non-residents other than foreign affiliate of residents or by their trustees or by other NROs. The same rule applies to all issued shares. Because under the previous system such prescription only concerned 95 % of the shareholding, s.59(2) Application Rules prescribes that the 95 % requirement instead of 100 % lasts until 1976.

The income of the company may only derive from : ownership of or trading and dealing in bonds, shares, debentures, mortgages, bills, or notes; lending money; rents, hire of chattels, or charterparty fees

up to a maximum of 10 % of the gross revenue; interest, dividends and royalties; estates and trusts; or disposition of capital property. It is important to stress that the income may originate from Canadian or foreign sources.

The principal business of the company must not be the making of loans, trading or dealing in securities.

Finally, the company must elect and not revoke under this section within 90 days of the commencement of its first taxation year after 1971. All NROs, even if they have elected to be treated as such in the past, must reelect under the new Act or incur the loss of their status[124]. When a company complies with all these statutory conditions it then qualifies as an NRO and is entitled to special tax treatment.

Sometimes doubts may arise about the qualification of a corporation as an NRO. In Cayuga Realty Ltd. v. M.N.R.[124a] the Revenue argued that an NRO (all shares of which were owned by non-residents), which had acquired two parcels of revenue-producing real estate, and which had partially paid the price and partially assumed a mortgage (which had three years to run) in favour of a Canadian resident, was no longer an NRO. The Tax Appeal Board refused to accept the contention and held that the prescription of s.70(4)(a)old Act [s.133(8)(d)(i)I.T.A.] referred to the capital structure of the corporation and not to assets it acquires in the course of the business. The Board also said that real estate mortgages are not included in funded indebtedness. In another case a company principally involved in stock and bond investment had given a sub-guarantee for two loans and received for

that a "commission". It was decided the company was not allowed to qualify as an NRO. The corporation, in fact, had engaged in the business of providing guarantees and money it received was the reward of a personal service. The payments were neither attached to the ownership of assets possessed by the corporation nor income from lending money (N.479 v. M.N.R.)[125]

B. Computation of Income and Tax

The law establishes certain rules for the purpose of computing the income of an NRO.

So capital dividends distributed by private corporations which generally are not computed as shareholders' income [s.83(2)(b)] are to be included in the income of an NRO shareholder in a private corporation : s.133(1)(e).

In contrast with the other taxpayers for whom only one half of the capital gains are taxable, an NRO must include in its income the full amount of capital gains or deduct the full amount of capital losses: s.133(1)(c)+(d)I.T.A.. The only capital gains taken into account are those realized on taxable Canadian property, as defined in s.115(1)(b) in regard to taxation of capital gains realized by non-residents. In relation to NROs, taxable Canadian property comprises real estate in Canada, shares in private corporations, and shares in public corporations if the NRO owns or controls not less than 25 % of the issues shares.

The result of this definition is to permit an NRO to make tax-free

capital gains on the sale of non-Canadian investments and on certain Canadian investments. This in accordance with the legislator's intention of taxing an NRO to the same effect as a non-resident[126].

When calculating the profit of the corporation no deduction may be made for mining depletion allowances nor for interest paid on bonds, debentures, securities and other indebtedness : s.133 (1)(a)+(b). This latter constitutes a major prohibition. The expression "other indebtedness" has to be broadly interpreted, as the Exchequer Court held in Peninsular Investments Ltd. v. M.N.R.[127]. The Court decided that such terms cover not only obligations secured or evidenced by securities but also obligations arising even from transactions other than borrowing. The reason why an NRO is denied to deduct any interest it pays off is that such interest flowing to non-residents is exempt from withholding tax. This rule may seem interesting for non-residents who have financed the company by lending money rather than by acquiring equity. But it is not in favour of the NRO itself or of the shareholders who only own stock, for the company suffers on these non-deductible amounts its own income tax, which is practically equivalent to the withholding tax. Having less after-tax profit available for dividends it cannot obtain any refund for that part of its income tax.

Other ordinary business expenses are normally deductible in order to determine profit.

No deductions from the net income are allowed when calculating the taxable except those specifically listed in s.133(2). These possible deductions are interests received from other NROs; net capital losses carried over from the years (and to be applied only against capital gains); and foreign tax paid, the NROs not being entitled to foreign tax credit [s.133(4)I.T.A.].

On its taxable income the NRO will pay tax computed at a special rate of 25 % as stated in s.133(3).

However, this comparatively simple taxation system will not apply until 1976, as another scheme is provided for the transition period 1972-75 by cl.59(1)(a) Application Rules. The corporate tax will be calculated as follows:

- 25 % of the lesser of the taxable income or the (full) net capital gains (i.e. after deduction of capital losses suffered in the year and carried over) on taxable Canadian property; plus
- 15 % of the excess, if any, of taxable income over net capital gains.

That means that capital gains of the NRO will suffer a 25 % tax from 1972, whereas its other income will be taxed at 15 % until the end of 1975 and then at 25 %. In regard to this transitional rule the new Bill has been amended so as to make the 25 % tax on capital gains immediately effective.

The tax remitted by an NRO is not definitive, for part of it will be refunded upon distribution of dividends --now caught under

Part XIII tax-- by the company, as will be seen later on.

C. Dividend Distribution

Discussion of distribution of dividends requires that a distinction be made between taxable dividends and exempt dividends.
In contrast with the old legislation taxable dividends necessarily paid out to non-resident shareholders will now suffer withholding tax, for there is no longer an exemption rule. According to s.133 (8)(e) taxable dividends do not include capital gains dividends.
By virtue of s.212(2) NRO capital gain dividends are exempted from withholding tax, which applies only to taxable dividends.
By means of the general principle of s.89(1)(j) dividends out of the tax-paid undistributed income or 1971 capital surplus on hand, if so elected, are not taxable dividends and therefore are not subject to withholding tax [s.212(2)I.T.A.]. It appears[128] that such provision concerns NROs too, for they are Canadian corporations in accordance with s.89(1)(a), as required by s.83(1)I.T.A.
This opinion finds confirmation in the new Bill's prescriptions on the computation of NROs'1971 undistributed income and capital surplus as well as in s.134, which says that a NRO cannot be considered a Canadian corporation except for the purposes of certain sections.
To summarize, the withholding tax --15 % until 1976 and then 25 %-- is levied on dividends other than capital gains dividends and those

out of undistributed surplus if the necessary election has been filed.

Before it was amended the new Bill did not allow distribution of tax-free dividends out of accumulated capital gains. The tax burden (50 % of the gains) would have been so heavy that shareholders would have preferred to act directly, and paying a maximum tax of 30 % (60 % of half the gains), rather than through an NRO. The new s.133(7.1) reads that an NRO may decide to distribute capital gains dividends.

The conditions are that the company have no 1971 undistributed income on hand, that the amount so designated not exceed the capital gains dividend account and that the company regularly so elect.

The payment of such tax-free dividends depends, as mentioned, on the "capital gains dividend account" a new figure defined by s.133(8) (c) as:

- the capital gains of all years after 1971, ending at the time of election, from dispositions of Canadian property (whether or not taxable) and of shares of other NROs; plus the capital gains dividends received from other NROs;
- minus the aggregate of :

the capital losses from disposals of Canadian property or shares of other NROs; 25 % of the net capital gains --they have been fully included when computing the corporation's income-- on taxable Canadian property; the capital gains dividends paid by the NRO

after 1971.

This prescription refers to Canadian property[128a], whether taxable or not, described in s.133(8)(b) as comprising property other than foreign property in the meaning of s.206(2)I.T.A.. It follows that capital gains from non-Canadian property do not benefit from the privilege of being distributed as capital gains dividends. They can flow to the shareholders only as taxable dividends liable to Part XIII tax.

Even if the withholding tax is the only Canadian tax paid on such gains --they are not imposed within the income of the NRO-- it appears that the law, in contradiction with the basic philosophy relating to such special status corporations, penalizes the shareholders of the NRO. Otherwise non-residents do not suffer any Canadian tax on foreign capital gains.

An NRO may, if a Canadian corporation,[129] distribute tax-free dividends out of its tax-paid undistributed income and 1971 capital surplus if it elects in accordance with s.83(1)I.T.A.

The determination of such 1971 figures is modified by a special rule in the event that the NRO has been at some previous time a normally taxable corporation. Thus the 1971 undistributed income hand must be diminished by the difference between that income and the corporation surplus at the end of 1971 for the years during which it was an NRO. This same amount shall then be added when computing the 1971 capital surplus on hand: s.133(5).

D. Refund of Tax

It has been mentioned that income tax paid by the NRO may be refunded if it makes dividends available to the shareholders, taxable dividends being subject to withholding tax. The purpose of refunding tax previously paid by the NRO and then assessing withholding tax (perhaps modified by treaty) on dividends is to ensure that the final tax burden will reflect the rate of Part XIII tax properly applicable to the shareholders[130].

The only tax which may be refunded is the tax paid by the NRO on its income but not the portion suffered on its capital gains or on non-deductible interest. The only way to become entitled to a reimbursement is by distribution of taxable dividends alone [s.133(8)(e) and s.212(2)] since payment of capital gains dividends does not count for such purpose.

The question of how much an NRO may receive back from the Revenue necessitates recourse to new fiscal figures requiring a very technical presentation.

The amount to which an NRO is entitled is called "allowable refund"; according to s.133(8)(a) it can be expressed through a formula :

$$\text{allowable refund} = \text{taxable dividend paid in the year} \times \frac{\text{allowable refundable tax on land}}{\text{greater of}\ \begin{cases} - \text{ taxable dividend paid} \\ - \text{ cumulative taxable income} \end{cases}}$$

The "allowable refundable tax on hand" is defined by s.133(9)(a) as:

- taxes paid as an NRO during all years after 1971; plus 15 % of the 1972 taxable income (if the taxable year started in 1971) excluding dividends received and deducting dividends paid off before the end of 1971;
- minus the aggregate of :
25 % of the net (full) capital gains from dispositions of taxable Canadian property after 1971; 1/3 of interests paid after the beginning of the 1972 taxation year (that being 15/85 for the transition period, cl.59(1)(b)Rules);and the allowable refund for the previous years.

The "cumulative taxable income" is described in s.133(9)(b) as:
-taxable incomes for all years after 1971; plus the 1972 taxable income (if the taxation year started in 1971) excluding dividends received and deducting dividends paid out before the end of 1971;
- minus the aggregate of :
net (full) capital gains on disposals of taxable Canadian property after 1971; 4/3 (or 100/85 until 1976) of the interest paid after the 1972 taxation year began; the taxable dividends paid since the first taxation year after 1971.

The allowable refund will be obtained without following any special procedure, s.133(6) simply establishing that the NRO must have filed its return within four years of the end of the year, which is not a severe condition. If the refund is available before the NRO is assessed, then the Department refunds it without application by

the taxpayer. But if the notice of assessment has been mailed before any allowable refund can be obtained, then the NRO must make application within four years of the end of the taxation year in order to oblige the Minister to repay.

It is also provided [s.133(7)I.T.A.] that where the NRO has or is going to have other tax liabilities the allowable refund will not be reimbursed but will be deducted from those amounts.

E. Capital Gains on Sale of NRO Shares

It has been said[131] that the most obvious injustice in the manner in which the new Bill treates the NROs arises from the fact that the non-resident shareholders will be liable for tax on capital gains realized on dispositions by them of such NRO shares. This is true and seems to contradict the idea that the NRO need only be a vehicle used by non-residents and that non-residents will not suffer a heavier burden than they would if acting personally.

The new legislation,however, imposes them on the variation in value of the NRO itself. It appears that in any case such tax will be paid indipendently of the percentage shareholding of the non -residents. Even if an NRO could theoretically be a public corporation (in which case ownership of 25 % would be a condition of taxability), it seems improbable that an NRO could comply with the prescriptions of s.89(1)(g) + Regulations. Thus the NRO being a company resident in Canada (other than a public corporation), any gain realized by

non-residents on disposition of shares will fall within s.115(1)(b)(iii)I.T.A..

The injustice is in a double taxation, one generally not intended when taxing NROs and their shareholders. Part or all of the capital gains obtained by the shareholders (when disposing of the shares) may be attributed to gains realized by the NRO itself on disposals of Canadian property.

If such gains were distributed to the shareholders they would be tax-free capital gains dividends because the gains have already been imposed within the NRO's income. If the NRO does not distribute them they increase the value of shares and, when disposed of, create a capital gain taxed in the hand of the shareholders.

VI. THIN CAPITALIZATION

A. In General

The new legislation introduces prescriptions to restrict so-called thin capitalization and, at the same time, to prevent one of the easiest types of tax avoidance open to non-residents.

Non-resident who wish to operate businesses or to invest through companies residing in Canada, may find it advantageous to finance their corporations by lending money to them rather than by subscribing share capital. This practice is called thin capitalization: the non-residents finance their Canadian companies through debt obligations instead of equity. The interest these companies pay on borrowed funds can be deducted as an expense, thus minimizing profits subject to corporate income tax.

Of course this device may also be used by residents, but the result is completely different for Revenue, which can only levy the withholding tax of 15 % or 25 % on lenders who do not reside in Canada, but would almost surely levy a higher tax on lenders who live in this country and pay their income tax at a progressive rate which may exceed the 50 % corporate rate. Moreover, residents are less tempted to engage in debt financing than non-residents, for when receiving dividends, residents benefit from the dividend tax credit not available to non-residents.

Dividends distributed to non-residents represent earnings which have suffered both corporate plus withholding tax, whereas interest payments flowing to non-residents interested in or controlling companies operating in Canada, represent income only imposed under Part XIII I.T.A. Were it not for these restrictions, the use of thin capitalization to gain tax advantages would have increased under the new Act, because it allows resident corporations to write off the interest paid by them on money borrowed for the purposes of acquiring shares in other corporations, thus abolishing the obvious discrimination under the previous act which allowed foreign companies to buy out Canadian entities at terms more advantageous than those available to resident companies.

The philosophy which the new provisions are based upon is implemented when such interest remunerations are treated in the same manner as dividends. Under some circumstances, interest paid to non-residents is disallowed as a deduction and so remains taxable. Because such interest continues to be liable to withholding tax, the final result is the same as if the non-resident had a larger shareholding and received dividends. The determinant circumstances evolve out of the proportion between the corporate equity and the debt outstanding to certain non-residents. The prohibition for the companies to deduct interest affects only a portion of the interest paid to the same non-residents. When the new Bill was first enacted, the thin capitalization provisions were extremely severe, because they

prohibited deducting interest payments regardless of the creditor, but later amendments have reduced this severity.

B. Loans to Companies

The restriction of deducting applies to interest to be paid on outstanding debts to specified non-residents.
Specified non-residents are of two types : a) shareholders who, alone or together with persons with whom they do not deal at arm's length own at least 25 % of the issued shares of any class and who are either non-resident persons or non-resident-owned investment corporations; b) non-resident persons or NROs who do not deal at arm's length with shareholders described above, but hold no shares themselves [s.18(5)(a)I.T.A.]. The creditor may also be a resident --a"subsequent lender"-- making a loan to the company because another taxpayer --a"first lender"-- has loaned money to him or to another third person on condition that the subsequent lender lend money to the company [s.18(6)]. It is submitted that the "first lender" will probably, but not necessarily, be a specified non-resident, for s.18(6) employs the word "taxpayer" rather than "specified non-resident".

Most of the commentaries relating to the new Bill describe the non-resident creditors as being foreign parents of Canadian subsidiaries. Such a statement could be misleading, but is probably the result

of the facts that the most obvious situations of thin capitalization arise in inter-company relationships and that s.18(4)(a)(ii)(B) refers to designated surplus, a concept used when one corporation takes over another. It is stressed that provisions penalizing thin capitalization affect non-resident individual shareholders,too.

Any company residing in Canada and having non-resident shareholders falls within such rules [s.18(5)(b)I.T.A.],except NROs, which are always denied the right to deduct the interest they pay out according to s.133(1)(a). The restriction has not been extended to trusts carrying on business in Canada[132a].

C. Disallowance for Interest Payment Deduction

S.18(4)I.T.A. establishes which proportion of interest paid by the company to non-residents may not be deducted. This may be explained through a formula . If :

A = greatest amount of outstanding debts to specified non-residents in the year;

B = corporations paid-up capital limit (defined by s.89(1)(e) as the paid capital minus the paid-up capital deficiency);

C = tax-paid undistributed surplus on hand at the beginning of the year;

D = 1971 capital surplus on hand;

E = capital dividend account [s.89(1)(b)];

F = amount which would be the designated surplus (see Part VII I.T.A.) if the control of the company were acquired by another corporation;

G = interest paid on outstanding debts to specified non-residents in the year

then the proportion of interest paid to non-residents which is not deductible by the company will be equal to :

$$\frac{A - [3 \times (B + C + D + E + F)]}{A} \times G$$

The outstanding debt is constituted [s.18(4)] by all interest-bearing obligations owing by the company to specified non-residents. The limitation does not apply to non-interest-bearing debt, specially not to interest-exempt current accounts between parents and subsidiaries[133]. Loans granted by persons who are not specified non-residents are not taken into account at all.

As already mentioned, the limitation affects only that interest which is related to debts owed to specified non-residents in accordance with an amendment of the new Bill which before revision disallowed interest related to debts to any lenders.

The sum of B+C+D+E+F represents the equity of a corporation. Roughly speaking, the company's equity for tax purposes can be obtained by

using tax values for assets and liabilities (with some major accounting and fiscal adjustments) in the computation of the corporation's net worth[134].

The formula of s.18(4) was not immediately enforced in conjunction with the other provisions of the new Bill when it was enacted on January 1,1972.

In order to alleviate the problems of thinly capitalized companies and to give them time to rearrange their financial structure, transitional prescriptions permit the amount calculated for the disallowance of interest expense to be reduced by a figure related to a company's "base year" (the tax year commencing before June19, 1971).[135] For the two taxation years following the taxation year starting in 1971 s.22(2) Application Rules provides another formula to be combined with that of s.18(4)I.T.A..

The provision of s.22(2) Application Rules has been explained in very clear terms in one of the latest commentaries on the new Act[135a]:

If:

A = greatest amount of outstanding interest-bearing indebtedness to specified non-residents during transitional year;

B = last amount of outstanding interest-bearing indebtedness to specified non-residents during base year;

C = equity for the base year;

D = equity for transitional year;

E = interest paid on outstanding interest-bearing indebtedness to specified non-residents during transitional year

then the disallowed proportion of interest paid to specified non-residents will be equal to :

$$\frac{A - [B - (3 \times C)] - (3 \times D)}{A} \times E$$

VII. CAPITAL GAINS

1. IN GENERAL

Since 1917, when the first income tax legislation was enacted in Canada, capital gains were tax-free. The new tax law,however, makes such gains taxable -- a most significant and controversial innovation. This fundamental aspect of the new tax system affects residents, non-residents who realize capital gains on disposition of certain Canadian property, and persons who cease to be residents.

Taxation of capital gains of non-residents will figure significantly in the treaties' renegotiation program of the government.
The majority of present tax conventions between Canada and other countries provides that a person residing in one treaty country and disposing of property in another treaty country shall be subject to capital gain taxation of the country in which he resides if the person realizing the capital gain has no permanent establishment[136] in the country in which he disposes of his assets. In other words, Canada has undertaken not to levy any tax on capital gains realized in Canada by residents of treaty countries. Such an undertaking previously posed no problem because Canada had no capital gains taxation of any sort, but was nevertheless necessary in order to ensure the tax exemption to Canadian residents obtaining gains when

selling property in countries that would otherwise have taxed them. In some treaties, the exemption covers all gains derived from the sale or exchange of assets (e.g. Art VIII Canada-U.S. Reciprocal Tax Convention); in other treaties, the privilege is limited to capital gains other than those from real estate (e.g. Art.12 Canada -U.K. Income Tax Agreement).

Although the new Bill applies to non-residents the taxation of capital gains, it appears that such rules cannot be applied to non-residents who abide in treaty countries unless the conventions are either renegotiated or terminated.

Another hypothesis does not seem probable at all. The federal government has declared that it intends to revise the existing treaties and to enter into new agreements. The negotiation of new conventions and the amendment of those now in force may prove difficult, and if the government wants to achieve its purpose by 1976, as it has said, Canada will have to make some concessions. These would consist of the exempting of capital gains (or some of them) made by non-residents in Canada or accepting that Canadian residents are taxable in other countries on the gains realized there.

With respect to some treaties, the principle of taxing capital gains will probably be determined by residence (as provided now), except perhaps for real estate and capital assets effectively connected with a permanent establishment in Canada[137].

The general rules applying to the taxation of capital gains of

non-residents are largely the same as for residents: it lies far beyond the purpose and limits of this paper to analyse such technical details of the new legislation.

It should be noted,however, that capital gain (capital loss) means the gain (loss) from the disposition of any property other than eligible capital property, resource property, or life insurance policies [s.39(1)I.T.A.]. The capital gain is arrived at by deducting from the proceeds of disposition (sale price, other compensation, insurance or expropriation proceeds) [s.54(h)I.T.A.] the adjusted cost base (defined in s.54(a) and determined by s.53) and the expenses related to the disposition [s.40(1)]. Capital gains are caught under taxing provisions not only when assets are effectively disposed of, but also in various events that constitute "deemed dispositions" (dispositions by way of gift,changes in the use of assets, and especially the death of taxpayers) [s.70(5)I.T.A].

According to s.38, the taxable capital gain is one half of the capital gain and the allowable capital loss, one half of the capital loss. Generally speaking, the allowable capital losses for the year may be deducted from the taxable capital gain [s.3(b)]. The net capital gain so obtained is included in the taxpayer's income and taxed at his own rate. Thus the final result is the same as in the United States where the full net capital gain is imposed at a rate equal to the half of the taxpayer's one.

Individuals are allowed to make a supplementary deduction of capital losses up to 1,000 $ against their other income [s.3(e)(ii)I.T.A.]. Net capital losses may be carried back one year and forward for an indefinite number of years up to total absorption [s.111(1)(b)]

unless the taxpayer is a corporation whose control changes [s.111 (4)]. If the taxpayer dies, the whole of the unabsorbed net capital loss may offset income from other sources [s.71 and 111(2)]. Properties giving rise to capital gains have been separated into different classes (personal use property, listed personal property) in order to restrict the deductibility of capital losses from capital gains in the same class, instead from capital gains of any other class, and to establish a minimum amount --$ 1,000-- referring to which certain gains and losses will be computed for tax purposes.

2. NON-RESIDENTS

As mentioned, the new Bill imposes tax on certain capital gains realized by non-residents.

The first rule is contained in s.2(3)(c)I.T.A. which reads that non-residents who have disposed of a taxable Canadian property in the year or in a previous year will pay an income tax in Canada. The general provision of s.3(b) states that only net taxable capital gains --i.e. taxable capital gains less allowable capital losses-- are included in the taxpayer's income; it follows that non-residents will suffer the income tax only on net taxable capital gains derived from disposition of taxable Canadian property.

Just as non-residents holding employment or carrying on business in Canada must file a tax return, so now must non-residents who dispose of taxable Canadian property, and their tax will be calculated

by reference to their own applicable tax bracket if they are individuals or to the fixed corporate rate if they are companies. If the non -residents have income from other sources, their taxable capital gains will be added to it.

A. Taxable Canadian Property

The only taxable capital gains of non-residents [s.115(1)(a)(iii) I.T.A.] are those from disposition of taxable Canadian property, a concept comprising a certain number of property items listed in s.115(1)(b)(i) to (viii). After Bill C-259 was given first reading in Parliament, some minor amendments were made.

The items of taxable Canadian property as amended are :

- real property in Canada or interests therein;
- capital property used in carrying on business in Canada;
- shares, or interests in shares, of corporations resident in Canada other than public corporations;
- shares, or interests in shares, of public corporations if at any time during the five years preceding the disposition or the part of those years following 1971, the non-resident and/or related persons(i.e. those with whom he does not deal at arm's length) owned not less than 25 % of the issued shares of any class of the capital;
- an interest in a partnership if at any time in the 12 months preceding the disposition or the part of those months after 1971, at least 50 % of the fair market value of the partnership property,

including the money at hand,consists of taxable Canadian property;

- a capital interest (defined by s.108(1)(c) as a beneficiary's right to receive any part of the trust's capital) in a trust resident in Canada other than a unit trust;
- a unit in unit trust [s.108(2)] other than a mutual fund and residing in Canada;
- units of mutual fund trusts (defined in s.132(6)I.T.A.) if at any time in the five years before the disposition of that part of those years after 1971, the non-resident taxpayer and/or related persons owned at least 25 % of the issued units.

The notion of taxable Canadian property is narrower than that of Canadian property; the latter is defined nowhere in the Act, but may be assumed to be anything that is not a foreign property according to s.206(2). Such is assumed in the case of NROs, for which the concept of Canadian property [s.133(8)(b)] plays a significant role in some provisions. Non-taxable Canadian property typically comprises portfolio holdings of public corporation shares or mutual fund trust units, if less than 25 % of the corporation or trust and most of the Canadian debt securities (bonds, debentures, mortgages, hypotecs, etc.). Capital gains which non-residents obtain on such Canadian property are not taxed in Canada.

This is true particularly in the case of public corporation shares which non-residents may dispose of without paying any attention to tax consequences. For this reason, non-resident shareholders will favour the distribution of dividends out of surpluses [s.83(1) I.T.A.]. The reduction of the adjusted cost basis of shares, normally

caused by such dividends, does not affect non-residents (Moreover, the same dividends are not taxable and not liable for withholding tax [s.212(2)]).

When the capital gains of the year are large, individual taxpayers are often interested in spreading them over the years;for this purpose, they may consider either a general averaging or a forward averaging annuity. Non-residents, however, do not have such choice: the only device they can use is the general averaging [s.117(2); s.61].

If non-residents suffer foreign taxes (capital gain or income) when disposing of their taxable Canadian property, they cannot claim any deduction against the tax payable in Canada, for the foreign tax credit [s.126] is a relief exclusively granted to residents. Finally, s.40(2)(a) expressely denies to non-residents the reasonable reserve that s.40(1) allows for an amount not yet received from the sale of assets (deferred capital gains).

B. Enforcement of Tax

The legislature has paid particular attention to the means by which the avoidance of capital gains tax owed by non-residents may be prevented. To this end, it has enacted provisions setting up a system of "compliance certificates" for the purpose of ensuring tax collection. There are two types of certificates : one must be requested of the Department by the non-resident, the other is

optional and depends on the non-resident taxpayer's choice. The system is so organized that a purchaser --presumably a resident,but perhaps a non-resident-- risks suffering an ultimate liability, if the non-resident vendor fails to comply with legislation regarding those certificates.

Before the disposition

A non-resident who intends to dispose of his taxable Canadian property, except shares of public corporations and mutual fund trust units, may inform the Minister of Finance of the identity of the purchaser, the property to be sold, the estimated proceeds, and the asset's adjusted cost base (the result being the expected capital gain)[s.116(1)]. There is no obligation to follow this procedure.

After paying Revenue 25 % of the foreseen capital gain (i.e. 50 % of the taxable gain) or furnishing an acceptable security the non-resident vendor and the proposed purchaser will be issued a certificate setting forth the amount of the estimated proceeds ("certificate limit")[s.116(2)I.T.A.]. If the disposition conforms to all clauses in the certificate, no further step has to be taken until the moment when the taxpayer has to file his yearly tax return.

After the disposition

The vendor may also dispose of his taxable Canadian property without applying for a certificate prior to the transaction. After

disposing of such property --save public corporations shares and mutual fund trust units-- the non-resident shall within ten days inform the Department about the purchaser, the property, the price actually paid by the buyer and the adjusted cost base of the transferred asset [s.116(3)I.T.A.]. Such a post-disposition notice is required by the statute also in the event that a compliance certificate was granted before and,later, a modification as to the purchaser or as to the actual gain took place.

Upon payment of 25 % of the actual capital gain or upon lodging acceptable security by the non-resident, both parties to the transaction will be given a certificate concerning the disposition[s.116 (4)].

If the vendor fails to comply with s.116(3) and does not therefore send the prescribed notice, he is guilty of an offence and can be fined between $ 200 and $ 10,000 , or both fined and jailed up to six months [s.238(2)].

Purchaser liability

According to s.116(5) the purchaser is liable to pay the Revenue on behalf of the vendor 15 % of the excess of the price he has paid over the "certificate limit" fixed in the pre-sale certificate, if any.

It seems that if the vendor has not previously asked for any optional certificate, the purchaser must remit to the taxation authority 15 % of the full price, as the certificate limit would be nil[138]. The

statute does not order the purchaser to retain the 15 % amount on the price; it simply reads that he is entitled to withhold it or to otherwise recover it from the vendor. The purchaser could encounter difficulties when he attempts to recover the amount he has paid on behalf of the non-resident; thus use of the withholding system will likely prove more frequent. After the Minister has issued the post-sale certificate, the purchaser ceases to be responsible.

The liability of the purchaser was reduced somewhat subsequent to the first reading of the new Bill. When the vendor's status as a resident or non-resident is unknown, the purchaser is not necessarily liable. The duty of the purchaser is that of making reasonable inquiries as to the vendor's status; if after inquiring, he has no reason to believe that the vendor does not reside in Canada, he is no longer liable. The notion of "reasonable inquiry" is undefined and will probably remain so until the matter comes before judicial authority. As the purchaser is nowhere in the Act defined as a resident, the liability created by s.116(5) presumably extends to everybody, whether or not resident, to whom a non-resident disposes of taxable Canadian property[139]?

3. EMIGRANTS

The legislature has also enacted provisions concerning those taxpayers who leave Canada without disposing of their property; the provisions are intended to prevent such persons from escaping taxation of

capital gains.

A. Deemed Disposition

According to s.48(1)I.T.A., taxpayers who cease to be residents in Canada are deemed to have disposed of their property --other than taxable Canadian property, or rights to receive pensions, or deferred profits, or annuities payments-- at a price equal to its fair market value at time of departure.

The provision does not apply to taxable Canadian property, for capital gains on its disposition are always taxed whether or not the owner has become a non-resident, because non-residents suffer the taxation of gains obtained from such property [s.115(1)(a)(iii) and (b)]. If the taxpayer has emigrated to a country which is bound to Canada by a treaty limiting or excluding the taxation of capital gains, the tax on gains from disposition of taxable Canadian property will not be imposed, either entirely or in part. Nor does the provision concern rights to payments receivable from pension plans,registered retirement saving plans, profit sharing plans, or annuity contracts, because such payments to non-residents are subject to the withholding tax [s.212(1)(h) to (o)].

Any other property is deemed to have been disposed of for proceeds amounting to the fair market value. The capital gain is determined by substracting the adjusted cost base from the fair market value. One half of the result of the preceding calculation equals the taxable

capital gain which is included in the taxpayer's income. If the taxpayer is an individual other than a trust,only the taxable gains in excess of $ 2,500 (i.e. gains in excess of $ 5,000) are taken into his income [s.48(1)].

The same provision provides that after the deemed disposition, taxpayers who cease to be residents in Canada are considered to have immediately reacquired their property at a cost equivalent to the same fair market value. It is difficult to understand what the legislature intended by this rule, for it seems to be immaterial to the tax law. In fact if emigrant taxpayers do not come back to Canada, such property will no longer be considered for Canadian tax purposes; if they come again to Canada, they fall within the rule covering those who become residents.

The justification given by the government for taxation of such deemed capital gains is that it is fair to assess them because they accrued to the taxpayers while they shared the advantages of living in Canada[140].

It is not clear at all whether s.48(1) covers only capital property, which comprises depreciable property, and property whose capital gains are taxable [s.54(b)I.T.A.], or any property other than those excluded; this aspect of the law has evoked two commentaries. The first and apparently more logical commentary contends that s.48(1) only relates to capital property because the rule is stated

for the purposes of Division B/subdivision c which deals with taxable capital gains and allowable capital losses[141]. The other commentary argues that the deemed disposition rule applies to any property other than specifically excluded, the argument being based on a comparison with s.69(1)(b) which reads that a person who makes an inter vivos gift of anything, capital property or otherwise, is considered to have received "price" equivalent to the fair market value and therefore to have realized a capital gain[142].

B. Deferral Election

If the taxpayer, especially an individual, ceases to be resident only for a certain number of years and afterwards becomes again a resident of Canada, then the deemed disposition rule may lead to some excessive hardship. The new Bill, therefore, provides a relief measure granting to some taxpayers the opportunity to "defer" capital gains to that time when property is actually disposed of.

According to s.48(2), this choice is offered only to individuals other than trusts, and companies qualifying as Canadian corporations [s.89(1)(a)].

To benefit from the election one has to furnish acceptable security which may consist of a charge on the property of the taxpayer or of a third person, or of a guarantee from other persons.

If a taxpayer who has made a deferral election leaves Canada the taxpayer is not considered to have disposed of his property

other than that excluded by s.48(1) but he is deemed to be a resident throughout the year in which he disposes of the property. Consequently, for that taxation year,the taxpayer is taxable in Canada not only on his taxable gains from the disposition of property, but in compliance with s.3 I.T.A., on his total world income. Where the Canadian rates are higher than those of the country of residence, the taxpayer will suffer supplementary income tax, although he may deduct from Canadian tax the foreign tax he has paid [s.126]. Thus deferral election implies more than a simple deferral of tax[143]. The taxpayer will be treated as a resident in the disposition year except for the purpose of tax-free mortis causa [s.70(6)I.T.A.] or inter vivos [s.73(1)I.T.A.] transfers or distributions to a spouse or exclusive spouse's trust, as well as for special exceptional reserves [s.72(2)] in the year of death [s.48(2)(d)].

It is noteworthy that the provision only applies when the actual disposition brings a capital gain; it would be unduly harsh if the emigrants were required to suffer Canadian tax on their foreign income because of a disposition causing them a capital loss.

Individuals electing the alternative to deferral election will probably be emigrants who intend to come back to Canada shortly after leaving and who do not sell their property. Those emigrants who do not plan to return are more attracted to the $ 2,500 exemption granted by s.48(1).

For companies, opportunities to use the election are extremely

restricted by the law, for such companies must be Canadian corporations which are able to give up their residence in this country. Considering the definition of residence [case-law and s.250(4)I.T.A.] and of Canadian corporation [s.89(1)(a)], it appears that the election is open to corporations incorporated outside Canada and continuously resident in Canada since June 18,1971[144].

4. IMMIGRANTS

S.48(3) provides that persons becoming residents of Canada are deemed to have acquired the property they own at that time at a cost equal to fair market value at the moment they establish residence in Canada.

Two classes of property are excluded : property for which a deferral election has been made under s.48(2) and property that would be taxable Canadian property. Without this restriction, non-residents could escape taxation of capital gains by taking up residence in Canada shortly before the proposed disposition and by having the gains computed by reference to a cost equivalent to the practice made possible by s.48(3).

VIII. CONCLUSION

The particular innovations which the new Income Tax Act brings to the taxation of non-resident individuals and corporations are perhaps less revolutionary and confusing than some other aspects of the new law. As regards non-residents, the three main changes seem to be taxation on capital gains, new treatment of non-resident -owned investment corporations, and prohibition of thin capitalization. These are major changes affecting essential principles of the entire system of taxation of non-residents. With respect to taxation of capital gains realized by non-resident persons, it may be observed that, in fact, it simply is an aspect of a basic modification of the attitude which previously held all capital gains to be non-taxable.

Beside these major innovations, there are a number of other changes. Some of them, less evident than those above, theoretically may have great consequences; for example, the imposition of a tax on discount on bonds, or the termination of the benefit of a dividend tax credit to resident individuals participating either in resident companies which are not Canadian corporations or in non-resident corporations doing business in Canada. Other modifications comprise merely technical modifications, such as the increase in the withholding and additional tax rates or the supplementary requirements for payment of tax-exempt interest.

Non-residents are not only affected by changes in provisions concerning their tax treatment: the tax burden they suffer also depends upon taxation of residents, especially of Canadian companies in which they are interested. Rules such as those involving corporate distributions, small business incentive for private corporations, and foreign accrual property income, will certainly have repercussions on the tax impact which non-residents feel. In a few years, the international ramifications of the intra-Canadian tax provisions will be better known, and it will then become possible to study their consequences on non-residents. Some of the provisions taxing non-resident persons will be modified by double taxation treaties which Canada will renegotiate or by new conventions. Therefore, one must be extremely cautious when trying to foresee the effects of tax legislation which can be superseded in part by international treaties. For example, fiscal conventions may grant exemptions and tax reductions or make taxability dependent upon particular qualifications.

Canadian citizens worried about foreign ownership and control of Canadian economic structures would welcome legislation discouraging foreign investments by taxing them heavily, but those Canadian will be disappointed because the new Act does not discourage non-residents from operating business or investing in Canada.

Other Canadians believe that Canada should be as open as possible

to foreign investments in order to finance its economic development and industrial activities. For them, the new Act probably taxes too heavily non-resident investments. Non-residents controlling corporations resident in Canada suffer an especially heavy tax burden : a corporate tax of 50 % and a withholding tax of 25 %, without -of course- any dividend tax credit.

More moderate and realistic in its views than the opponents and proponents of foreign investment in Canada, the Carter Commission stated that Canada needs an inflow of foreign capital to support its economic growth[145]. But the commission also recognized the necessity to counterbalance foreign influence in some fields by encouraging Canadian residents to devote their financial resources to direct investment in Canada[146]

The Carter Commission suggests three ways to achieve this goal. First, withholding tax rate should be increased to 30 %, the possibility of reduction by treaty being always open. The increase in the withholding tax rate should not be applied to dividends[147]. To justify this restriction on the application of the rate increase to dividends, Carter insists that the proposals of integration of corporations and resident shareholders would constitute a sufficient incentive to induce Canadians to acquire more equity in resident corporations. The Carter Commission restricts the integration proposals to residents, so that the residents would be better able to compete against foreign shareholders[148]. No increase in the withholding tax on dividends, therefore, would be required.

Second,the commission suggests that measures be taken to prevent thin capitalization of companies in which non-residents are interested. The substitution by non-residents of lending money for purchasing equity is a typical form of tax avoidance and as such must be fought[149].

Third, the commission recommends abolition of the concept of the non-resident-owned investment corporation, an institutionalized tax-haven opportunity,not serving the true interest of Canada[150].

The recommandations of the Carter Commission have been only partially implemented in the new tax legislation.

First, the withholding tax rate has been increased only to 25 %, effective since 1976. The increase is 5 % less than the Carter Commission suggested. By so doing Canada may have remained slightly more attractive to some investors than the United States where the corresponding tax amounts to 30 %, unless modified by special treaty. The increase to 25 % also extends to dividends flowing from Canadian companies to non-resident shareholders. With the exception of the small business incentive,the Carter Commission's proposals of integration are not enacted by the statute. Instead of giving residents a competitive advantage in acquiring Canadian equity, the new law, by raising withholding tax may discourage non-residents otherwise attracted to the acquisition of shares in Canadian-based companies.

Second, thin capitalization has been penalized by preventing

companies from deducting,under certain circumstances, interest payments.

Third,the non-resident-owned investment corporation has not been abolished, but important changes have been introduced into the law. Apart from increasing the corporate tax rate, dividends to shareholders are now subject to withholding tax. The company will obtain a refund of tax previously paid upon distribution of dividends. Probably, legislature does not consider such companies to be a threat to the effectiveness and integrity of the tax system.

A last, brief observation may be made about taxation of capital gains. The new rule, which requires the inclusion of one half of the gain in income, concerns residents as well as non-residents. The latter are taxed only if the assets they have disposed of are classified as taxable Canadian property. This fundamental innovation will raise complex problems in the area of taxation of non-residents, especially because the new statutory provisions openly conflict with most of the existing treaties, which exempt non-residents from tax on capital gains. The question of deciding whether statute or conventions will prevail is delicate and involves both constitutional and international public law. Apart from the legal aspect, it will be important to ascertain the ultimate effect of the capital gains tax on non-residents. It will be possible, to a certain extent, to see whether non-residents have previously invested in Canada, principally because they have been attracted by the opportunity to obtain tax-free gains. It will

appear whether some investors desert Canada, considering it less attractive. That is a question that only the next years will answer.

FOOT - NOTES

I. Chapter

1. Foreign Ownership and the structure of Canadian Industry Report of the TASK FORCE headed by Prof. M.H. WATKINS January 1968, pp. 5-13

1a "Carter on the taxation of international income flow" MIESZKOWSKI - 1969 (22) National Tax Journal p.97

1b "International Aspects I of the White Paper on Proposals for Tax Reform" A. SHORT - 1970 Conference Report of the Canadian Tax Foundation p.171

2. Countries with which Canada has income tax conventions :

United States of America	France
United Kingdom	West Germany
Australia	Danemark
New Zealand	Sweden
Union of South Africa	Norway
Japon	Finland
Trinidad	Belgium
Israel	Netherlands

II. Chapter

3. "Liability for tax = Residence, Domicile, Citizenship ?" SHERBANIUK - 1963 Conference Report of the Canadian Tax Foundation, p.315

4. 1928 AC 217

4a 1928 AC 234

5. 2 (1946) DTC 812

6. 1949 DTC 536

7. 4(1950) DTC 232 (T.A.B.)

8. 5(1904) TC 101

9. 1950 DTC 437

10. 1952 DTC 1183

11. 1971 DTC 232

12. 1971 DTC 39

13. 1957 DTC 230

14. 1962 DTC 1225

14a The Principles of Canadian Income Taxation
F.E. laBRIE, CCH 1965, p.16

15. "Income Tax Residence Rules"
KOERNER - 1961 Conference Report of the Canadian Tax Foundation, p.235

16. 1969 DTC 503

17. 1969 DTC 754

18. see notes 13 and 14

19. 1906 AC 455

20. 1929 AC 1

21. 1925 AC 495

22. (1941) 64 CLR 241

23. (1952) 1 All ER 646

24. 1969 DTC 5051 (Ex. C)

25. 1960 AC 357

26. 1961 DTC 716 (T.A.B.)

27. 1970 DTC 6072
see also Zehnder & Company v. M.N.R. - 1970 DTC 6064

28. 1970 DTC 6370 (Ex. C), now under appeal

29. 2(1945) DTC 692 (Ex.C) ; 2(1946) DTC 824 (S.C.C.) ,
2(1946) DTC 839 (P.C.)

30. 1971 DTC 5186 (Ex. C), now under appeal

III. Chapter

31. (1880) 15 Ch. D. 247

32. (1884) 53 LJ Ch. 99

33. 2(1943) DTC 610 (Ex. C)

34. 1881/82 QB 414

35. 1896 AC 325

36. 1942 SCR 476

37. (1922) 1 AC 417

38. 13 (1928) TC 539

39. 1961 DTC 1099

40. "Carrying on business in Canada"
KEYES - 1962 Canadian Tax Journal, p.41

41. 1967 DTC 175 (T.A.B.), now under appeal

42. 1969 DTC 127 (T.A.B.)

43. 1970 DTC 6370

43a 1971 DTC 131 (T.A.B.), now under appeal

43b It may be worthy of notice that s.255 I.T.A. reads that the expression "in Canada" so frequently repeated in this chapter includes the sea bed and subsoil of the submarine areas adjacent to the Canadian coasts in respect of which exploring and drilling rights or licenses are issued by the federal or provincial governments

44. (1893) 1 QB 326

45. 4(1898) TC 25

46. 1925 KB 30

47. see note 38

48. (1914) 6 WWR 939

49. Keyes, loc. cit.

50. LaBrie, op. cit. p.21

51. (1933) 2 DLR 85 (SCC)

52. 1936/37 Ex CR 71

53. see note 36

54. see note 50

55. 1967 DTC 421

56. see note 41

57. see note 42

58. see note 43a

59. see note 39

60. 1952 DTC 202

61. "Investment in real estate in Canada by non-residents" SILVER - 1968 Conference Report of the Canadian Tax Foundation, p.177

62. "Tax Problems for United Kingdom Companies doing business in Canada" Prof. J.M. MacIntyre - 1968 British Tax Review, p.306

63. see note 60

64. 1964 DTC 194 (T.A.B.)

65. 1962 DTC 100 (T.A.B.)

66. see notes 42 and 58

67. Analysis of the Canadian Tax Reform Bill 1971 CCH, September 1971, p.265

68. LaBrie, op. cit. p.616

69. Tomorrow's Taxes Canadian Institute of Chartered Accountants, September 1971,p.29

70. see note 55

71. see note 65

71a MacIntyre, loc. cit.

71b 1966 DTC 5358 (Ex. C) ; 1968 DTC 5033 (S.C.C.)

72. LaBrie, op. cit. p.468

73. LaBrie, op. cit. p.435

74. A wide definition was given in s.400(2)old Income Tax Regulations; several particular cases were enumerated therein. See also s.2600(2) for individuals

74a e.g. Ontario : s.1.(1)(18) of the Income Tax Act, 1961-62, Ontario Statutes 1961-62, c.60 referring to the federal regulations

74b E.g.: --s.3(f) of Protocol to 1942 Canadian-United States Tax Convention:"the term"permanent establishment" includes branches, mines and oil wells, farms, timber land, plantations, factories, workshops, warehouses, offices, agencies and other fixed places of business of an enterprise..."
--art.4 of 1966 Canadian-United Kingdom Tax Agreements: "the term"permanent establishment" means a fixed place of business in which the business of the enterprise is wholly or partly carried on and shall include especially a place of management; a branch; an office; a factory; a workshop; a mine, quarry or other place of extraction of natural resources; a building site or construction or assembly project which exists for more than 12 months...."

75. "U.S. Business Operations in Canada"
SILVER - 1966 Canadian Tax Journal, p.368

76. MacIntyre, loc. cit.

77. "Taxation of U.S. Private Investments in Canada"
WILLIAMSON - (1963) Canadian Tax Paper n.36, p.89

78. Silver, loc. cit. at note 75

79. MacIntyre, loc. cit.

80. Williamson, op. cit.

81. CCH Analysis, p.270

82. Summary of 1971 Tax Reform Legislation
The Honourable E.J. Benson, Minister of Finance, p.58

83. 1966 DTC 130 (TAB)

84. see note 71b

IV Chapter

85. see e.g., National Trust Co. Ltd., Trustee of Sam Gorman v. M.N.R. 1954 DTC 33 (TAB)

85a LaBrie, op. cit.p.620

86. Williamson, op. cit.

87. CCH Analysis,p.267

88. M.J. Walsh Ltd. v. M.N.R., 1955 DTC 593 (TAB)

89. 1971 DTC 5235, now under appeal

90. 1966 DTC 5001 (Ex.C.)

91. CCH Analysis, p.267

92. Tomorrow's Taxes, p.239

93. "Withholding on income of non-residents"
D.McGURRAN - 1960 Canadian Tax Journal p.61

94. Javelin Foundries & Machine Work Ltd. v. M.N.R., 1967 DTC 392 (TAB)

95. P.R. Pearson, Trustee in Bankruptcy for William Pitt Hotel Ltd. v. M.N.R., 1964 DTC 224 (TAB)

96. 1 (1938) DTC 424

96a s.213(2) extends the exemption to the shareholders of a company holding shares in a foreign business corporation and operating public utilities in the shareholders'country through the intermediary latter corporation.

97. see, for attempt of examining these technical provisions under the old Act:
"Foreign Ownership - Canadian Provision"
S.D. THOM - (1964) Canadian Tax Paper n.38, p.31

98. 1967 DTC 5289; 1968 DTC 5220

99. Silver, loc. cit. at. 61

100. 1969 DTC 5142 ; 1970 DTC 6271 (S.C.C.)

101. McGurran , loc. cit.

102. 1962 DTC 247

103. 1962 TR 9 (H.L.)

104. B.K. Sanden (at the Conference)
see also
"Parent-Subsidiary Know-how Charges (Inter-Company Transactions)"
B.K. SANDEN - (1964) Canadian Tax Paper n.38

105. "Know-how and Withholding"
A. SHORT - 1964 Canadian Tax Journal, p.354

106. 1964 TR 129 (H.L.)
see also Commissioners v. United Aircraft Corp. (1943) 68
C.L.R. 525 (H.C. of Australia)

107. I.R.C. v. Desoutter Brothers Ltd. (1946) 1 All ER 261
Tootal Broadhurst Lee Co. Ltd. v. I.R.C. (1949) 1 All ER 261

108. 1964 DTC 428

109. Short, loc. cit. at note 105

110. 37 (1957) TC 54 (H.L.)

111. 1969 DTC 5204

111a see also
"Technical Service Fees are Royalties"
STIKEMANN - April 1971 n.162 Canada Tax Service Letter

112. 1967 DTC 5303

113. MacIntyre , loc. cit.

114. 1962 DTC 1338

115. "The management fees tax"
A. SHORT - 1963 Canadian Tax Journal, p.324

116. "International inter-company payments for services"
A. SHORT - 1965 Canadian Tax Journal, p.113

117. see note 108

118. House of Common Debates, July 22,1963 p.2487, Gordon

119. "Management or Administration Fee or Charge"
STIKEMANN, January 1964 n.84 Canada Tax Service Letter

120. Short, loc. cit. at note 116

121. MacIntyre , loc. cit.

122. see note 39

123. see note 85

V. Chapter

124. "The future Use of NROs"
January 1972 n.177 Canada Tax Letter

124a 1955 DTC 386

125. 1958 DTC 9 (TAB)

126. see note 124

127. 1961 DTC 702 (TAB) ; 1963 DTC 1149 (Ex. C)

128. "Tax Reform - International Income"
TOUCH ROSS & Co - January 1972 - p.33

128a so defined "Canadian property" is a larger concept than "taxable Canadian property"; e.g. bonds or other obligations issued in Canada, shares of public corporations amounting to less than 25 % of the issued shares, unit of mutual fund trusts amounting to less than 25 % of the issued units,....constitute Canadian property [s.133(8)(b) and 206(2)I.T.A.] without being taxable Canadian property, s.115(1)(b)

129. the assumption is in compliance with s.134 I.T.A., which reads that an NRO may not be deemed to be a Canadian or a private corporation save for the purpose of s.83(1)I.T.A.

130. see note 124

131. see note 124

VI. Chapter

132. Report of the Royal Commission on Taxation,Vol. 4 International Aspects of Income Taxation, p.549
"Adoption of the recommandation, that certain payments of interest by a subsidiary to a non-resident parent company should be deemed to be dividend, and therefore not be deductible,

would reduce the number of instances where manipulation between these types of payments could occur."

132a Tomorrow's Taxes, p.231

133. CCH Analysis, p.272

134. Tomorrow's Taxes, p.232

135. Touch Ross & Co, op. cit. p.36

135a see CCH -"Explanation of Canadian Tax Reform"February 1972, pp.343-44

VII Chapter

136. see note 74

137. CCH Explanation,p.76

138. Tomorrow's Taxes, p.233

139. CCH Explanation,p.75

140. Summary,p.34

141. CCH Explanation,p.71

142. "Gifts and Bequests, Emigrants and Immigrants and Residents" W.D. GOODMAN - Canadian Bar Papers on Tax Reform 1971,p.152

143. CCH Explanation,p.72

144. in fact even s.48(1) may only concern companies incorporated in a country other than Canada, for if they are incorporated in Canada (particularly after April 1965) they go on residing here no matter where the central control and management is located.

VIII Chapter

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146. ibid,p.213

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