

5. TAXATION

5.1 Federal Income and Capital Gains Tax

Canada, a modern industrial and service economy, has in common with other advanced countries a complex tax system the intricacies of which must be successfully navigated if a business is to avoid an otherwise unnecessary tax burden. Despite the complexities, the principal attributes of the tax system will be familiar to most people and similar to those of other advanced economies.

(1) Individuals and Proprietorships

(a) Residence

The primary determinant of a person's liability for tax under the *Income Tax Act* (Canada) (the "ITA") is residence. Residents of Canada are taxed on their world income from all sources while non-residents are taxed on income earned in or received from Canada. Whether or not an individual is resident in Canada can be difficult to determine if that person travels a great deal. It is possible for a person to be considered a resident for tax purposes even though he or she also resides in another country. Moreover, a person who visits Canada for 183 days or more in a year will be deemed to be resident in Canada throughout that year. Many tax treaties contain tie-breaking rules to determine which country has the primary right of taxation where an individual is simultaneously resident for tax purposes in more than one country. A person who resides in Canada for part of the year will be taxed on his or her world income for that part of the year (with a *pro rata* reduction in personal exemptions) and will be taxed on any income earned in Canada during the remainder of the year.

(b) Sources

The treatment of income for tax purposes varies by source, the principal sources being employment, business, property and capital gains. For the purpose of ascertaining taxable income, a major distinction is made between income from an office or employment and income from property or business. The ITA taxes the net profit earned from property or a business. Accordingly, it permits the deduction from gross revenues of expenses reasonably incurred for the purpose of gaining or producing income from the property or business, including such expenses of a capital nature as interest and capital cost allowance (allowable depreciation). For income from an office or employment, the ITA permits the deduction of only a narrow range of listed allowances and expenses.

(c) Capital Cost Allowance

The allowance for the depreciation of capital property as a business or property expense is subject to narrowly defined rules. For most types of capital property, a specified percentage of cost is deductible from gross revenue each year on account of depreciation. The percentage varies in accordance with the type or class of property and, in most cases, is applied to the total undepreciated capital cost (the balance remaining after deductions in prior years from original capital cost) of all properties in the particular class. If all capital properties in a class are disposed of for an amount greater than the total undepreciated capital cost of the class, the excess amount up to the total original cost is added back into income in the year of sale. Any surplus over the original cost of individual items of the class is generally treated as capital gain. If all capital properties of a class are disposed of for an amount less than the undepreciated capital cost, the difference may be deducted from revenue as a terminal loss. In most cases, only one-half the usual deduction for capital cost allowance is permitted for newly acquired capital property in the year of acquisition. Generally, there is no deduction permitted until the year the property is actually available for use, and the restriction to one-half of the usual deduction will apply to that year.

(d) Capital Gains and Losses

The ITA contains detailed rules governing the treatment of capital gains and losses which are generally defined respectively to be the excess or deficiency realized on the sale of capital properties above or below their original cost. Certain expenses related to the acquisition of a capital property are included in its cost base and certain expenses of sale may be deducted from the proceeds. Half of the gains realized on

the disposition of capital properties (taxable capital gains), after deducting half of the losses realized on the disposition of other capital properties in the same year (allowable capital losses), are included in income for tax purposes. If realized capital losses exceed capital gains in any year, the excess may be carried forward indefinitely for deduction from capital gains in future years. Capital losses are not deductible against any other type of income and are not recognized in certain types of transactions, such as where the property is transferred to a controlling corporation or to a spouse or where a similar property is acquired within thirty days.

An individual resident in Canada is eligible for an aggregate lifetime exemption from taxation of up to \$500,000 of net capital gains realized on the disposition of qualifying farm properties and the shares of qualifying small business corporations. The exemption may only be utilized to the extent that net taxable capital gains exceed cumulative net investment losses which have previously been claimed as a reduction of taxable income.

Normally, transfers of property between persons who are not at arm's length are deemed to be transferred at fair market value resulting in the deemed realization of any accrued capital gain. However, capital properties transferred to a spouse may be done on a tax-deferred basis pursuant to "rollover" provisions which deem the transfer to take place at the transferor's original cost. The realization of any accrued capital gain will be deferred until the property is sold by the spouse unless an election is filed not to have the provision apply. A similar "rollover" is available for transfers of qualifying farm properties, shares in family farm corporations and interests in family farm partnerships pursuant to which the farm property can be transferred at an elected amount between original cost and current fair market value to a child, grandchild or great-grandchild so long as the recipient is actively engaged in the farming business. This enables the farming business to be transferred to a younger generation without the immediate realization of taxable capital gains accrued on the farm properties (other than machinery and equipment).

Individuals resident in Canada are entitled to an exemption from capital gains tax on gains realized on the sale of a principal residence. A family unit is entitled to the exemption for a single principal residence during any period of time. Up to one-half hectare of surrounding land can be included in the exemption, although a larger area may also qualify if it is necessary for the use and enjoyment of the structure as a residence.

(e) Deductions and Tax Credits

In the calculation of an individual's taxable income, the ITA permits deductions for a number of personal expenditures which include pension contributions, union and professional dues, child care expenses, moving expenses, certain interest expenses and alimony or separation expenses. In addition, a number of non-refundable tax credits are available which reduce the amount of income tax otherwise payable. The non-refundable tax credits are calculated as a percentage of specified expenditures or allowances which include a basic personal allowance, an allowance for specified dependents, an age allowance for the elderly, a disability allowance, and expenditures on tuition fees, education expenses, medical expenses and charitable contributions. The credits are calculated as 17% of the specified allowances or expenditures in most cases and the rate is adjusted for inflation by reference to annual increases in the Consumer Price Index in excess of 3%.

(f) Rates of Tax

The federal income tax is imposed at graduated rates in four (4) brackets which are inflation adjusted by reference to the annual increase of 2.5% in 2009 in the Consumer Price Index. For 2009, the rates applicable to individuals are 15% of the taxable income of \$38,832 or less, 22% of the next \$38,832 of taxable income, 26% of the next \$48,600 of taxable income, and 29% of taxable income in excess of \$126,264. Each of the provinces and territories of Canada also levy an income tax, in each case imposed at graduated rates but applicable to brackets and at rates that vary from province to province.

In Ontario, where tax brackets have been indexed to inflation since 2009, the applicable rates for 2009 are 6.05% on taxable income up to \$36,848, 9.15% on the next \$36,850 of taxable income, and 11.16% on taxable income over \$73,698. Some provinces also impose surtaxes. Ontario imposes a surtax at 20% on all Ontario income tax payable in excess of \$4,257 plus a surtax of 36% on all Ontario income tax payable in excess of \$5,370. The combined federal and Ontario provincial income taxes and surtax result in

a combined marginal tax rate of 46.41% on taxable income in excess of \$126,264 in 2009.

(g) Tax-Free Savings Account

Starting in 2009, an individual resident in Canada and 18 years of age or older will be eligible to establish a Tax-Free Savings Account ("TFSA"). An eligible individual will acquire \$5,000 of TFSA contribution room each calendar year. Unused contribution room will be carried forward to future years. There is no limit that is applied to an aggregate contribution and the unused portions of the TFSA can be carried forward indefinitely.

An individual wishing to emigrate from Canada who holds a TFSA may keep it and continue to benefit from the exemption from Canadian tax on investment income and withdrawals. However, no contributions will be allowed and no contribution room will accrue while the individual is a non-resident of Canada.

(h) Alternative Minimum Tax

Individuals are subject to payment of an alternative minimum tax designed to prevent the undue reduction of tax by the use of tax shelters and preferences. A flat rate of 17% is applied to adjusted taxable income after deducting a basic exemption of \$40,000 (applicable provincial taxes are also payable). In calculating adjusted taxable income, a number of deductions normally available are added back in whole or in part. In addition, 60% of the non-taxable portion of net capital gains is included and the gross up of taxable dividends received from taxable Canadian corporations is excluded. The individual pays the greater of the regular tax liability and the alternative minimum tax. The excess of minimum tax over regular tax can be carried forward up to seven years in order to reduce the tax payable to the extent that the regular tax exceeds the minimum tax in any of those years.

(2) Partnerships

A partnership is treated as a separate legal person for the calculation of income for tax purposes. There is no general definition of partnership in the ITA, however, and whether or not one exists must be determined from the general principles of law as summarized in Section 4.3. The partnership's net income or profit from property or a business is calculated by deducting from gross revenues all expenses reasonably incurred for the purpose of gaining or producing income. This includes capital cost allowance plus other permitted deductions in the same manner and on similar principles as are applicable to individuals calculating income from the same sources.

Partnership profits or losses (including capital gains and losses) are apportioned to the partners on a source by source basis with each partner being allocated his or her proportionate share of the income or loss. Taxable income of each partner is then calculated separately, taking into account income from other sources and such items as personal taxable capital gains and losses, deductions and applicable tax credits. Business and property losses arising after March 22, 2004, may be carried back 3 years and forward 10 years and applied in reduction of taxable income in those years. The manner in which each partner's taxable income and tax are determined will vary depending upon whether the partner is a natural person, a corporation or a trust. "At risk" rules may limit the amount of any loss that may be deducted from other income by limited or passive partners.

The ITA treats an interest in a partnership as capital property and, accordingly, the disposition of a partnership interest can result in a taxable capital gain or an allowable capital loss. Where property is being transferred by individual partners to a partnership, it is deemed to be disposed of by the partners at fair market value and there is a tax-deferred "rollover" available enabling the transfer to be made without the current realization of a taxable capital gain. When a partnership is dissolved it is deemed to dispose of its capital properties at fair market value but there is a tax-deferred rollover available for capital gains tax purposes if the partners so elect and if each receives a proportionate undivided interest in all of the partnership property.

(3) Corporations

(a) Residence

As with partnerships and individuals, corporations are taxed on their income from property and business as well as capital gains and other specified sources. The same rules for determining the amount of such income and gains are applicable to corporations as are applicable to individuals and partnerships. Corporations which are resident in Canada are taxed on their world income from all sources. Corporations resident outside Canada are taxed in Canada on any income derived from carrying on business in Canada and on specified remittances from Canadian residents. A corporation is deemed to be resident in Canada if its central management and control is located in Canada. In addition, all corporations incorporated in Canada after April 26, 1965, are deemed to be resident in Canada.

(b) Public Corporations

Public corporations, generally those listed on a Canadian stock exchange and in certain cases those which have elected to be so treated, are taxed at the basic federal tax rate of 38% for active businesses on profits including taxable capital gains. Where the corporation earns its income in a province, usually it will also be subject to provincial income or corporations tax. An abatement of 10% on account of the provincial tax is allowed thereby reducing the basic federal tax rate to 28%. There are also general tax reductions that are applied gradually. Effective January 1, 2008, the corporate surtax which was previously applicable is eliminated. Thus the effective federal corporate income tax rate applicable January 1, 2009, is 19% of taxable income. The tax reductions will eventually create an effective tax rate of 15% effective January 1, 2012.

The Ontario corporations income tax is applied at the rate of 14% resulting in an effective combined federal and Ontario provincial tax rate of 33%. Manufacturing and processing income qualifies for a lower Ontario corporate tax rate which results in a combined federal and Ontario provincial rate of 24.5%.

(c) Private Corporations

Private corporations which are resident in Canada and which are not controlled by one or more public corporations are subject to a number of special rules in certain situations. The same income tax rates are applicable to private corporations as apply to public corporations unless the corporation is a Canadian-controlled private corporation ("CCPC"), which is an enterprise not controlled by either non-resident persons or public corporations or any combination thereof. A CCPC is entitled to the small business deduction which reduces the rate payable on the first \$400,000 of its annual active business income to 21%. This rate is further reduced to 11% by the 10% abatement on account of provincial tax. The small business deduction is phased out for CCPCs that have taxable capital exceeding \$10,000,000 and is eliminated completely when taxable capital reaches \$15,000,000.

A CCPC can reduce its Ontario basic income tax by claiming the Ontario small business deduction. The Ontario corporations tax rate applicable to CCPCs is 5.5% resulting in a combined federal and Ontario provincial CCPC tax rate of 16.5%. However, the Ontario surtax re Ontario small business deduction claws back the small business deduction from more profitable CCPCs. The Ontario tax rate reduction applicable to CCPCs is also subject to a clawback which results in increases to the effective tax rate applicable to CCPCs on income between \$300,000 and \$1,128,519.

(d) Income Distribution

A system of tax credits and refundable taxes has been incorporated into the scheme by which the distribution of corporate income, through the payment of dividends, is taxed. The aim of the tax credits is to reduce the double taxation which results when shareholders receive taxable dividends from a corporation paid out of corporate income which has already been taxed. To a large extent, double taxation is avoided where the dividends are received from a CCPC and paid out of its first \$400,000 of annual active business income. With respect to investment income and portfolio dividends, refundable taxes are applied to prevent a significant deferral of income taxes through the use of corporate intermediaries.

The cornerstone of the integration system is the dividend gross up and tax credit which are applicable to taxable dividends received by individuals resident in Canada from taxable Canadian corporations.

An individual is required to include in taxable income 145% of the amount of the eligible taxable dividends received. For dividends other than eligible dividends, the taxable amount is calculated by multiplying the actual amount of dividends (other than eligible) an individual has received by 125%. This is done to reflect the higher dividends a corporation could have paid had it not been subject to income tax at the corporate level. The individual is then allowed a tax credit equal to 18.9655% of the eligible dividends received and a tax credit equal to 13.333% of the other than eligible dividends. This reduces the income tax otherwise payable and reflects the income tax actually paid on the corporate income out of which the dividends were paid.

Inter-corporate dividends paid from one taxable Canadian corporation to another taxable Canadian corporation are generally received tax free by the recipient corporation. This is achieved by the allowance of a deduction equal to the amount of taxable dividends received. Portfolio dividends received by private corporations, controlled either by an individual or a related group of individuals, are subject to a special refundable tax at the rate of 33 $\frac{1}{3}$ % of the dividends received. The special dividend taxes are fully refundable at the rate of \$1.00 for each \$3.00 of dividends paid. Portfolio dividends are generally defined to be taxable dividends received from a corporation, the shares of which owned by the recipient corporation carry 10% or less of the votes attaching to, and have a value of 10% or less of the total value of, all outstanding shares of the payer corporation, unless the payer corporation is controlled by the recipient corporation and persons with whom the recipient does not deal at arm's length. If the recipient corporation owns more than 10% of the shares of the payer corporation or controls the payer corporation, the dividends received will be subject to the special tax if the payer corporation receives a refund of tax on payment of the dividends.

Investment income received by a taxable Canadian corporation, including interest income, the taxable portion of capital gains and other property income, is subject to taxation at the regular corporate tax rate. However, investment income, other than taxable dividends, received by a CCPC is subject to an additional refundable tax of 6 $\frac{2}{3}$ % and, on the payment of dividends by a CCPC, it is entitled to a refund of such 6 $\frac{2}{3}$ % refundable tax plus 20% of the regular tax on investment income at the rate of \$1.00 of refund for each \$3.00 of dividends paid. The non-taxable portion of capital gains are added to a capital dividend account from which dividends may be paid to shareholders free of tax.

(e) Corporate Reorganization

There are a number of special rules in the ITA applicable to corporate reorganizations such as amalgamations, dissolutions and the transfer of property to corporations in exchange for shares. All such situations involve the disposition of property which can result in the realization of taxable capital gains. If the qualifying conditions are met, such corporate reorganizations can be accomplished on a tax-deferred basis that flows the original capital cost base through to the recipient of the property thereby postponing the realization of any accrued capital gain. The ITA makes no provision for consolidated income tax returns by affiliated corporations. Where it would be advantageous for income tax purposes for the results of the operations of affiliated corporations to be consolidated in one tax return, the desired result can often be achieved by an appropriate corporate reorganization if all conditions can be satisfied.

(f) Thin Capitalization

Corporations resident in Canada which have non-resident shareholders are subject to a limitation on the deductibility of interest expense from income for the purpose of preventing the distribution of profits by the payment of interest which is subject to a low rate of withholding tax. Where interest is payable to a non-resident shareholder which, either alone or together with associated shareholders, holds at least 25% of the issued shares of any class of shares of the corporation, the thin capitalization rules limit the deductibility of interest by the corporation if the debt to equity ratio of the shareholder, or the associated group of shareholders, exceeds two to one (2:1) by disallowing as a deductible expense the interest payable on the excess indebtedness. Included in the calculation is any indirect indebtedness, such as where a non-resident shareholder lends funds to a third party contingent upon the third party lending an equivalent sum to the corporation. The rule does not apply to loans from third parties guaranteed by a non-resident shareholder.

(g) Branch Tax

Corporations which are not resident in Canada but which carry on business in the country are

subject to a special branch tax. It is designed to equalize the incidence of Canadian income tax on the income of the Canadian branch with the income tax which would have been incurred if the business had been carried on through a subsidiary incorporated in Canada. In addition to normal corporate income tax imposed upon its income, a subsidiary is subject to the deduction of withholding tax on the distribution of that income by way of dividends to its non-resident shareholders. The branch tax is imposed at the rate of 25% on after tax income of the branch with an allowance in respect of investment in property in Canada. Where a tax treaty is in force, the rate of tax is usually reduced to that of the withholding tax applicable to dividends under the treaty.

(4) Trusts

Under the ITA, a trust is taxed as an individual. A Canadian resident trust is taxed on its world income from all sources while a non-resident trust is taxed on its income earned in Canada. The residence of a trust is determined by the residence of the trustee or trustees who control the property of the trust.

Testamentary trusts are taxed at the graduated personal tax rates applicable to the annual income of individuals. Most other trusts, except for some established prior to June 18, 1971, are taxed at the current maximum rate applicable to individuals (29% federally) in order to prevent income splitting and the reduction of the effective overall rate of tax through the establishment of multiple trusts. Provincial income taxes are paid over and above those imposed federally with no deduction on account of taxes paid in other jurisdictions being allowed. In calculating taxable income, most of the usual deductions applicable to individuals are permitted. These include expenses reasonably incurred for the purpose of earning income from business or property but exclude the personal credits and deductions available only to individuals.

There are a number of special rules regarding the computation of the income of a trust in connection with the deduction of amounts paid or payable to beneficiaries of the trust. Until recent proposed changes to the ITA, a trust could deduct from its income all amounts payable to beneficiaries which were actually so paid or the payment of which was enforceable by a beneficiary. Income flowed through a trust to beneficiaries resident in Canada retained its character and provisions in the ITA provided for the flow through of such items as dividend tax credits, tax free capital dividends, foreign income and foreign taxes. As discussed in Section 4.7(2), as a result of the increasing number of corporations converting to income trusts, this tax advantage will be eliminated. Effective 2011, a distribution tax will be imposed on distributions from existing publicly-traded income trusts and limited partnerships. The new rules apply to any publicly-traded "income trust" (or publicly-traded partnership), other than one that only holds passive real estate investments.

Certain amounts paid or payable to non-resident beneficiaries are fully taxable in a trust and the after tax income is exempt from withholding tax upon distribution to the non-resident beneficiaries with the result that the non-resident beneficiaries incur approximately the same rate of tax as they would have paid had they earned the income directly. These include income from real property in Canada, income from a business carried on in Canada and taxable capital gains from the disposition of certain taxable Canadian property.

Property contributed to a trust is assumed to be transferred at fair market value. Such amount will be the deemed proceeds of disposition of the property to the transferor and the cost base to the trust for purposes of calculating capital gains. A rollover of the adjusted cost base resulting in deferral of capital gains tax is available for the transfer of property to certain trusts in favour of the transferor's spouse, the spouse and the transferor jointly, or solely the transferor.

Every 21 years there is a deemed disposition and re-acquisition of the property held by a trust at fair market value resulting in a deemed realization of any accrued capital gains. Any capital gain deemed to be realized by the trust at that time is fully taxable. In the case of a qualifying spousal trust, the deemed disposition occurs only on the death of the spouse. As with individuals, a sale of capital property by a trust will result in the realization by the trust of any accrued capital gain or capital loss.

Income of a trust which is payable to a beneficiary, and the payment of which the beneficiary is entitled to enforce, must be included in the beneficiary's income for the year whether or not it is actually

received. The beneficiary must also include in income, for tax purposes, the value of any benefits received from the trust (other than a distribution of capital). Where a beneficiary receives trust property in satisfaction of all or part of a capital interest in the trust, there is a "rollover" of cost base resulting in no gain or loss being realized at that time and a deferral of potential capital gains tax liability until the beneficiary disposes of the property. The "rollover" is not applicable to a distribution to non-resident capital beneficiaries of property other than real property and certain other property.

5.2 Non-Resident Withholding Tax

The ITA imposes a tax at the rate of 25% on many types of payments received by non-residents of Canada from persons resident in Canada (irrespective of whether or not the payment is actually made from Canada) and requires that the Canadian resident payer withhold the amount of the tax from the amount paid or credited to the non-resident. A Canadian resident who fails to withhold the required tax and remit it to the Receiver General for Canada becomes liable to pay the tax.

In calculating the withholding tax payable, the rate is applied to the gross amount of the payment and no deductions are permitted. Most tax treaties which Canada has entered into reduce this rate for many types of payments. A recent amendment to the ITA effective January 1, 2008, eliminates withholding tax on most interest payments paid to persons dealing at arm's length with the payer.

Types of payments subject to withholding tax are management or administration fees or charges, trust income, rents, certain pension benefits, certain annuity payments, interest (to persons not dealing at arm's length with the payer), and both taxable and capital dividends. There are special rules applicable to many of the categories. This often results in exemptions in specified circumstances or entitles the non-resident recipient to file a tax return and have tax imposed on the net amount received after deducting applicable expenses assessed under the general rules of the ITA applicable to Canadian residents.

Along with the recent amendment excluding certain types of interest payments from withholding tax, there are also other exemptions. Many types of bonds, debentures, notes and mortgages of either the federal or provincial governments of Canada or their agencies (or which are guaranteed by the Government of Canada) are exempt from withholding tax.

A non-resident of Canada which is resident in a country that imposes income tax and which is exempt under the laws of that country from the payment of income tax may, upon application, be issued a certificate of exemption by the Minister of National Revenue if the non-resident would also be exempt from tax under the ITA if it were resident in Canada. This rule will apply to certain trusts or corporations administering pension or retirement funds, charities, municipally owned corporations, non-profit organizations and mutual insurance corporations. The certificate exempts the holder from the deduction of withholding tax from interest on bonds, debentures and similar obligations issued after June 13, 1963, if the payer and recipient of the interest deal at arm's length.

A non-resident recipient of rent from real property situated in Canada may elect to file an income tax return under the ITA and be taxed on net income received under the rules applicable generally to residents of Canada. For that purpose the non-resident will be deemed not to be exempt from income tax in Canada, the rent will be deemed to be the non-resident's only income and certain deductions, such as the carry forward of losses from prior years for deduction from income, will not be available in calculating taxable income. Additionally, the non-resident may elect to appoint an agent resident in Canada to receive the rents on the non-resident's behalf. The agent is permitted to calculate and deduct withholding tax only against net rents available to be remitted to the non-resident after the payment of allowable expenses from the gross rents received. Any withholding tax which is remitted is applied against the tax liability assessed following the filing of the tax return by the non-resident and any excess is refunded.

5.3 Impact of Tax Treaties

The statutory rate of non-resident withholding tax under the ITA is 25%. This rate is usually reduced to 15% on dividends where a tax treaty between Canada and the non-resident's country of residence is in effect. In many cases the withholding tax on dividends paid to a non-resident corporation with a

substantial shareholding in the Canadian corporation paying the dividends may be reduced to as low as 5%. A comparable reduction will normally be made in the rate applicable to the branch tax. Additionally, tax treaties often restrict the entitlement of Canada to impose capital gains tax on the gain realized on the sale by a non-resident of shares of a Canadian corporation where the value of the shares is not derived principally from Canadian real property.

5.4 Provincial Income and Capital Taxes

(1) Individuals, Proprietorships, Partnerships and Trusts

Income taxes are imposed by all provinces and territories of Canada and in all cases, except Quebec, administration and collection is performed by the Canada Revenue Agency (“CRA”) established by the federal government so that separate provincial income tax returns are not required. All of the provinces and territories set their own tax rates and brackets which are applied to taxable income as calculated for federal income tax purposes.

Provincial income tax is imposed on the employment and investment income of residents of the province and, where the province of residence has changed during the year, the income tax is imposed by the province in which the individual resided on the last day of the year. Provincial income tax on income from business is imposed by each province in which a permanent establishment (which by definition is not limited to a fixed place of business) of the business is situated. Where income tax is levied upon the same business by more than one province, the income is allocated among the provinces according to a formula which primarily takes account of gross revenues received and salary and wages paid in the provinces concerned. Income from a business carried on by a partnership is allocated to the partners by source for the purpose of calculating taxable income and provincial tax. Income of a trust is allocated in the same fashion as for other individuals.

Individual provinces permit certain tax credits in addition to those tax credits permitted for federal income tax purposes. For example, the Province of Ontario allows credits against provincial tax otherwise payable in connection with the taxpayer's age, residential rent and realty taxes paid, political contributions, retail sales taxes and equity investments in small business development corporations.

(2) Corporations

All provinces of Canada levy an income tax on the income of corporations carrying on business in the province. Income for this purpose is calculated on virtually the same basis as for federal income tax purposes. As with income tax on individuals, provincial corporate income tax is administered and collected by the CRA except for the provinces of Quebec and Alberta where separate income tax returns must be filed. Ontario has recently formalized an agreement with the federal government to have the CRA assume administration of the Ontario provincial corporate income tax (except for tax years ending before 2009), which has resulted in Ontario corporations having to file only one income tax return each year thereby reducing their tax administration burden. In cases where a corporation has dealings in more than one province, liability for tax is dependent upon the presence of a permanent establishment in the provinces concerned. Corporate income is allocated among the provinces in accordance with the same formula applicable to individuals who carry on business in more than one province.

The rate of corporate tax imposed varies from province to province. In the Province of Ontario the corporate income tax rate is 14% and for the first \$500,000 per year of active business income of a CCPC for which the rate is reduced to 5.5% by the small business deduction. Effective July 1, 2010, the lower rate of Ontario income tax will be reduced to 4.5% and the basic rate will be reduced to 12%. The basic rate will further be reduced until it reaches 10% on July 1, 2013.

In addition, the small business deduction is offset by a provincial surtax of 4.25% applied on a graduated basis when taxable income is between \$500,000 and \$1,500,000, after which point the entire small business deduction is eliminated. The surtax will be eliminated effective July 1, 2010.

(3) Capital Tax

The provinces of Ontario, Quebec, Saskatchewan, Manitoba, Nova Scotia and New Brunswick levy a tax on capital employed through a permanent establishment by corporations in the province. All provinces except Alberta impose capital taxes on financial institutions at rates higher than those applicable to corporations generally. If a corporation has a permanent establishment in more than one province, its capital is allocated among the provinces in a similar fashion as income. Capital for this purpose is quite broadly defined and in the Province of Ontario includes not only paid-up capital but all surplus accounts, long-term debt, short-term capital related debt, certain reserve funds and all bank loans. For the purpose of calculating Ontario corporate income tax, the capital tax payable is deductible from income.

The Ontario capital tax will be completely eliminated on July 1, 2010. For businesses mainly engaged in manufacturing and resource activities, the Ontario capital tax was eliminated effective January 1, 2007.

(4) Ontario Corporate Minimum Tax

The Province of Ontario imposes a Corporate Minimum Tax ("CMT") at the rate of 4% on corporations which have either annual gross revenues exceeding \$10 million or gross assets in excess of \$5 million. Effective July 1, 2010, the corporate minimum tax rate will be reduced from 4% to 2.7%. More small and medium sized business will be exempted from this tax. The tax is applicable to a corporation's book income computed in accordance with Canadian generally accepted accounting principles. It is adjusted to reverse consolidated or equity methods of accounting within corporate groups and to eliminate inter-corporate dividends included in income and booked capital gains which are deferred under applicable rollover provisions. Where a corporation carries on business in more than one province, its tax base is reduced to the portion allocated to Ontario. The CMT is payable only to the extent it exceeds the regular tax liability and any CMT paid can be carried forward up to 10 years to reduce regular tax payable to the extent that it exceeds CMT in those years. The amount carried forward is adjusted for any change in the proportion of corporate income allocated to Ontario.

5.5 Death, Departure from Canada or Entry into Canada

(1) Consequences of Death

(a) Death Duties

Except for the deemed disposition of capital property which occurs under the ITA on the death of an individual, and the deemed realization of taxable capital gains in consequence thereof, there are no death duties, succession duties or estate taxes levied by the federal government or by any provincial government in Canada. A few provinces levy an estate administration tax. In Ontario it is imposed when an application is made to the Court for the appointment of an estate trustee on the value of the assets to be administered under the appointment at the rate of \$5.00 per \$1,000.00 of value on the first \$50,000.00 of value and \$15.00 per \$1,000.00 of the balance.

(b) Capital Gains Tax

The ITA provides for a deemed disposition and re-acquisition of all capital property owned by the deceased immediately prior to death. In the case of non-depreciable capital properties, the deemed proceeds are equal to the fair market value of the property at the time of death. This will result in the realization of either a capital gain which is taxable if the value of the property has increased since it was acquired, or a capital loss deductible against other capital gains if the value of the property has decreased since it was acquired. Any capital gain deemed to be realized on qualifying farm property or small business shares will be eligible for the capital gains exemption of up to \$750,000 to the extent not previously used if the deceased was a resident of Canada. This will apply to those qualifying dispositions on or after March 19, 2007. The recipient entitled to receive the capital property will be deemed to have acquired the property at the same fair market value.

If the property deemed to be disposed of is depreciable property of a prescribed class, the proceeds deemed to be realized will in most cases fall somewhere between the original cost of the property and

the undepreciated capital cost. This may result in a recapture of depreciation which is included in income and taxed as such. There may in addition be a taxable capital gain if the fair market value of the property has increased above original cost. No capital loss is allowed, but there may be a terminal loss fully deductible from income if the fair market value of all property in the class has decreased below the undepreciated capital cost. The recipient entitled to receive the property will be deemed to have acquired the property at the same value unless such value is less than the cost to the deceased. In this event, the recipient will be deemed to have the same cost as the deceased and have taken the difference as capital cost allowance which may be recaptured and added to income on a subsequent sale of the capital property by the recipient.

Where the recipient entitled to receive the capital property is the spouse of a deceased Canadian resident, or a qualifying trust of which the spouse is the beneficiary, there is a "rollover" which eliminates the deemed disposition and reacquisition by the deceased and results in the spouse or spousal trust receiving the property at a deemed cost equal to the cost base of the deceased in the case of non-depreciable capital property or equal to the undepreciated capital cost in the case of depreciable property. The effect of the "rollover" is to defer the realization of any taxable capital gain, any recapture of capital cost allowance and the imposition of tax until the property is subsequently disposed of by the spouse or the spousal trust. No such "rollover" is available upon the death of a non-resident.

If capital losses exceed capital gains in the year of death, the difference may be deducted from other types of income both in that year and in the preceding year to the extent that they exceed the capital gains exemption claimed in previous years.

(2) Departure Tax

Upon a person ceasing to be a resident of Canada, the ITA provides for a deemed disposition of most properties owned at the time of departure for proceeds equal to fair market value and a deemed reacquisition at the same amount resulting in the deemed realization of accrued capital gains and losses. The excess of deemed realized capital gains over deemed realized capital losses is taxable at that time at the rate applicable to capital gains.

Exemption from the deemed disposition and realization is provided for only a few types of property such as pension and retirement benefits and Canadian real property which continues to be taxable upon disposition by a non-resident of Canada. An election is available to individuals to postpone the deemed disposition for specified properties provided that security is furnished for the tax which would otherwise be payable and the election is not made selectively among the departing individual's properties in such a way that losses exceed gains thereby creating a deemed net loss that may be offset against actual gains.

Any individual who has been resident in Canada for 60 months or less during the 10 years preceding the date of departure is exempt from the deemed disposition of any capital properties owned at the time the individual became a resident of Canada or were acquired by bequest or inheritance by such person during the period of residence.

Corporations which cease to be resident in Canada do not have available to them the election to defer the deemed realization of capital gains, and they are subject to an addition tax on the amount by which the corporation's net deemed proceeds of disposition exceeds its paid up capital and outstanding debts and obligations. The tax is imposed at the rate of 25% and applies for the tax year considered to have ended upon the corporation's emigration to the new locality. Additionally, the 25% rate will be reduced to the rate applicable to dividends paid to a parent corporation in the country in which the corporation becomes resident under a tax treaty in force between Canada and that country.

(3) Entry Considerations

(a) Revaluation

Persons entering Canada and becoming residents are deemed to have acquired most properties owned by them at that time at fair market value so that gains accruing only while the taxpayer is resident in Canada are taxed on ultimate disposition. This rule does not apply to properties that are classified as taxable

Canadian property and any properties in respect of which an election against deemed disposition was made on a previous departure from Canada. Such properties retain the original cost base so that all accrued gains will be taxed on a subsequent disposition.

(b) Immigration Trust

Persons entering Canada who have substantial assets may be able to achieve considerable tax savings by establishing a non-resident trust in a tax haven or a low tax jurisdiction which can result in income being earned free of Canadian income tax for up to 5 years. This exemption is available where no contributor of property to the trust has resided in Canada for a total of 60 months before the end of a particular taxation year of the trust. A person entering Canada who is able to establish a non-resident trust for the benefit of resident family members who will be entitled to receive only capital distributions from the trust has an opportunity to arrange for investment income to be earned through the trust without the imposition of Canadian income tax. The rules are very technical, but if due care is exercised in the establishment and administration of the non-resident trust, substantial tax savings should be achievable.

(c) Timing of Income

Differences exist in the taxation rules between Canada and the former country of residence. The rate of income tax may be significantly different between the two jurisdictions and, if the person can control whether certain income will be received either immediately before or immediately after entry into Canada, arrangements should be made to receive the income in the lower tax jurisdiction. Additionally, income such as interest which has accrued prior to entry into Canada may be fully taxed on receipt in Canada even though it was taxed on an accrual basis in the former jurisdiction, and it may be possible to take steps to avoid the double taxation which would result.

5.6 Ontario Land Transfer Tax

(1) Rates of Tax

The Province of Ontario imposes a tax on the conveyance of real property in Ontario. The rate of tax imposed is 0.5% of the first \$55,000 of the value of the consideration paid, 1% of the amount exceeding \$55,000 up to and including \$250,000 and 1.5% of the amount exceeding \$250,000. Where the property consists of one or two single family residences, a tax rate of 2% is levied on the consideration in excess of \$400,000. With respect to leases, those for a term which cannot exceed 50 years, including rights to extension or renewal, are not subject to tax. However, the granting of an option to purchase land is taxable.

(2) Imposition

The Land Transfer Tax is imposed at the time of the registration of the conveyance in most cases. However, for an unregistered transfer of a beneficial interest in land held in trust, the person acquiring the beneficial interest is required to file a return containing details of the conveyance and to pay the tax within 30 days after the conveyance. Any person who holds a legal interest in land in trust for another person is also required to file a return within 30 days of becoming aware of a disposition of a beneficial interest in the land.

(3) Deferral on Corporate Reorganization

A deferral is available for the land transfer tax payable on the transfer of beneficial interests in land between affiliated corporations resulting from a corporate re-organization. On application for the deferral, an undertaking must be given that the two corporations will remain affiliated and the acquiring corporation or another affiliated corporation will continue to own the land during the 36 months next following the acquisition. Security for the deferred tax must be furnished. If the undertaking is satisfied or land transfer tax is paid on registration of a conveyance during the 36 months, the deferred tax will be cancelled and the security will be returned.

5.7 Municipal Land Transfer Tax

(1) Rates of Tax

Effective February 1, 2008, the City of Toronto imposes a tax on the conveyance of real property in Toronto. The rate of tax imposed is 0.5% of the first \$55,000 of the value of the consideration paid, 1% of the amount exceeding \$55,000 up to and including \$400,000, 1.5% of the amount exceeding \$400,000 up to and including \$4,000,000, and 2.0% of the amount exceeding \$4,000,000. Where the property consists of one or two single family residences, a tax rate of 2.0% is levied on the consideration in excess of \$400,000. With respect to leases, those for a term which cannot exceed 50 years, including rights to extension or renewal, are not subject to tax. However, the granting of an option to purchase land is taxable.

(2) Imposition

The Municipal Land Transfer Tax is imposed at the time of the registration of the conveyance in most cases. However, for an unregistered transfer of a beneficial interest in land held in trust, the person acquiring the beneficial interest is required to file a return containing details of the conveyance and to pay the tax within 30 days after the conveyance. Any person who holds a legal interest in land in trust for another person is also required to file a return within 30 days of becoming aware of a disposition of a beneficial interest in the land.

5.8 Other Canadian Taxes

(1) Customs Duties and Excise Taxes

Most goods entering Canada are subject to customs duties under the *Customs Act* (Canada) which imposes duty at various levels and rates depending upon the goods in question and the country of origin. The duty may be calculated as either a percentage of the fair market value of the goods in the country of export or a flat rate per unit. Remissions or drawbacks are currently available for goods subsequently exported or incorporated into other manufactured goods which are exported, with the exception of certain goods traded between Canada and the United States. Under the Canada-United States Free Trade Agreement ("FTA"), drawbacks may not be given with respect to most materials imported by a party from third countries and subsequently used in goods exported to the other party.

The principal effect of the FTA has been a three-stage phase out of all duties on goods traded between Canada and the United States effective on January 1, 1998, which was carried forward under NAFTA for goods traded between Canada and the United States. Tariffs on virtually all originating goods traded between Canada and Mexico were also eliminated in 2008, with the exception of Canadian agricultural goods in the dairy, poultry, egg and sugar sectors (which are exempt from tariff elimination).

Duties may also be imposed under the *Special Import Measures Act* (Canada) where goods are being sold in Canada at prices below the selling price in the country of origin, in competitive markets and under similar circumstances where like goods are also manufactured in Canada. For such a tax to be invoked, the Canadian manufacturer whose market is being undercut must submit a complaint and establish a potential harm to the domestic industry. No limit on the tax is imposed and accordingly it can be quite substantial. The Canada Border Services Agency investigates the complaint and charges a temporary duty until an injury is established and an exact amount can be imposed. If no damage is found to exist, the temporary duty will be refunded. For disputes involving NAFTA partners, the agreement permits a binational review procedure to examine the domestic anti-dumping and countervailing duty determinations between the nations involved. Each country is obliged to petition for such an arrangement if requested by a person who is entitled under its law to commence the domestic review procedures.

Excise tax may also be imposed on importers as well as domestic manufacturers of the goods listed in the schedules to the *Excise Tax Act* (Canada) ("ETA"). In the case of imported goods, the excise tax is imposed on the customs duty paid value. The goods listed include numerous tobacco products and accessories, wines, transportation vehicles, gasoline, time keeping devices and various other items. Recently, amendments were introduced to eliminate excise taxes on a number of goods, including watches and jewellery products, which became effective on May 2, 2006.

(2) Goods and Services Tax

The Goods and Services Tax ("GST") is a multi-stage value added tax imposed on the supply of most property and services in Canada, including real or immovable property. The GST is imposed at the rate of 5% on the sale price of taxable property and services at each stage of the production and distribution process. Imports of goods (other than settler's effects) are subject to GST on duty paid value on entry into Canada. Imports of services and intangible personal property are also taxable and the importer is required to self-assess and pay the GST, unless the services or intangible personal property are to be used in a taxable commercial activity which will result in GST being collected by the importer (or such activity is not taxable by reason of being zero-rated).

Every person engaged in commercial activity in Canada, including non-residents, is to register and collect GST on all sales of taxable property and services as trustee on behalf of the taxing authority, subject to certain exemptions including the exemption available to small businesses having annual revenues not exceeding \$30,000 and the requirement that registered purchasers of real property self-assess and remit the GST directly. In most cases, except for sellers of exempt goods and services, registrants are entitled to an offsetting input tax credit ("ITC") for GST paid on inputs of property and services. GST Returns are to be filed and net tax is to be paid or net credits are to be claimed either monthly where annual revenues are \$6 million or more, quarterly where annual revenues are \$500,000 or more, or annually with quarterly instalments where total revenues are less than \$500,000.

The tax base of taxable property and services is very broad but there are two categories of exceptions applicable to property and services classified either as tax-exempt or as zero-rated. No GST is imposed in the former class, but the seller is not entitled to claim ITCs so there can be a substantial component of GST in the final selling price of tax-exempt property and services. There is also no GST charged on zero-rated property and services. However, the seller is entitled to claim ITCs so the GST is eliminated from the final selling price of all zero-rated property and services.

The category of zero-rated goods and services is quite narrow and includes basic groceries, prescription drugs, medical devices, agricultural and fishing products, farm livestock and many transportation services where the destination is outside Canada. All exports of goods and services are also zero-rated so that there will be no component of GST in the final selling price of goods and services exported from Canada. The category of tax-exempt property and services is broader and includes health care services, educational services, child care services, long term residential rents, unrenovated used residential housing, sales of land by individuals who did not use it in the course of a farming business or other commercial activity, and domestic financial services (which include trading in precious metals except for first sales and imports which are zero-rated), as well as non-commercial sales by non-profit organizations and charities and certain municipal and other governmental services.

Most real property sales and rentals are treated in substantially the same fashion as the sales of goods and services with GST charged on the sale price and rentals paid and ITCs being allowed subject to the principal exceptions relating to long-term residential tenancies and re-sales of unrenovated housing. A partial rebate of GST paid is available to purchasers of new housing priced under \$450,000. Rebates of GST are also available to non-residents of Canada for most goods which are taken out of the country within 60 days of purchase in Canada and for up to 30 days of hotel accommodation while visiting Canada.

In three provinces, Nova Scotia, New Brunswick and Newfoundland and Labrador, the GST has been combined with the local provincial sales tax and the combined tax is called the Harmonized Sales Tax or HST. These three provinces are known as participating provinces. Effective January 1, 2008, the HST rate was reduced from 14% to 13%. The HST is almost identical to the GST subject to a few minor variations. Effective July 1, 2010, Ontario will harmonize the existing 8% Ontario retail sales tax (RST) with the federal goods and services tax (GST) effective. As with other provinces, the HST will be applied at a rate of 13%, the provincial component of which will be 8%.

(3) Provincial Sales Tax

All provinces other than the three provinces which have adopted the HST impose a retail sales tax on goods sold within the province. Effective July 1, 2010, Ontario will also adopt the HST and will not impose a separate retail sales tax.

(4) Additional Taxes on Alcohol and Tobacco

In addition to other taxes imposed by the federal government, excise duties are charged to manufacturers and importers of tobacco products, beer, wine and spirits under the *Excise Act* (Canada) as well as the more recent *Excise Act, 2001* (Canada). Both pieces of legislation set out the rates of duty for such products, which may be quite substantial. Under the ETA, manufacturers and importers of these goods require an excise tax license. Similarly, all producers and packagers of these products must be licensed under the *Excise Act* (Canada) and the *Excise Act, 2001* (Canada).

In Ontario, as in most other provinces other than Quebec and Alberta, most alcoholic beverages are sold only through government outlets where substantial mark-ups significantly increase the price to the consumer (although domestic beer and wine may be sold through certain separate privately owned outlets). The province also imposes higher sales taxes on alcoholic beverages and substantial special taxes on tobacco products.

(5) Real Property Taxes

Municipalities in Canada rely on revenue principally derived from real property and business taxes. In Ontario, real property taxes are levied separately for general municipal purposes and school funding purposes. The tax in Ontario is based on the current value of land assessed for municipal tax purposes under provincial legislation which must be updated on a regular basis.

Individual municipalities apply a municipally determined tax rate to the assessed value of real property within the municipality and the rate is fixed in light of the municipality's revenue requirements. Business occupancy taxes formerly levied by municipalities in Ontario have been repealed and the lost revenue is being recovered through increases in the real property tax rate. The municipalities are authorized to fix separate tax rates for different classes of property established by the province. Municipalities in Ontario also raise some revenue through the imposition of various business licence fees, but generally may only impose such licenses for consumer protection, nuisance control or health and safety purposes.

(6) Employer Health Tax

The Province of Ontario has imposed the Employer Health Tax ("EHT") to assist in the funding of health care which is provided without charge to residents of the Province. The tax is a payroll tax imposed at graduated rates on the total remuneration paid to employees in Ontario, beginning at a rate of 0.98% and increasing up to a maximum of 1.95%. Eligible employers are exempt from paying the EHT for the first \$400,000 of the payroll. The EHT is paid in either one annual payment or multiple monthly instalments depending on the size of the payroll.