Questions And Answers On Tax Reform

The Department of Finance
The Canadian Institute of Chartered Accountants and
The Canadian Bar Association

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The answers given in this book provide additional explanations of the policy proposals contained in the White Paper on Tax Reform. They are intended to assist in understanding the proposals and to facilitate the consultations to which the government is committed. They should not be construed as an explanation of the legislation that will be introduced to implement the tax reform proposals.

FOREWORD

This book contains the edited transcript of a video roundtable discussion on tax reform held June 21, 1987 and is being distributed by the Department of Finance as a courtesy to tax professionals across Canada. The roundtable was sponsored by the Canadian Institute of Chartered Accountants (CICA) and the Canadian Bar Association (CBA) and was made in co-operation with the Department of Finance. This book also includes answers to questions which could not be addressed within the time limits of the video session. Copies of the videotape are available through the CICA or CBA.

The CICA and CBA would like to express their appreciation to officials of the Department of Finance for their effort and co-operation in making this book available to tax professionals. They would also like to thank the many professionals who took time to send in questions for the roundtable.

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INCOME TAX REFORM

OVERVIEW

1. **Question**

Could you briefly outline the consultation process and the timing for Stage One legislation?

Answer

The White Paper proposals are aimed at producing a fairer system with lower rates and a broader base. In view of the broad range of changes proposed, it is important that Canadians and especially tax professionals understand how the proposals will work and that we are made aware of any concerns regarding the operation of specific measures. This is a White Paper, and we look to the professional community to bring comments to us on the operation and operability of the proposals that the Minister has made.

To meet this objective, over the course of the summer we will be meeting with numerous groups to explain and clarify details of measures and to hear and consider their views. At the end of the summer, the Standing Committee on Finance and Economic Affairs will be holding hearings to seek the views of Canadians on the proposals. With the input obtained from the standing committee, from our own discussions, from the round tables and so on that the professions will be holding in the fall, we expect to be in a position by late autumn to introduce Ways and Means Motions on the first stage of tax reform -- that is, the income tax measures and the interim measures with respect to the current federal sales tax. Clearly, to move forward with the second stage of tax reform on the sales tax proposals will take longer. This video production is an important element in our effort to reach Canadians on the workings of the tax reform proposals and to begin this process of dialogue which we expect to take place over the weeks and months ahead.

2. **Question**

You mentioned Stage One and the move to Stage Two of the reform process. There seems to be a little confusion on this with some of the comments in the press on a couple of fronts. What kind of a time frame do you see Stage Two taking? Is this likely to be an extended process or is it likely to move ahead fairly expeditiously?

Answer

Well, as the Minister said, we don't really know. What we plan to do is to begin to work immediately with the provinces to see whether there is a possibility of making a national sales tax system work. We'll be hearing from Canadians on that over the course of the fall and we will move as fast as we can move, and I think that's about all one can say.

3. **Question**

I notice a suggestion in the media that it's only when we get to Stage Two that we will pay for Stage One. Would you like to comment on that?

Answer

There's been a certain amount of misunderstanding on this. Stage One of the proposals -- the income tax proposals and the repairs to the current federal sales tax -- is, in and of itself, essentially neutral in its impact on the deficit. Certainly over the five years from now till 1992 or 1993 it is essentially neutral; although some years we win a little bit of revenue, other years we lose a little bit of revenue. So the question in some sense really relates to how we would see the sales tax and Stage

Two of the proposals working, and there we would expect that that Stage would also be revenue neutral: major changes on the sales tax which would pay for the replacement of the current federal sales tax, the very significant enhancement of the sales tax credit that will come along with it, the removal of the corporate and personal surtaxes, and an alteration in the brackets of the personal income tax schedule so that middle-income taxpayers would derive additional benefit. That also would be essentially a fiscally neutral change.

4. **Question**

One thing which some of us thought might be covered in this reform round but was not in the document was at least a revisit of the international area and the trusts area, which I think all of us recognize needs some reworking. Can you give us any comment as to your plans there?

Answer

There are many things in the Act as it stands that need reworking from a technical standpoint. We have a long-standing commitment to have technical bills from time to time. We continue to work away as hard as we can on technical deficiencies and improvements. Indeed, the two areas you mentioned are ones in which we hope to be in a position soon to bring forward appropriate changes.

5. **Question**

Just to revisit the provincial question for the moment. Is it fair to ask you, in your briefings of the provinces and discussions with provincial ministers, what their reaction has been to the income tax changes? Do you expect that they will generally go along with them or are they likely to resist them?

Answer

We worked very closely with the provinces over the last year and we think there is a general understanding of the objectives of the changes including the need to lower tax rates and to broaden the base. Clearly, individual provinces have their own particular needs and will be moving ahead in the normal course of events with budgets. But again, over the five-year period, for the provinces taken as a whole, the changes proposed leave them roughly even in terms of revenue, although, again, it's not absolutely identical year by year.

6. **Question**

Could you explain the apparent large benefit to the two provinces of Ontario and Alberta?

Answer

Well, as you know, there is a significant broadening of the corporate tax base and even though Quebec, Ontario and Alberta are not part of the corporate tax collection agreement, historically they have followed fairly closely the federal base. So if they do not move their rates, and since corporate income tax in Ontario and Alberta represents a fairly significant slice of their total revenue pie, that means that at unchanged rates there is some significant increase in corporate revenues in those provinces.

BUSINESS MEALS AND ENTERTAINMENT EXPENSES

7. **Question**

It is suggested that the cost of meals at recreational events provided by an employer for the general benefit of the employees will not be caught by the 80 per cent rule. Will meal costs reimbursed to employees working overtime where there is a general company policy, or a union contract, that provides for such reimbursement of meals while working overtime, be subject to the 80 per cent rule?

Answer

The quick answer is yes such costs will be subject to the 80 per cent limitation. The general idea behind this rule is that there is a personal consumption element with respect to meals and certainly the employee who is working overtime should not be treated any differently than the employee who is on travel status. Therefore that personal consumption element will be taken into account - the 80 per cent limitation in that specific case will apply.

8. **Question**

That takes us to another category: meal costs which are incurred at recreational events which aren't held for all employees of a company at large but may be held for divisions of a company. We're thinking about such things as picnics and Christmas parties or indeed even general meetings of divisional groups within a company. How does the 80 per cent limitation apply here?

Answer

That is a far more difficult question to address with a very categoric answer. There is an exception to the rule for benefits that would be available to all employees. Given the contexts that you have just described, it would be a question of fact. Guidelines will have to be developed and interpretation bulletins will have to be issued dealing with different examples so the taxpaying public will understand what the rules are and how they will apply to particular situations. In general, when an event or company cafeteria is for the benefit of all the employees, the limitation will not apply; but will apply when it's available to selected employees. There will have to be a demarcation line. Therefore I can't give you a categoric answer, but recognize the need to develop guidelines in this area.

9. **Question**

I take it for example that the executive dining room is clearly out. But where you have, say, a division of a major manufacturer that is operating rather independently of other groups in the company, could functions for the entire division be excluded under this rule?

Answer

In that kind of example, where it is an entire division that comprises a large number of employees and whatever is being made available is available to all the employees, the limitation would not apply.

However there will have to be lines of demarcation. It's hard to discuss particular situations because the facts of each particular case will have to prevail. It would be very difficult to put side by side a situation where you have a division with 400 or 500 employees with one where you have 2 or 3. So those kind of guidelines as I indicated earlier will hopefully delineate between the kinds of expenses that will fall within the limitations and those that will not.

I think the thrust of the proposal is quite clear. But where the administrative guidelines will have to be developed, as in many situations, that becomes a little more difficult and we recognize the need to get those rules out.

10. **Question**

Will the 80 per cent limitation apply to meal costs incurred by a taxpayer and subsequently billed to a third party? I guess here we're zeroing in on the professional practices of accountants and lawyers and the like who would possibly bill such costs to a client.

Answer

To the extent that the meal costs are incorporated in the billing and are not identified as a meal allowance, the limitation will apply to the taxpayer who is sending out the bill. However, if it is itemized as a meal expense and billed as such, then the 80 per cent limitation will apply to the client or customer.

11. **Question**

Where we have an individual incurring such costs directly, either as an employee or perhaps as a partner in a firm and then charging back to the company only 80 per cent of the cost of the entertainment or the meals, how is that going to be handled?

Answer

A quick reaction to that is that if it were possible to follow such costs to the ultimate payor, you would probably want to accommodate it. As a practical matter, however, it may be difficult to deal with such arrangements -- particularly where the employer pays a standard meal allowance rather than reimburses actual expenses -- and it may therefore be necessary to have the 80 per cent limitation apply to the employer.

12. **Question**

Does the 80 per cent limitation on entertainment expenses apply to lunch expenses incurred by an employer for an employee, and is there a distinction between a Christmas party for employees and a luncheon meeting with an employee paid for by the employer?

Answer

In the first case, the 80 per cent limitation will apply. There is not any difference between an employee on travel status and providing an employee with a meal. In that particular situation it's not generally available to all employees, and therefore where an employer does provide a meal or takes an employee out for a meal, the limitation will apply. In the context of the Christmas party for all employees, the cost would be regarded as an entertainment expense that is broadly available and therefore would not be caught by the 80 per cent limitation.

13. **Question**

More line-drawing?

Answer

More line-drawing, but I think in the context of the principle that is being developed here, it's more of a clear-cut situation of something being available to all employees of the firm.

AUTOMOBILE EXPENSES

14. **Question**

This question involves a transitional issue. What is the effect of the current imputed stand-by charge on the proposals? For example, if someone acquires, say, rather than a $20,000 automobile, a $50,000 automobile, how are the current provisions going to impact on those proposed in the White Paper?

Answer

They won't. At the corporate level or the employer level they'll be restricted to claiming capital cost allowance based on a total cost of $20,000, while the benefit imputed to the employee would be based upon the actual cost of the automobile.

15. **Question**

A related question has to do with the coming into force of these provisions. There appears to be some confusion in the Notice of Ways and Means motion and the White Paper itself with respect to when the proposals relating to automobiles will come into force. You might comment on that?

Answer

I note that the White Paper refers to fiscal periods ending after 1987. Both of these measures, that is, the $20,000 restriction and the measures applicable to personal-use automobiles, will apply to fiscal periods that both commence after June 17, 1987 and end after 1987.

16. **Question**

So it only applies with respect to automobiles purchased after that effective date or leased after that effective date?

Answer

That's right. (The $20,000 cost limitation) applies for automobiles purchased after June 17, 1987 (otherwise than pursuant to an agreement in writing entered into on or before that date), and again only for those fiscal periods that start after June 17 and that span into 1988. (The measures applicable in respect of personal use also apply only for those fiscal periods that start after June 17 and that span into 1988.)

17. **Question**

Do the restricted expense rules as proposed apply to automobiles owned by a corporation or automobiles owned by a partnership?

Answer

To answer that question you really have to separate the two proposals -- one to restrict the maximum depreciable capital cost of an automobile to $20,000, and the other proposals applicable with respect to significant personal use. On the $20,000 rule, corporations, partnerships, individuals - all taxpayers -- will be restricted to a depreciable cost of $20,000 for automobiles in order to exclude the luxury element. In the case of the rules relating to personal use, corporations obviously can't make personal use of automobiles themselves, with the result that that proposal will not apply directly to a corporation. It will apply to partnerships because CCA is claimed at the partnership level on behalf of the individual partners, and it will apply to individuals.

18. **Question**

A further question has to do with the proposal to restrict carrying charges on money borrowed to purchase a passenger vehicle. The restriction is going to be $250 a month which equates to a effective interest rate of about 12 1/2 per cent a year, if you are going to fully finance a $20,000 automobile. The question is, how that restriction impacts upon someone who leases an automobile and whether or not the full lease cost for a $20,000 automobile will be deductible or whether there will be some consideration given to, in addition, the limitation on any carrying charges which of course are normally built into the lease charge?

Answer

The lease charges will be restricted for luxury automobiles or automobiles costing more than $20,000. We recognize that there is a financing component built into the lease cost and we expect that the rules when implemented will pick that up in the context of restricting lease charges for automobiles that cost in excess of $20,000.

19. Question

Will any details be forthcoming as to what constitutes "a reasonable allowance based on distance" travelled which will continue to be excluded from income?

Answer

Revenue Canada will be reviewing the need to issue guidelines as to what constitutes a "reasonable allowance".

20. Question

Page 84 contains statements relating to the "standby-charge" for employees, as follows:

- removal of the reduction of the standby charge where personal use of the automobile is less than 1,000 km per month;

- removal of the election to include in income one half of the standby charge, in lieu of itemizing the operating expenses where the vehicle is used less than 50 per cent for business purposes.

In other words, do these changes apply to all automobiles, or just to "passenger vehicles"?

Answer

These changes will apply with respect to all motor vehicles, not just with respect to "passenger vehicles" as defined in the document.

21. **Question**

Why is there no provision for the exclusion of any premium for commercial insurance coverage from the employee's income in the statement on page 84?

Answer

A reimbursement by an employer of the premium for commercial coverage because of the use by the employee of a vehicle in his employment will be excluded.

22. **Question**

Are the expenses which are denied under resolution 3(b) -- insurance, licensing, parking -- also denied when business use is 20 per cent or less?

Answer

Yes they will be.

23. **Question**

Will depreciation recapture or terminal loss apply on the disposition of a vehicle used 20 per cent or less for business purposes?

Answer

No.

24. **Question**

Assume that a self-employed person with a December 31 fiscal year acquires a $50,000 passenger vehicle in August 1987. Capital cost allowance of $7,500 is claimed in the 1987 fiscal year. In 1988, is CCA claimed on $20,000 or $12,500 (i.e. $20,000 minus $7,500)?

Answer

Capital cost allowance for 1988 would be calculated by reference to $12,500.

25. **Question**

Is the business use percentage applied to the $250 per month or is the result of the "actual interest x business use percentage" limited to $250 per month? In other words, is it possible to claim $250 per month if the business use is less than 100 per cent?

Answer

The business use percentage applies to the $250 per month.

HOME OFFICE EXPENSES

26. <u>Question</u>

A couple of questions on this issue of home office expenses and the carryover of the excess. There seems to be some confusion as to whether the carryover is a one-year carryover or an indefinite carryover. Could we have a comment on that?

<u>Answer</u>

The intention is that when the home office expenses exceed the income for the year the excess will be carried over and treated as an expense incurred in the next year. To the extent that those carried-over expenses and any further actual expenses in the second year exceed the income from the business in that year, they would then qualify to be carried over for the third year. That is the mechanical way in which we think this carryover is best implemented. Certainly it's the simplest and most straightforward way of implementing this proposal.

27. <u>Question</u>

So it's a continual roll forward, as opposed to a year-by-year categorization?

<u>Answer</u>

That is correct.

28. <u>Question</u>

One question was raised on the measurement of income to compare the expenses to, and the questioner asked, would it be necessary to identify the business income that arose from the activities in the home as distinct from those that might arise elsewhere, and do you have in mind that kind of an allocation?

Answer

No we don't. Perhaps in textbook theory one might think it appropriate to try to identify the income from the business carried on through the home, but as a practical matter that would not be possible. So it's the income from the business overall, without any attempt to narrow it down to the income from that part of the business that is conducted through the home.

MINIMUM TAX

29. **Question**

We want to move now to look at the question of the interaction of the minimum tax with all these changes. First, in a very general way, I have not been able to find anything in the document to do with minimum tax at all. Could you give us some idea as to how you see the existing minimum tax interacting with the various proposals we have here?

Answer

There will be a number of consequential changes to the minimum tax legislation following the White Paper proposals. In general, these changes are really consequential -- they don't fundamentally alter the design of the minimum tax. For example the rate of tax will continue to be 17 per cent as it is right now. Those deductions which have been converted into credits and that are currently deductible from the minimum tax will now become creditable from the minimum tax. Thus for example, under the minimum tax, taxpayers now are allowed to deduct personal exemptions and marital exemptions and exemptions for children. In future, they will be allowed to claim a credit in lieu of the personal exemptions. Those deductions that are disallowed are not converted into credits and will remain non-deductible from the minimum tax. So these changes will generally parallel the current system and will not alter the basic design of the minimum tax.

30. **Question**

One of the rationales for the 17 per cent rate under the existing system is that it was half of the top individual rate, and some suggestion has been that perhaps it should be reduced to 14 1/2 per cent being half the top personal rate, but I guess you are sticking to the 17 level?

Answer

Yes the government proposal is to leave the rate as it is. This is also the lowest rate that is applicable to individuals on income and it was felt appropriate to leave the rate as it is.

31. **Question**

What portion of capital gains will be included in the minimum tax base?

Answer

As you know, there is now a dual regime for capital gains. Those capital gains that are over and above the lifetime exemption are fully included in the minimum tax base and that will continue to be the case under the new regime. So those capital gains that exceed the lifetime exemption amount will be fully included in the minimum tax base. In the case of those capital gains which are eligible for the lifetime capital gains exemption, the portion that is included in the minimum tax base is only the exempt portion of capital gains. Thus for example if you have \$300 of capital gains and the taxable portion of \$150 is eligible for the lifetime exemption, you only include the \$150, the exempt portion, in the minimum tax base. Under the new system, the provision will be similar. In the case of the capital gains eligible for the lifetime exemption, it is the exempt portion -- that is one-third (one-quarter after 1989) -- that would be included in the minimum tax base.

32. **Question**

Questions about the exemption level at \$40,000: Will that continue to be such or will that be turned into a credit at \$6,800, being 17 per cent?

Answer

The exemption of \$40,000 will remain \$40,000.

33. **Question**

How would the carryoverwork for 1986 or 1987 being carried forward into 1988?

Answer

Our carryover rules will also remain largely unaltered. The carryover amount, as under the current rules, will be available for offset against any difference between the regular tax and minimum tax liability in the future years.

CAPITAL GAINS

Chairman: Well, what many people were expecting to happen, did happen; the lifetime capital gains exemption was capped at the $100,000 limit, and although it remains at the $500,000 limit for farmers and it has been increased effective for 1988 to the $500,000 level for qualifying small business corporation shares, a number of questions have come up in this area and there is no particular order to these questions, but I will just raise them as they appear.

34. **Question**

The first question is a technical point, and it has to do with the capping of the lifetime capital gains exemption at $100,000. Will the $50,000 amount that is noted in subsection 110.6(3) be increased to $66,667 and $75,000 in 1988 and 1990, respectively, as the taxable portions of the capitals gains increase?

Answer

The fundamental intent is to ensure that $100,000 of net capital gains, before computing the taxable part, continues to be exempt. In order to achieve that - as a technical matter - it will be necessary to increase the portion of the taxable gain that qualifies to $66,667 and subsequently to $75,000.

35. **Question**

The second question is perhaps something of an anti-avoidance question, but it deals with the situation as to the time of determining whether the shares of a small business corporation will qualify for the $500,000 lifetime capital gains exemption. And there, of course, is the requirement that a corporation employ all of its assets or substantially all of its assets in an active business before the shares will qualify for the lifetime capital gains exemption. The question is that, if immediately prior to a disposition -- with regard to a corporation that might not qualify because it has 15 per cent or 20 per cent of its assets, say, in investment type assets rather than in active business assets -- if those assets are transferred out and it can get onside and then the shares of the corporation are sold immediately thereafter, will that kind of timing permit the sale of the small business corporation shares to qualify for the $500,000 lifetime exemption?

Answer

It's an interesting question you've raised and rather an intricate one. The intention is, as noted on page 79 of the document, that it has to qualify as a small business corporation at the time of the disposition. And you've correctly recognized that there may be circumstances in which the corporation may not have been engaged in an active business at all, and yet disposes of all its assets after a very profitable investment history and therefore there is a large gain with respect to the shares. Would it be possible in such circumstances for the corporation then to go out and acquire, or convert all of its property into, active business assets in order to qualify its shares for the $500,000 exemption. There will be rules to limit the conversion. The purpose of the exemption is to recognize the gain on a successful small business corporation, not to allow the gain with respect to any investment corporation that is converted into a small business corporation.

36. **Question**

This next question is related, in some respect, to the one just posed. It has to do with some confusion that may have arisen over the 24-month holding period, which seems to me to say that before you can claim the lifetime capital gains exemption on the sale of shares of a small business corporation, you must have held those shares for a 24-month period prior to the date of disposition. Perhaps that's a question in itself, but let me just continue on and pose the supplementary question. Will there be exceptions built into the rules to take into account death and to take into account contractual obligations such as shareholders' agreements which may compel individuals to sell their shares prior to the 24-month holding period being reached?

Answer

That's a multi-stage question. I think I'd first like to clarify that there is not a 24-month holding period requirement in all cases -- for example, where a corporation has not been in existence for two years. The description of this measure on page 79 indicates that the corporation has to be a small business corporation, as that expression is defined, at the time of the disposition, and that the shares were not held by anyone other than the taxpayer, or a person related to him or her, throughout the immediately preceding 24 months. So that it is not necessary, for example, for the corporation to have been in existence for 24 months, and it's not necessary either for the shareholder to have held the shares for 24 months. Indeed, if you look at the proposed change outlined on page 140 of the document, you will see that a special rule is proposed that would enable an individual that carried on business directly to roll the assets into a corporation and subsequently sell the shares of that corporation. He might sell them fairly quickly after the reorganization or, in common parlance, the incorporation of the business. It's intended that the exemption would apply in those circumstances, and this will enable those individuals who carry on the business in an unincorporated form to so arrange their affairs to qualify for the exemption, and that is generally intended.

37. **Question**

Just to perhaps clarify in my own mind how and when the 24-month period would apply. Would it apply in those circumstances where you have unrelated parties selling and purchasing shares of a small business corporation? Mr. A sells to Mr. B and then the shares go up in value within a short period of time and, within a 24-month period, Mr. B sells those shares to an unrelated party, again for a gain. Would Mr. B be entitled to claim the lifetime capital gains exemption on that sale? Is that a circumstance when the 24-month rule would apply?

Answer

Yes the rule would operate to deny the exemption to Mr. B -- unless he were related to Mr. A.

38. **Question**

A further question raised involves the circumstances where an individual sells his shares in a small business corporation in 1987. However, he sells the shares on an instalment basis -- he's not cashed out, in other words -- and he claims a reserve for the unpaid balance such that in 1987 he would have a capital gain of $100,000. Assume that gain qualifies for the lifetime exemption, and then in 1988 and subsequent years, as the reserve comes in, he then of course has a capital gain during those years. The question is, during the 1988 and subsequent taxation years, would the enhanced lifetime capital gains exemption be available with respect to the capital gain arising on the falling in of the reserve?

Answer

That's not a question that's addressed directly in the paper itself. It is in the category of something to which we want to give further consideration. The preliminary intention would be that if it's a qualifying sale after June 18 of the shares of a small business corporation, it will be possible to obtain a carryover of the reserve until 1988 in order to benefit from the enhanced exemption. However, I want to emphasize that the $500,000 limit does not apply until 1988. This is an area in which we really do want some consultations with the profession in order to put some fine-tuning on the rule that will eventually come forward.

39. **Question**

A further proposal in the White Paper is that with respect to qualifying farming property. For real property acquired after June 17, that property will no longer be eligible in most circumstances for the lifetime capital gains exemption. What I was wondering is, if you have a farming corporation or a farming partnership, will those rules in any way impact upon the sale of the shares of an otherwise qualifying farming corporation or farming partnership, because of course the underlying property being sold in effect will be the real estate, and that real estate may have been acquired after the transition period?

Answer

I would take issue with the underlying assumption that the change to the definition of qualifying property will disqualify most farm real estate. That simply is not accurate. However, there is a change but it's only with respect to qualifying farm real estate acquired after June 17, 1987 where the real estate itself is sold. It is not intended that this change have any impact on the existing rules which allow the $500,000 exemption with respect to the sale of shares in a family farm corporation or an interest in a family farm partnership.

40. **Question**

Okay, you have answered my question, although I see it as being a very difficult proposition when you are selling your farm to sell only the real estate without, in effect, selling the entire farm. But presumably you're saying that if the whole business is sold, you would be allowed to claim the exemption even though one of those assets is real estate that was acquired after June 17, 1987.

Answer

Let me give you just a quick background. We were interested here in trying to restrict this to a bona fide gain with respect to farm real property. To some extent under the existing rules it was open to members of the non-farm community, such as land speculators, to obtain the exemption. It was less a problem under the existing rule because, of course, over the course of time, the capital gains exemption for all categories of capital property would be expanded to $500,000. Now that there is an absolute difference in the limit, it's necessary to restrict the exemption for farm real estate to what I would call bona fide circumstances, and that's the intention. That should serve as background to this change.

41. **Question**

I'd like to pick up on a point you were speaking to earlier on the sale of a CCPC, and you clearly drew the line of a disposition after June 17, 1987, concerning the ability to set a reserve and then bring the reserve into income in 1988 and beyond and have the $500,000 exemption. What's your position going to be as far as pre-June 17, 1987 sales where reserves are sitting or may be claimed for a sale earlier this year. Will that be able to be categorized as a CCPC reserve and rolled into 1988?

Answer

We want to give some further consideration and consultation on this before we draw the final line. Quite clearly the reserve, as the paper indicated, would qualify in 1988 for the purposes of the $100,000 capital gains exemption. The paper itself is very clear on that. The open question is, would a pre-June 18 sale qualify for the purposes of the special gain for shares of small business corporations. There is little justification for allowing the special exemption in these circumstances since, at the time of the sale, the tax consequences were fully understood.

42. **Question**

One of the questions raised, which I think you can deal with fairly quickly, along the same lines: again, speaking to capital gains reserves coming forward from 1986 or 1985 being brought into income in 1987. Would they be subject to the capital gains exemption?

Answer

No they won't. The changes that we're discussing generally come into effect for the 1988 taxation year. Certain aspects of the exemption, in relation to qualifying farm property, relate to property acquired after June 17, but the increase in the limit to $500,000 for shares of small business corporations will not take effect until the 1988 taxation year.

43. **Question**

Carrying on a somewhat similar line, again with pre-1988 reserves with the intention to increase the amount of capital gain that is included in income. If the capital gain is created in 1988, 1989, 1990 by a bringing back to income of a reserve from prior to reform, how much of it creates a capital gain or a taxable capital gain in that year?

Answer

The reserve amount brought into income will be adjusted in accordance with the new inclusion rates so that in 1988 the inclusion would be two-thirds and after 1989 the inclusion rate would be 75 per cent.

44. **Question**

The same rate for any other gain realized in that year?

Answer

Yes.

45. **Question**

For capital gains realized by corporations prior to taxation years that straddle July I, 1988 and for which reserves have been claimed, what proportion of the reserve included in income in each year will be a capital gain in that year?

Answer

As the paper notes, there will be a proration. If, for example, you have a company with a December year-end with total capital gains of, say, $100,000, then the inclusion rate on capital gains would be prorated on a daily basis. In effect, one-half of the gains -- in this example, 182/365ths -- would come in at the half rate and the remainder would come in at the two-thirds rate, and the proration depending on the number of days within the straddle period. Because of integration, as noted in the documents, for Canadian-controlled private corporations, the proration will be based on January 1, 1988 rather than July 1.

46. **Question**

Let's go back to the question of the capital gains and how much of the gain will qualify for the exemption, particularly this new concept of the cumulative net investment loss. There are a whole series of questions here. To lead off in that regard, could you clarify whether it is the full amount of the gain or the taxable portion of the gain in subsequent years that will have to exceed the cumulative net investment loss carry-forward before you qualify for exemption?

Answer

It is the taxable portion of the gain that we're talking about. So that effectively you have to earn taxable gains in excess of previous cumulative net investment losses before capital gains will qualify for the exemption.

47. **Question**

The next question I have relates to the concept of being actively engaged in the business to gain exclusion from the categorization as a cumulative net investment loss. Would you care to comment on what sort of criteria might be under consideration for determining when an individual might be actively engaged in the business for that purpose?

Answer

This again is a proposal of the White Paper on which we are prepared to consult. We have a similar concept currently in Income Tax Act Regulation 1100 and we'll be developing that concept. Let me say, of course, that being actively engaged in the business is not the only criterion as to whether or not an individual's circumstance means that he or she is or is not affected by the investment loss rules.

48. **Question**

Where an individual might be clearly considered to be carrying on or be actively engaged in the business through an interest in a partnership -- and let's just take that as a given for the moment -- what about his financing costs on his partnership interest, the carrying costs, for example, on the investment in the partnership? Would that be wrapped into the exempt area or indeed would that fall into the cumulative net investment loss?

Answer

Are we talking about a limited partnership or a general partnership? The investment loss rules will apply with respect to all limited partnerships and then to certain other partnerships where the individual is not actively engaged in the business. If we are talking about a limited partnership type of circumstance then we pick up all the losses flowing from the partnership as well as any associated interest and other financing costs. If it is a general partnership or other co-venture arrangement in which the taxpayer is actively engaged, the costs or losses would not constitute an investment loss.

49. **Question**

You raise an interesting concept as to whether one can be actively engaged in carrying on the business of a limited partnership. Would you care to comment on that?

Answer

It's not really relevant. All losses and costs relating to limited partnerships will be included in the cumulative net investment loss.

50. **Question**

Questions in particular with regard to being actively engaged in the business: one questioner asked, if the partner was involved in selecting tenants for a residential building and collecting rents from such tenants, would he be considered to be actively engaged in the business?

Answer

That's an interesting question. It comes back to the general criteria for individuals being affected by these rules. The example highlights the general point which should be emphasized: namely that in addition to any limited partnership arrangement, any loss for the year from renting or leasing of real property owned by an individual or by a partnership is to be included in the investment loss. Thus, whether the individual was or was not involved in the various activities that you described, that loss would be picked up under the proposals. Of course, in any other type of rental business, whether or not an individual is actively engaged in the business will be a question of fact depending on the circumstances. In this case, such factors as the degree of individual participation along the lines that you've talked about will obviously be taken into account. But in the straightforward real estate rental example, any loss is automatically included in the investment loss category.

51. **Question**

Moving to a slightly different area, the question has been posed with respect to dividends. Is it the cash amount of the dividend or the grossed-up amount of the dividend that will be taken into account?

Answer

Cumulative net investment losses will include all investment expenses net of any investment income received, and for that purpose the grossed-up amount of dividends will be included in the computation.

52. **Question**

Getting into the distinction between the categories of capital gains that will qualify for the $500,000 exemption and the $100,000 exemption: a specific question on small business corporations: If an individual has financed his capital

investment in the small business corporation with outside borrowing and has deductible interest against his other income, will that interest count for the cumulative net investment loss against the $500,000 exemption?

Answer

The proposal is to include all interest, including interest related to an investment in shares of a small business corporation, in the category of costs that enter into the investment loss calculation. However, it is not the intention to match individual carrying charges or other deductions against individual realizations of capital gains. We are looking at one pool of cumulative net investment losses. It is not the intention for there to be any kind of streaming of certain deductions, such as interest expenses in your example, against one part of capital gains, which might qualify for $500,000 or $100,000 gains. An individual will be carrying one cumulative pool of investment losses that will apply against gains realized after these rules come into effect, no matter what type of gain that happens to be.

53. **Question**

What about the area of resource expenditure losses? Would a loss for a resource limited partnership be considered to be an investment loss or a business loss?

Answer

Following again the general principle that all limited partnership arrangements fall within these rules, that would be an investment loss, not a business loss.

54. **Question**

The next question deals with how the changes in the computation of the capital gain beginning in 1988 will impact upon a private corporation's capital dividend account. Will the addition to a private corporation's capital dividend account be equal to the non-taxable portion of the capital gain, that is, one-third in 1988 and one-quarter in 1990?

Answer

The intention is that the non-taxable portion of the gain will be included in the capital dividend account.

55. **Question**

So therefore, when we are looking at reserves that private corporations may have claimed on their capital gains and when those reserves come in in 1988 and in subsequent years, we will be looking at the reduced amount going into the corporation's capital dividend account?

Answer

That is correct.

56. **Question**

A further question that is posed is rather an interesting one that involves a private corporation's fiscal year as straddling January 1 -- January 1 being the date, of course, when the two-thirds rule will come into effect for capital gains realized after that date. Say we have a corporation that has an April 30 year-end and the corporation has made a disposition of capital property in May of 1987 and has realized the gain. The directors of the corporation believe, say, they have a $3,000 taxable capital gain, and therefore $3,000 falling into the corporation's capital dividend account, not knowing at that time of course what the White Paper was going to hold and bring to bear on this surplus situation. So they immediately made a distribution of the $3,000 capital dividend account. The question now comes at year-end, following the introduction of the White Paper, as to whether or not the company did indeed have that amount in its capital dividend account or whether it has made an excessive distribution and could be subject to Part III tax?

Answer

We recognize that for certain corporations that may have distributed the balance in their capital dividend account as of some date before June 18, assuming that one-half of the gain would be included, there may be a problem. We're certainly prepared to look at that to ensure that the rule doesn't work in any unintended way -- that there is an appropriate transitional rule. But with respect to the capital dividend account and distributions out of it after June 17, the rule should work, we believe, as you discussed. The amount going into that account will be whatever the non-taxable portion of the gain is, and for straddle years that will of course depend on the proration rule discussed previously.

57. **Question**

The paper also indicates that a CCPC, whose assets are shares in operating companies who also qualify as SBCs, could qualify as a small business corporation for the purposes of the capital gains exemption. Presumably an intermediary holding company between the top holding company and the operating company would not, per se, disqualify the top company's eligibility for SBC status. Is this presumption correct?

Answer

Yes, the rule for the purposes of the capital gains rests on the existing definition of small business corporation in the Act.

58. **Question**

Also, the paper refers only to shares in operating companies when referring to subsidiaries. Current Section 248 refers to shares and certain debt obligations. Is this definition to be amended to refer only to shares?

Answer

The definition will not be altered but the capital gains exemption will apply only with respect to dispositions of shares.

59. **Question**

Will the deductions for earned depletion be considered "resource expenses" for the purpose of computing a taxpayer's net investment losses?

Answer

Investment losses are to be determined taking into account all deductions including depletion claimed by the taxpayer.

60. **Question**

If in 1988 I have a $450,000 capital gain on the sale of shares of a small business corporation on which I claim the capital gains exemption, can I still claim another $50,000 with respect to gains on other property?

Answer

Yes.

FARMING/FISHING

61. **Question**

Why don't we move for a minute and deal with questions in the area of farmers. We have some new rules for the computation of farming income to apply to fiscal years that commence after June 17. A relatively simple question is, does this apply to farmers of the sea -- fishermen?

Answer

Generally speaking the answer to that is no. The cash basis of accounting will still be available for fishermen.

62. **Question**

This is a question with respect to fiscal years currently in process. Will there be any restriction on maximizing 1987 fiscal year losses for cash basis farmers by purchasing additional inventory late in the year to create carryovers?

Answer

The answer is no. The existing rules will generally apply up until the end of this year and therefore that should not be a problem provided all the other rules and regulations are complied with and reasonable tests applied.

63. **Question**

On the issue of the computation of income on the modified accrual basis and the question of determining the cost for such things as crops in the field, harvested grain, non-purchased livestock, natural births and so on, is there any intention to assign a cost to that type of inventory?

Answer

No. Inventory costs will generally apply only with respect to purchased inventory. A farmer will be able to value his inventory either at market or at the lower of cost or market. For those farmers using the lower of cost or market rule, a nil cost will apply to produce grown or to animals born on the farm.

64. **Question**

If a farmer did choose to put everything at market for income-levelling purposes, he'd still be able to do that?

Answer

Yes.

65. **Question**

Can the cost of a race horse acquired after June 17, 1987 by a farmer (currently not restricted by section 31) be fully written off in a fiscal period that ends before 1988?

Answer

Yes, the new rules will not apply for fiscal periods ending before 1988.

66. **Question**

Are the start-up rules and the 10-year loss carryforward rules appropriate for farmers growing trees that cannot be harvested within 10 years?

Answer

The start-up rules will allow tree farmers to deduct up to $15,000 of farm losses against other sources of income in the first four years of the operation. After that period, if the profitability test cannot be met, restricted losses may be carried forward for up to 10 years. It should also be recognized that, by valuing inventory at market and with the cash basis adjustment, a tree farmer can defer the period at which losses are recognized. All of these measures will better match income against revenues and will reduce the tax-shelter potential of tree farms disposed of on capital account after the current deduction of all pre-production expenses.

67. **Question**

The tax reform proposes that losses from farming incurred by a taxpayer can be deductible from his income from other sources only if the taxpayer is a qualifying farmer who has net income in at least three of the most recent seven years. Is net farm income to be determined after the deduction of interest cost? If so, an otherwise legitimate farmer would be unable to deduct his farming losses against his income from other sources simply because of his interest burden, which may already be in place or which could arise because of increases of interest rates in the future or because of additional borrowings to finance farm improvements or expansions. Are there any "reasonable expectations of profit" relieving provisions after the proposed tax reform?

Answer

Net farm income will be computed after the deduction of interest expense for the purposes of the profitability test. However, any losses denied under this rule may be carried forward for 10 years against farm income. As well, even where the objective profit test has not been met, a taxpayer can still achieve qualifying farmer status by showing that, on an ongoing basis, there is a reasonable expectation of meeting these criteria.

68. **Question**

The gross revenue requirement for a full-time farmer as proposed in tax reform may also cause undue inequity in certain instances. If the farmer has substantial income from other sources, such as interest and dividends because of personal wealth, his farming loss will be restricted even though the farmer is a full-time farmer. Are there any relieving provisions to address any inequity in this regard?

Answer

The gross farm profit test is designed to obviate the necessity for a "chief source of income" test and is quite lenient in view of the fact that it is gross farm revenues which are compared to net income from other sources.

69. **Question**

Does the 20 per cent maximum write-off for racehorses apply to all farmers?

Answer

Yes.

SECTOR IMPACT

70. **Question**

Moving to a couple of general questions on sector impacts, the questioner makes the statement that the mining, manufacturing and financial services industries are under pressure already. Why then did the Minister single them out for specific corporate tax increases?

Answer

It's probably not fair to characterize the changes that have been made as singling out any particular sector or any particular industry. The changes that are being proposed affect all sectors across the economy. If you look at the various sectors, each sector of the economy will now have taxable income that will be closer to the income it reports for financial statement purposes. It is fair to say that those sectors that have before now experienced lower than average tax rates, will have relative increases in their taxes payable. Those sectors which have traditionally had higher than average tax rates will experience reductions. But I should add that not all preferences have been removed. We haven't moved to a completely level playing field. A sector such as mining, for example, although its tax rate will increase somewhat, will still have an average tax rate about 3 percentage points less than the tax rate experienced on average across sectors. Manufacturing began prior to tax reform with an average tax rate that was basically equal to the average corporate tax rate, and it will remain about at the average. The changes have been designed, in particular, to ensure that those profitable firms that have previously been able to avoid tax will begin paying tax.

71. **Question**

You mentioned manufacturing and it staying in relative terms at about the same position. How does our manufacturing sector and its tax burden compare to that of the United States after their reform? Do you have any data on that?

Answer

Yes, I think I have to start with a disclaimer in answering a question of that sort. When you make any general comparisons of the tax impact of a regime in one country versus a regime in another country, you have to recognize that individual firms and individual sectors will experience tax treatments in particular cases that could be quite different from the average. For example, they may have a different profile of expenditures than average, there is considerable variation in state and provincial tax rates, and in looking at the U.S. it is very difficult to anticipate in advance what the likely impact of the new minimum tax would be. It's therefore hard to draw a clear conclusion. Nevertheless, in looking just at tax factors and not at the many other factors that affect competitiveness, it is fair to say that manufacturing and resource sectors retain a competitive position vis-a-vis the U.S., at least on average. And in fact if you look at the pattern of taxation in the United States and the pattern of taxation in Canada, in both countries the variation has been reduced. So in some sense the two countries are converging in terms of pattern of tax vis-a-vis one another and that means, looking across all sectors overall, that the ability of Canadian firms to compete in other sectors, other than the ones that I focused on at the beginning of my remarks, will be enhanced.

LOSS TRANSFERS

72. **Question**

Our next question deals again with a somewhat conceptual area. Whatever happened to the paper on loss transfers, that was introduced with the 1985 budget? Are there still plans to go forward with new rules to enable the transfer of losses among a related group of companies?

Answer

These proposals have not yet been implemented. However, it should be recognized that rules that have been put in place to limit the ability of firms to transfer deductions to other firms are generally not applied within corporate groups. We've had, since the 1985 paper on loss transfers was put out, a number of special rules introduced which exempted such transactions. In addition, the new preferred share tax which is being put in will not be applied within corporate groups. Thus, there has been a special accommodation for corporate groups and transactions and arrangements within corporate groups within the system. With regard to the proposals themselves, we have had a number of discussions on an ongoing basis with provincial officials. They have expressed legitimate and serious concerns with the proposal. The federal government believes that it is important, in order to achieve real simplification in the implementation of such a system, that the provinces should be part of that system, and so we will be continuing to talk with the provinces. The provinces will undoubtedly want to wait until they can see how the tax reform proposals fully evolve and how they impact the taxation of industries because it's probably easier to implement a proposal of this type from their point of view in an atmosphere where losses recorded by corporations really are business losses and not tax-driven losses.

CAPITAL COST ALLOWANCE

73. **Question**

The next question is on the put-in-use rule, a new rule proposed to be brought into our Act borrowed from the United States and other countries that have it. Many people believe it only applies to real estate, but it's much broader than that, of course; it applies to any assets in which capital cost allowance or investment tax credits may be claimed. The first question is one dealing with timing and when it comes into effect. If a manufacturing plant construction commences now in 1987, and the plant is not put into use until January 31, 1991, does this mean that no depreciation can be claimed until 1991, assuming the fiscal year of the corporation is a calendar year?

Answer

No, it does not mean that. The proposal is generally intended to ensure that costs of assets cannot begin to be written off until they have been put in place and there is income being earned with respect to the expenditures that have been made. That's the general principle that is going to be applied. But, the change will not be implemented until 1990. That means that any expenditures that are made in 1987, 1988 or 1989, regardless of when a project may be completed in the future, will continue to be written off under the current rules. In other words, deductions relating to depreciable property will be recognized when the assets are acquired. For projects that are completed in 1990, in effect there is no change because, while the expenditures are subject to the rule, if it is put in use in that year there will be no impact. So it's only for expenditures on projects that are not completed until 1991 that there will be any impact and that will only be with respect to expenditures that are made after 1989. So in the specific example you mentioned, expenditures that are made in 1990 would be recognized for tax purposes in 1991.

74. **Question**

But nonetheless, these new rules could apply to projects that are started prior to 1990?

Answer

Absolutely. Looking forward from today, any project which is underway right now has a further 3 1/2 years to complete that project before it is really affected by the rules.

75. **Question**

The key words in the document with respect to the put-in-use concept, it seems to me, is that you cannot claim your CCA and investment tax credits until the earlier of the year the asset is put in use and the year in which the construction of an asset by or on behalf of a taxpayer is completed and is thus ready for use. In the resource sector there are some very large projects that go on, of course, and some specialized machinery and equipment are often constructed for those projects. Occasions do arise where certain individual pieces of machinery may well be completed and be standing alone but not in production prior to the completion of the facility to house the machinery and equipment, and before the operation is ongoing. Because that individual piece of machinery or equipment is completed, would that mean the test would have been met and capital cost allowance and ITCs can therefore be claimed on that individual piece of machinery even though the building and the business may not have commenced?

Answer

No, the concept of completion would be related to the project as a whole, not its component parts, and the piece of machinery or the component would not in effect be available for the earning of income or available for use until the other constituent parts of the project had been completed.

76. **Question**

I'd like to raise a question which is still in the area of capital cost allowances. One question that has been raised is the question of the impact of the new rules on existing pools of cost, on existing pools of earned depletion, and so on. To what extent will these changes impact those pools?

Answer

They will have no impact. The changes are prospective in nature. It's only expenditures made after 1987 that will be affected by the changes in CCA rates.

ELIGIBLE CAPITAL EXPENDITURES

77. **Question**

Why is there no transitional phase in for the new ECE rules (i.e. - no 2/3 stage)?

Answer

Each time the inclusion rate is changed, a number of adjustments would be required to the ECE pool and the write-off rate. For the sake of simplicity, the inclusion rate was moved to 3/4 so as to require only one adjustment to the pool balance.

78. **Question**

Will the ECE rules apply to CCPCs as of January 1, 1988?

Answer

No. The rules proposed for corporations require that the inclusion rate be increased to 3/4 for eligible capital receipts for fiscal periods commencing after June 30, 1988 for all corporations including CCPCs.

PREFERRED SHARES

79. **Question**

Again a question of the timing of the impact, now we're moving into the area of preferred shares and the form of tax that is effectively being imposed. To what extent will this apply to existing and outstanding preferred shares or any shares?

Answer

The new regime does not apply to any issues that are made or were in progress as of June 18, 1987, so it does not apply to existing shares with one exception. It also does not apply to any shares that are currently held by any shareholder. However, in the future certain acquisitions of shares by a specified financial institution -- that is, a financial institution or a corporation associated with it -- will be restricted, with a phase-in of the restriction over the next 2 1/2 years.

80. **Question**

One other question with the new preferred share rules and it refers to the ability of the paying corporations to take a deduction for 250 per cent of the tax, which it is noted, will reduce the taxable income of the corporation. The statement is made: such a reduction may impair the ability of that corporation to claim foreign tax credits and investment tax credits. Will there be any mechanism to relieve this difficulty? Will excess foreign tax or investment tax credits be available to offset this distribution tax?

Answer

The purpose of the new tax on preferred share dividends is to ensure that some Canadian tax has in fact been paid with respect to a flow of dividends -- tax paid either on the underlying income or on the dividends. So only to the extent that the corporation in fact is paying Canadian tax will it be able to offset the new preferred share tax. So explicitly by design, foreign tax credits and investment tax credits would not be available to offset the new tax.

ANTI-AVOIDANCE MEASURES

81. **Question**

We're moving to a new area -- the new anti-avoidance rules. The rules as laid out in the White Paper have caused some consternation perhaps. I think it's the one area in the documents in which there seems to be no particular date suggested for implementation of that rule. Would you care to offer some comments on the rule itself and also on what the plans of the government are for the possible implementation of that rule?

Answer

You're quite right. The White Paper and the supplementary material really don't indicate any effective date for the new rule and I think that reflects a couple of concerns. The obvious one is that a rule such as a general anti-avoidance rule inevitably carries with it uncertainty for taxpayers, and the feeling was that it would be reasonable to allow an appropriate time for taxpayers to adjust to the new rule. For example, it has been suggested that there are a number of transactions that might at first blush appear to be within the scope of the new rule such as charitable donations and RRSP contributions. Hopefully there will be a period of time wherein we can convince people that, as a matter of law and looking at the words themselves, that is not the intention nor is it the result. As well, the absence of an effective date reflects the government's commitment to consulting to ensure that, to the extent the uncertainty can be minimized with changes to the words themselves, that can be effected. In any event the new rule would not apply to transactions undertaken or committed to before the consultations are completed and the decisions relating to the final form of the general rule are taken and made public.

82. **Question**

There seems to be somewhat of a new legislative approach with regard to the new 245(6). It starts out with a general statement of intention as to where the provision might apply and some questioners have raised the issue as to whether that new approach might be extended to other areas in the legislation and if not, how the courts might well view that single approach with regard to the anti-avoidance rules. Do you have any comments on that aspect?

Answer

Yes, I do. The addition of the purpose clause plays a very important part in circumscribing or restricting the scope of the rule. Whether or not it would be appropriate to add a purpose clause to other provisions of the act -- indeed the suggestion in the question is that it might well be added to all the anti-avoidance provisions -- I think is a bit extreme. In the final analysis, courts presumably will look to the words used to determine what the expressed intent is in interpreting the provision, and whether or not you add a purpose clause, presumably the expressed intent will in the final result be determined by the language used and the scheme of the statute as a whole.

83. **Question**

Along the same lines, the papers indicate on page 139 that the term "business" in applying the business purpose test would have its ordinary broad meaning rather than a narrow legislative meaning in terms of describing a source of income under the Income Tax Act generally. Is it the intention that the general broad meaning be given any legislative definition or how do we know that that intention would really find its way into having the force of law?

Answer

We believe that the juxtaposition of the word business with purpose should be sufficient to indicate that the broader meaning of purpose is the one that should prevail. As well, it seemed to us very difficult to define business without defining business purpose, and we had really no enthusiasm to embark on that venture. That's why we haven't defined the word business in this context.

84. **Question**

One final point which I would be remiss if I did not raise on behalf of the Canadian Bar Association. The Canadian Bar Association is critically concerned about the anti-avoidance rule, about the uncertainty that it may bring into our tax system, and even though we don't have time to go into many of the questions that I have, the Canadian Bar, along with the joint committee on taxation, the CICA and the Bar, will be making briefs on this anti-avoidance provision. I think it's fair to say that it's in this area where the real lawyering goes on in the tax community and this is an area, therefore, where you can expect us to have a great deal to say.

Answer

Yes, I think we all accept that the last word hasn't been said on that area.

85. **Question**

In paragraph 245(5)(b), there are two references to "any person". Does this refer to the same person? If so, that person would have 90 days from the mailing of any notice of assessment to him for the year in which the avoidance transaction occurred to request the Minister to make an adjustment. If a determination is made pursuant to proposed subsection 245(4) with respect to another taxpayer, say two years after the year in which the avoidance transaction occurred, it is very possible the first person, as a practical matter, would never have an opportunity to meet the 90-day requirement. How will this person ever be in a position to exercise the rights provided by proposed paragraph 245(5)(b)?

Answer

It is important to note that in most cases the parties to an artificial transaction that is to be ignored under the new rule will be reassessed, and subsection (5) will not apply to them. We were concerned, however, that there may be cases where other persons were affected by the artificial transaction and adjustments might be appropriate to avoid double taxation. In most cases this adjustment should be fairly obvious and it would be made as part of the assessment process. At present there is no provision for notice to be given to any person under subsection (5) of a related notice of assessment. This raises difficult questions of taxpayer confidentiality. In view of the concerns raised, further consideration will be given to determine whether the rights provided to such persons in subsection (5) could be made more effective.

86. **Question**

What is the effective date of proposed section 245?

Answer

The White Paper does not contain an effective date for proposed section 245. As noted in the commentary on the new rule, it is important that the inevitable uncertainty that such a rule will create be kept within tolerable limits. The delay in introducing the new general anti-avoidance rule reflects the government's commitment to the need for a reasonable period for effective consultation on proposed tax changes, particularly one such as a general anti-avoidance rule.

87. **Question**

Assume a transaction took place before June 18, 1987 that would otherwise be the subject of an adjustment under proposed subsection 245(4). If such transaction puts a taxpayer in a position of otherwise being liable to less tax in future years, would proposed section 245 be imposed in an effectively retroactive manner to increase the taxpayer's future income tax liability?

Answer

The new general anti-avoidance rule will not be applied retroactively.

88. **Question**

Will the staffing of the Rulings Division of Revenue Canada be increased to deal with the expected increase in requests for advance income tax rulings that will occur as a result of the enactment of proposed section 245?

Answer

There are no plans to do so. The premise of the question is that the new rule will create so much uncertainty that there will be a flood of ruling requests. While we agree that there will be some uncertainty as to its application, the extensive notes and the publication by Revenue Canada of an interpretation bulletin on the new provision should reduce the uncertainty. Also it is important to remember that the bulk of transactions have a business purpose and will be unaffected by the new rule.

89. **Question**

Proposed paragraph 245(5)(a) provides that the Minister may make certain adjustments in order to eliminate double taxation. Will there be a legislative definition of "double taxation"?

Answer

No.

90. **Question**

In Annex 1, two different illustrations are discussed related to transferring assets to a corporation in order to realize a capital gain on the subsequent rate of shares. However 245(1) is said to apply to only one of these transactions, as transactions of this type are very common particularly because of the capital gain exemption. Can the Minister give a clear and unambiguous explanation as to when Section 245(1) will apply?

Answer

It is unclear what part of Annex 1 is being referred to. The annex contains a general statement that the new rule may apply where an asset is transferred to a corporation for its shares as part of a series that involves the subsequent sale of the shares to an arm's length party. It is not intended that the rule apply where a corporation or an individual transfers all the assets of a business to a corporation and then sells the shares of the corporation. In the case of an individual, this may be designed to secure the benefit of the capital gains exemption.

91. **Question**

With respect to the association and related party rules, which will be changed? What will the changes be?

Answer

The scope of the existing rules has been narrowed as a result of adverse court decisions which permit what might be termed rather artful arrangements to circumvent the associated company rules. The changes in these areas will be made to deal with a number of the deficiencies.

NATURAL RESOURCE INDUSTRIES

92. **Question**

Will the new "at risk" restrictions apply to the mining exploration depletion allowance at all (one would expect so)?

Answer

Under the new rules, the amount of the Canadian exploration expense attributed to limited partners will be restricted under the at-risk rules. The partners' entitlement to earned depletion will to that extent be impacted by the at-risk rules.

93. **Question**

Concerning interactions of the proposed "at-risk" rules (p. 114) and the mining exploration depletion phase-out (p. 112): is the MEDA entitlement to be calculated by the time when the partnership actually incurred the expense (one would expect) or when the partner is entitled to add the CEE to his CCEE?

Answer

The entitlement to earned depletion will depend on the time at which the actual expenditure was incurred.

RETIREMENT PLANS

94. **Question**

The White Paper proposes a longer phase-in period for deductible limits for RRSP and money purchase RPP contributions. Will there be a corresponding restriction on the deduction for defined benefit plan contributions? The Act current provides for the deduction of such contributions in excess of $3,500.

Answer

No change is contemplated to the existing deduction for contributions to defined benefit plans.

RESEARCH AND DEVELOPMENT

95. **Question**

Does the elimination of the investment tax credit for buildings acquired or rented include leasehold improvements?

Answer

Yes.

96. **Question**

The new ITC application rules provide that the capital cost is not reduced until the subsequent taxation year. Will there be a similar rule with respect to the investment tax credit on R&D expenditures?

Answer

Yes.

SOFT COSTS

97. **Question**

If a developer does not follow generally accepted accounting principles in capitalizing soft costs, what will the tax accounting basis be for capitalization?

Answer

The rules in this area will be patterned on the existing rules for the purposes of subsection 18(3.1) of the Income Tax Act, which requires the capitalization of certain costs attributed to the construction period for buildings.

COMPLIANCE

98. **Question**

Why was it considered necessary to introduce a penalty provision in connection with late or deficient instalments over and above the current late non-deductible instalment interest charge?

Answer

This was considered necessary to improve compliance.

99. **Question**

When will the new reporting requirements for financial institutions for security sales be effective?

Answer

This will be determined following consultations with the institutions to determine the precise procedures to be adopted for implementing this recommendation.

SOURCE DEDUCTIONS

100. **Question**

If an employer only pays employees monthly, will he be required to make weekly or bi-weekly remittances?

Answer

No.

FOREIGN TAX CREDIT

101. **Question**

In computing the federal foreign tax credit for an individual will federal tax otherwise payable for the year be reduced by the new credits for personal exemptions, education, pension, etc?

Answer

Yes.

JOINT RETURN

102. **Question**

Tables A 4.2 and A 4.3 of the background paper on Income Tax Reform illustrate the tax payable by married one-earner and married two-earner families with two children. These tables highlight the following substantial tax penalty for one-earner families:

Total Family Income	Total post-reform tax One Earner	Two Earner	Difference	
	$	$	$	%
20,000	955	240	715	298
30,000	4,150	2,295	1,855	81
50,000	13,110	8,635	4,475	52
75,000	24,290	17,385	6,905	40

The Objectives of Tax Reform include a statement that "Individuals in similar economic circumstances should be taxed more equitably than they are now."

In view of this stated objective, and the many existing provisions that combine family income to determine eligibility for deductions and credits, why has the government not introduced joint returns to eliminate this major inequity in the personal tax system?

Answer

The "tax penalty" referred to in the question arises largely because of the differences in work-related expenses between the one-earner and two-earner family. Each earner in the two-earner family receives the basic credit ($1,020) which is higher than the spousal credit ($850) because the basic credit provides recognition of work-related expenses. Both adults in the two-earner family have to pay CPP and UI premiums because each is entitled to receive CPP and UI, and they receive a tax credit in recognition of this. In addition, the two-earner couple may incur child care expenses which the tax system recognizes. A system of joint taxation would provide similar recognition. Thus, the "tax penalty" of individual taxation is much less than a comparison of Tables 4.2 and 4.3 would suggest.

Joint returns effectively impose a penalty on becoming married since a two-earner couple filing jointly would pay higher taxes than two single persons with the same total income.

Joint returns provide a disincentive for the second spouse to work since their income is taxed at the first spouse's marginal tax rate.

Joint returns result in the proliferation of rate schedules to take account of varying family circumstances.

For these reasons, among others, there has been a trend away from joint taxation over the past 20 years. (Examples include Denmark, Sweden, Austria, the Netherlands and Italy.)

PROVINCIAL TAX IMPLICATIONS

103. **Question**

Currently, prior to the tax reform rules, provincial income taxes for individuals were generally computed as a percentage of basic federal income tax, which is after the federal dividend tax credit and the scientific research tax credit but before the federal foreign tax credit, political contribution tax credits, etc. The tax reform proposals will increase an individual's taxable income by converting tax exemptions to tax credits. Will the provinces compute provincial income taxes after the tax reform by reference to the basic federal income tax after the deductions of the new tax credits?

Answer

Yes, those credits which have replaced the existing personal exemptions and other deductions will reduce the basic federal tax on which the provincial tax for individuals is calculated.

Sales Tax Reform

SALES TAX REFORM

GENERAL QUESTIONS

1. **Question**

The Minister of Finance has stated on prior occasions that sales tax reform would only occur after further discussions with the provinces followed by a public consultative process. When do you expect that discussions with the provinces will be completed and when will Finance officials be prepared to meet with taxpayers to hear their views on the proposed system? When can we expect draft legislation and implementation?

Answer

The National Sales Tax presents an opportunity to achieve sales tax reform on a national basis and to consolidate existing systems into one. It is worth examining further. The provinces have expressed initial interest. Given the opportunity of a national system, it makes sense to explore this possibility.

The federal and provincial Ministers of Finance will meet this fall to continue their discussions on sales tax reform. In preparation, a working group of officials from the provinces and the federal government will begin work this summer. These discussions will be pursued to determine whether a consensus can be reached with the provinces. The issues involved are complex and it would be premature and counterproductive to try to impose a fixed timetable now.

If a consensus cannot be achieved the government will implement either a federal Goods and Services Tax or a federal Value-Added Tax. Either of these would meet the goals of sales tax reform.

In addition to working with the provinces, the government will want the views of interested groups and individual Canadians on the three variants of the multi-stage sales tax. Sales tax reform will be moving ahead as quickly as possible -- and in a way that provides an opportunity for businesses and individuals to become familiar with the principles and operation of this entirely new tax system.

2. <u>**Question**</u>

What happened to BTT?

<u>**Answer**</u>

The federal Goods and Services Tax is the Business Transfer Tax. The new term more clearly indicates that the tax is a sales or consumption tax. The name has been changed to promote a clearer public understanding of the tax.

3. <u>**Question**</u>

Japan recently failed in its attempt to introduce a VAT. Why do you think that the Canadian government will be successful in its attempts?

<u>**Answer**</u>

The Japanese experience is not relevant for several reasons.

First, Japan was attempting to introduce a general sales tax where none existed before. In Canada, however, we are replacing an existing badly flawed sales tax with one that is economically efficient, minimizes compliance and administration costs, and is fair in its application both to firms and across sectors and, most importantly, to those in need.

Second, the Japanese did not provide any low-income offset. The existing refundable sales tax credit in Canada will be enriched upon implementation of the multi-stage tax to ensure the tax is fair to those in need.

In contrast to the recent Japanese experience, many other countries, such as the United Kingdom, France, West Germany, Austria and New Zealand, have successfully implemented multi-stage sales taxes.

NATIONAL SALES TAX

4. **Question**

   Where do the provinces currently stand in respect of a National Sales Tax?

   Answer

   There has been extensive consultation with the provinces throughout the process of developing the tax reform package. The possibility of a national sales tax has arisen for preliminary discussion in these consultations, and provinces have expressed an initial interest in exploring more fully the opportunities offered by a national system.

   Any province choosing not to participate can be easily accommodated under the national system by simply assigning a zero rate to the provincial element of the tax in that province.

5. **Question**

   Have the discussions with the provinces included the breadth of the base -- for example, whether food and clothing would be taxed?

   Answer

   As indicated above, federal and provincial ministers will meet in the fall of this year to pursue their discussions in greater depth. Clearly, throughout these discussions a wide range of issues will need to be reviewed, including the key question of the tax base. A common tax base agreed to by both levels of government is essential to a viable national system.

6. **Question**

Will the government implement a National Sales Tax without the support of all 10 provinces? If so, how many provinces would have to participate?

Answer

Yes. The national system would provide the flexibility needed to accommodate provinces which might decide not to participate. This could be accomplished quite simply by designating the provincial rate as zero in any such province.

Although it is not possible to be more precise without further discussions with the provinces, a substantial degree of provincial participation would be required if the national system is to be a worthwhile approach to sales tax reform.

7. **Question**

Why, in looking at introducing a National Sales Tax, does the government not consider the possibility of implementing a joint federal-provincial single-stage retail tax?

Answer

A comprehensive, joint federal-provincial single-stage retail tax would solve many of the problems with the current manufacturers' sales tax and yield many of the economic benefits to Canada that a multi-stage sales tax will yield.

There are, however, several drawbacks to a retail sales tax that make the multi-stage sales tax a superior approach:

- Because it would be a single-stage levy, a national retail sales tax system would be incapable of completely relieving all business inputs from tax. This would lead to some degree of double taxation as well as embodying a tax cost in the price of export products.

A retail sales tax is a less secure source of revenue than a multi-stage tax. By dispersing the collection of tax over a number of points, a multi-stage tax reduces both the incentive to misreport and the revenue consequences of misreporting. In addition, the availability of input tax credits on business purchases encourages accurate reporting. By contrast, a retail sales tax may be more vulnerable to errors because it relies on a single point of collection.

TAX RATE

8. **<u>Question</u>**

The alternatives proposed for replacing the existing federal sales tax do not indicate the rate of tax under consideration, other than the 8 per cent used for illustrative purposes in the document. Does the government have a proposed tax rate for each of the alternative tax systems? If the tax rate required is dependent on how broad the tax base is, does the government have a target for how much revenue is to be generated by the new system?

<u>Answer</u>

The new system will need to generate sufficient revenues:

- to replace the existing federal sales tax;
- to remove the personal and corporate income tax surtaxes;
- to fund further tax reductions for middle-income Canadians; and
- to significantly enrich the refundable tax credit for low-income Canadians.

Until final decisions are made about the breadth of the tax base, it is not possible to specify the actual rate. However, the broader the base, the lower the rate needed to generate a given amount of revenue.

ECONOMIC EFFECTS

9. **Question**

Will the proposed new sales tax not result in higher inflation?

Answer

The new system will replace an existing tax that is imposed at a high rate. The new tax will mean lower rates on currently taxed commodities. On the other hand, the shift from a more narrowly based tax will increase the prices of previously untaxed goods and services. This one-time price increase would be offset, in part, by price reductions in currently taxable commodities. As a result, there will be a relatively modest one-time increase in the price level. After a brief period, price trends will return to normal.

It is important to remember that at the same time the new sales tax is implemented, consumer purchasing power will be reinforced by the removal of the income tax surtaxes, further income tax reductions for middle-income households and a substantially enriched refundable sales tax credit.

Until final decisions are taken about the breadth of the tax base, it is not possible to specify the actual rate or the precise impact of the tax on prices.

10. **Question**

In view of the fact that the United States does not have a value-added tax, won't the introduction of one in Canada encourage business to favour the U.S. over Canada?

Answer

No. The existing system encourages businesses to favour the U.S. over Canada. The existing federal sales tax penalizes businesses operating in Canada -- approximately one-half of the tax collected is from business inputs. This hurts firms exporting from Canada. In addition, domestic products competing in Canada with foreign imports bear an FST burden that is, on average, one-third higher than that borne by imported goods.

The new sales tax will remove these biases against Canada's ability to compete. Tax will be removed from business inputs and imports will no longer enjoy a tax advantage over domestic products. As a result, the new sales tax will place Canada in a more competitive position.

TECHNICAL ISSUES

11. **Question**

Will the multi-stage sales tax be invoiced separately at the retail level?

Answer

The government's commitment is to ensure that the tax is visible for consumers and simple for retailers.

This could be accomplished in a number of ways:

- through the fact that the tax will be a uniform percentage of the price to consumers;
- through tax-extra pricing;
- in some European VAT countries where the tax is frequently included in the retail price, visibility is maintained by displaying signs in stores which indicate the tax rate and that the tax has been included in the selling price.

In addition, in implementing the new tax it will be important to ensure that there is consistency of pricing and advertising practices among retailers.

12. **Question**

Currently, excise duties are subject to sales tax while excise taxes are not. The document is silent on how these are to be treated in the future. Will they remain in place? If so, how will the excise duty and excise tax situation be dealt with specifically?

Answer

The question of the treatment of excise duties and excise tax is under review. This will be determined when the new tax is implemented.

The current air transportation tax will be modified on the introduction of the new tax to reduce the impact of the new tax on domestic and trans-border air travel.

REAL ESTATE

13. **Question**

How do you plan to treat foreclosures of real property under sales tax reform?

Answer

When a lender forecloses on a loan and seizes real property of the debtor that had been put up as security for the loan, there will be no immediate sales tax consequences.

The lender would be subject to sales tax on any resale of the repossessed property (other than a used residential home). If the lender is a financial institution it could claim a bad debt deduction for any remaining unpaid amount.

14. **Question**

By taxing new residential dwellings but not used dwellings under the proposed system, are existing homeowners not at an advantage? Will this not treat sales of new and used dwellings inequitably?

Answer

Residential construction materials are currently subject to an 8 per cent federal sales tax. Under the new tax, sales of new homes will be taxable.

Used homes will not be taxable under the new tax because either the existing federal sales tax will have been paid on the materials used to build them or the new sales tax will have been paid on the purchase of homes when they were new. This approach avoids the inequity of double taxation.

15. **Question**

What is meant by the term "substantial renovation"? Would the meaning be different for an 800-square-foot condominium versus a 4,500-square-foot home?

Answer

This term is important because the resale of a used home in the course of a business that involves the purchase, substantial renovation and resale of such homes will be taxable, whereas the resale of used homes generally will be tax-exempt.

The reason for this approach is to ensure that a taxpayer who is in the business of renovating and reselling homes will be taxable on the value added to renovated homes, and to equate the resale of substantially renovated homes with the sale of new homes.

Guidelines will be developed to determine the meaning of "substantial renovation". There is no apparent reason why these guidelines would vary depending on the size of the home.

FARMERS AND FISHERMEN

16. **Question**

Is it the government's intention to require farmers and fishermen to calculate and remit tax under a reformed sales tax system?

Answer

Whether farmers and fishermen are included in the new sales tax system will depend on the final composition of the tax base. The base will be a major item in the federal government's discussions with the provinces and in consultations with interested groups.

In considering this question it is important to recognize that the multi-stage tax is designed to be a tax on consumption that is ultimately paid only by the final consumers of goods and services. It is not designed to be a tax on the producers and sellers of goods and services.

Concern is often expressed that if farmers and fishermen are taxable they will not be able to pass on the tax. This ignores three key points.

1. For commodities whose domestic price is determined in the international market (e.g., grain, fish), farmers and fishermen would have little difficulty in passing the tax on to final consumers. They would simply add the amount of tax to the internationally set sale price. They would not have to worry about competition in Canadian markets from importers as imports sold at the same internationally determined price would be taxed at the same rate when they enter Canada. All export sales will be tax-free.

2. In circumstances where farmers and fishermen can influence prices -- when they sell through co-operatives or producer marketing boards -- they would also have little difficulty in passing the tax on.

3. Finally, the vast majority of farmers and fishermen sell primarily to other businesses -- processors, distributors, marketing boards and co-ops. If the products were taxed, business purchasers would be able to claim an input tax credit for an equal amount. Since these purchasers would be able to recover any tax charged by farmers and fishermen, the market position and profit margins of farmers and fishermen would be effectively unchanged.

Under the current federal sales tax, the tax on a variety of their purchases (e.g., farm equipment and fuel) is relieved through a complex mixture of exemptions and rebates, involving detailed record-keeping. Despite this tax relief, certain goods remain taxed, including for example building materials, pick-up trucks and small tools. In addition, virtually every other good and service purchased by farmers and fishermen includes an indirect tax element. This increases their costs. In contrast, participating in the new sales tax system would allow farmers and fishermen to remove all of the tax on their inputs by simply claiming a credit.

All export sales under the new system will be tax-free. For producers in the export market, the new system would allow them to remove the tax on their purchases while incurring no tax on their products. In these instances, producers would receive refunds.

Finally, if they were in the system, the new sales tax would improve cash flow for primary producers. While they would collect tax at the time of a sale, they would remit it only after the end of each reporting period -- quarterly for many farmers and fishermen, and annually for the smallest.

The government will want to discuss the whole issue of the role of farmers and fishermen in the new system with these groups.

NON-PROFIT ORGANIZATIONS

17. **Question**

You've indicated that the tax will apply to the commercial activities of non-profit organizations. Could you give us some examples.

Answer

The background paper on sales tax reform released with the White Paper set out a proposed treatment of non-profit organizations for discussion.

Under this approach, as a general rule, most of the activities of charities and non-profit organizations would be exempt because a multi-stage sales tax applies to sales of a commercial nature. Therefore these organizations would be taxable only on sales of a commercial nature. This would ensure the fair and uniform application of tax to commercial sales made by the profit-making and non-profit sectors and minimize competitive distortions.

Examples of taxable activities for charities and non-profit organizations would include the following:

- the sale of goods in a retail store;
- the sale of food or drink in a restaurant, cafeteria, or pub;
- admissions to a professional theatrical, musical or other such performance, film presentation, slide show, horse race or professional athletic event; and
- any sale of land to a private individual for purposes of residential construction or personal use.

Charities would not be taxable on any other supplies. However, non-profit organizations would be taxable on any other commercial activity involving the supply of property or service of a type that is generally supplied by a commercial business. As a result, there would be no sales tax advantage to a commercial enterprise in being set up on a non-profit basis.

Although certain supplies made by charities and non-profit organizations would be taxable, there would be two over-riding exemptions, which would apply to any supply other than a supply of land for personal use.

(1) Volunteer exemption: Under this rule, any supply that otherwise would be subject to tax would be exempt when made in the course of an activity where all or substantially all of the staff involved in the management and operation of the activity are unpaid volunteers

(2) $5,000 threshold: Under this exemption, otherwise taxable supplies made by a charity or non-profit organization would not be subject to tax if the revenue from all such supplies made by the organization does not exceed $5,000 per annum. This would parallel the $5,000 threshold for individuals making sales almost exclusively to final consumers.

COMMERCIAL ACTIVITIES OF PROVINCES

18. **Question**

The sales tax papers do not elaborate on a number of issues applicable to the extractive industries such as (1) the treatment of amounts paid to governments to acquire oil and gas or mining rights; and (2) the treatment of provincial royalties and provincial mining taxes. Will the proposed sales tax apply to these items and will they therefore be creditable under the proposed regime?

Answer

The question is whether the new sales tax will apply to sales and other receipts of provincial governments.

A multi-stage tax works best when it is applied on a broad base of commercial activities, regardless of whether they are performed by the Crown or ordinary citizens.

For this reason the federal government proposes to make all of its own commercial activities subject to tax. The federal government will discuss with the provinces how a national sales tax or the federal-only variants of the new tax might apply to their sales.

FINANCIAL INSTITUTIONS

19. **Question**

The sales tax reform proposals provide specific rules for taxing financial services such that they will only be taxed on an institution's margin. However, taxpaying businesses will not be entitled to use these charges as an input credit. Will this not result in cascading and double taxation -- two of the government's criticisms regarding the current system?

Answer

Since the net margin of a financial institution represents a relatively small fraction of the interest charged to its customers, any cascading of tax should not cause significant economic distortions.

For example, assuming a financial margin of 2 percentage points and a tax rate of 8 per cent on that margin, the tax on a $30,000 loan paid in one lump sum at the end of one year would only be $48. If the tax is split evenly between the borrower and depositors the tax borne by the borrower would be only $24.

It is not possible to calculate the taxable margin of a financial institution on a transaction-by-transaction basis. It would therefore be very difficult to calculate an appropriate credit to a non-financial business in respect of individual financial transactions.

20. **Question**

Has the government considered whether the special rules for imposing a multi-stage sales tax on financial institutions might constitute an "income tax" for purposes of section 1 of Article II of the Canada-U.S. Tax Treaty? Please comment.

Answer

The new sales tax is not an income tax. Accordingly, the Canada-U.S. Income Tax Convention (1980) will not apply to the new sales tax. This is consistent with the treatment of European value-added taxes.

TRANSITION

21. **Question**

What transitional provisions are envisaged in the changeover to a reformed sales tax system?

Answer

On implementation of a multi-stage tax, many firms such as wholesalers and retailers will be holding inventories of new goods for sale on which federal sales tax will have previously been paid and such taxpayers will be entitled to recover this tax. Details concerning the calculation of the rebate will be announced sufficiently in advance of implementation to give firms adequate time to prepare for the changeover.

Federal sales tax changes have traditionally been effective as of certain specified dates without any special relieving provisions for contracts entered into prior to that date. This practice reflects the fact that there is no simple and equitable way of relieving existing contracts from the impact of a tax change. As a result, many businesses make explicit arrangements in their contracts for future tax changes. In accordance with established practice, no general exemption will be provided for existing contracts entered into prior to release of the implementing legislation. Given the considerable time that will elapse between the release of the legislation and the implementation date, most taxpayers should be able to arrange their affairs to take the new tax system into account. Nonetheless, there may still be circumstances where it is appropriate to provide transitional relief. If so, details of any such transitional relief will be provided at a later date.

Special rules will be required to ensure fair treatment of transactions which straddle the implementation date. For example, payment may be received prior to the implementation date but delivery of the goods or services may occur after that date. On the other hand, payment may be received on or after implementation but the delivery may be before. Rules will be developed to define clearly the application of the new tax to such transactions.

Additional transitional provisions may have to be considered in changing to a National Sales Tax, which integrates both federal and provincial sales tax systems. These provisions would be developed in the course of consultations with provincial governments.

Interim Sales Tax Measures

INTERIM SALES TAX MEASURES

TELECOMMUNICATIONS SERVICES

1. **Question**

Is it the government's intention to provide exemption to providers of telecommunications services on their inputs when the service being sold is subject to tax? In other words, could a telephone company buy equipment exempt of FST if it is used in providing a service which will be taxable under the proposed tax on telecommunications services?

Answer

No relief will be provided from the federal sales tax on equipment used by businesses liable to collect the telecommunications services tax, as the two are different taxes imposed on different persons. The telecommunications services tax is imposed on the end user, while the federal sales tax is imposed on the producer of the equipment. However, in terms of the telecommunications services tax itself, licensees who purchase telecommunications services as an input in providing a taxable telecommunications service to another person will be relieved from tax on their purchase of the telecommunications services input.

2. **Question**

Taxable services billed before June 19, 1987 are proposed to be exempt if the service is provided and payment is made on and after January 1, 1988. Does this grandfathering include firm price contracts made prior to June 19, 1987 but which extend beyond January 1, 1988 and which will be billed after that date?

Answer

As stated, telecommunications services provided on or after January 1, 1988 will be relieved from tax only if the charge was actually billed before June 19, 1987. In this context, "billed" means a demand for immediate or almost immediate payment by the user, not an agreement between the supplier and user for future payment of specific amounts. No relief will be provided for firm price contracts signed before June 19, 1987 where no billing has occurred.

3. **Question**

Since the tax is to be imposed on the consumer or user (unlike the existing legislation, where the manufacturer is the taxpayer), what is the service provider's position if the user fails to pay the tax the former is required to collect?

Answer

Responsibility for collecting the tax is placed on the telecommunications company. A provider of taxable telecommunications services who fails to collect the tax imposed on the service will be liable for payment of the tax. The tax collection system parallels that in place for the Air Transportation tax. As well, relief will be provided to the telecommunications company in the case of bad debts.

4. **Question**

Some public utilities are constrained in their pricing policies by provincial rate regulators. In some cases charges for services are bundled, i.e., the line charge relates to both the service and equipment. Since the tax is intended to be levied only on the service charges, will these companies be allowed to notionally segregate the equipment component of their prices for tax calculation purposes?

Answer

The tax will not apply to sales and rentals of terminal equipment or to charges for internal wiring unless the supplier requires subscribers to acquire the equipment or wiring exclusively from it or a related person. Where charges for taxable and exempt services are bundled, carriers will be allowed to collect the tax on the value of the taxable services only. It is expected that this value would be determined by them based on the amount they charge for such services when not sold in conjunction with tax-exempt equipment sales and rentals. Discussions are presently in progress on a number of issues identified by the industry pertaining to bundled charges.

TAX LEVIED AT WHOLESALE LEVEL

5. **Question**

Is the government gradually bringing in a wholesale tax through the back door?

Answer

No. The government has shifted to a wholesale tax only for specific commodities where the inequities that exist can best be addressed in this way, pending comprehensive reform of the sales tax system.

6. **Question**

As a result of the proposed changes for a number of consumer goods, what percentage of domestic consumption will now be taxed at the wholesale level?

Answer

Approximately 15 per cent of taxable goods will be taxed at the wholesale trade level.

RELATED MARKETING COMPANIES

7. **Question**

It is proposed that marketing companies related to the manufacturer of goods be deemed to be the manufacturer of the goods. The new rules will apply where a product is imported into Canada primarily by one or more distributors related to the exporter as well as where domestic manufacturers sell primarily through a related distributor.

What is meant by the term "distributor"? Could it include retailers selling exclusively to consumers?

Answer

"Distributor" includes any person who buys goods for resale, and hence includes retailers. In instances where a retailer is related to the supplier and becomes the deemed manufacturer, Revenue Canada would consider whether a notional value determination is appropriate.

8. **Question**

If importers selling directly to consumers are caught by the new rules, will consideration be given to allowing the use of notional values by such persons? Where determined values are not already in place in a given industry, can we expect new ones to be issued prior to January 1, 1988?

Answer

This issue is being considered by Revenue Canada officials. We have been advised that importers who are deemed to be manufacturers will be entitled to use existing notional value rules and that Revenue Canada will consider creating new determined values where the need for such values is demonstrated.

9. **Question**

When a company abroad is selling to both related and unrelated distributors in Canada, how is it proposed that monthly tests of that foreign company's sales be carried out to ascertain if the "primarily" condition has been infringed?

Answer

The sales tax system is based on self-assessment by the taxpayer. Related distributors of imported products will be expected to determine whether sales of the foreign manufacturer's products in Canada are made primarily through related distributors. It should be noted, however, that once the threshold is exceeded in a given month, the deemed manufacturer status will apply for the following year. Thus, only related distributors whose sales are close to, but less than, the "primarily" limit will have to verify the percentage of sales by the foreign manufacturer through related persons on a monthly basis.

10. **Question**

In the same proposal, the term "primarily" is "generally defined to be more than half of total sales". What does this mean -- is it not to be a definite proportion? Will it be based on quantities or values?

Answer

Primarily means more than 50 per cent. In order to be effective, this test has to be applied on the basis of quantities of identical goods.

11. **Question**

The new marketing company rules will apply where a domestic manufacturer makes sales of a product in Canada primarily to one or more related distributors. If a domestic manufacturer sells 10 per cent of a particular product line in Canada to a related distributor and sells the other 90 per cent of that product line in the export market, will the "primarily" rule kick in, notwithstanding that prices in the domestic and foreign markets may vary?

Answer

Sales outside Canada are not relevant for the purposes of this provision. If sales of a product in Canada are made primarily to one or more related distributors, the new marketing company rules will apply.

12. **Question**

Discretion is going to be provided to the Minister of National Revenue to relieve a business from the new deemed manufacturer provision. This discretion will be available where the physical manufacturer makes sales of "identical goods in reasonable quantities" to independent distributors at the same price as to his related company. How will "identical goods" and "in reasonable quantities" be defined? Will administrative tests such as those in the current ET202 be used? Will variations in color or packaging preclude goods from being regarded as "identical in all respects"? And will the interpretation of "same price" in that provision be flexible enough to permit, for example, volume pricing differences?

Answer

A definition of "identical goods" may be required and to that end, discussions are currently in progress with Revenue Canada officials.

13. **Question**

Will the Minister's decision in such instances be subject to appeal?

Answer

The normal appeal rules and procedures will apply.

14. **Question**

Will the Departments of Finance and/or National Revenue be in a position prior to January 1, 1988 to provide written rulings as to the applicability of the deemed manufacturer rules to related companies, both importers and domestic marketing companies?

Answer

As in the past, Revenue Canada will attempt to provide as much information as possible on the new rules, once the ways and means motions and enabling legislation have been presented to Parliament in the fall.

15. **Question**

While the "related" status will be established within the provisions of the Income Tax Act and, specifically, Interpretation Bulletin IT-419, will the Minister of National Revenue for Customs and Excise accept Revenue Canada, Taxation's decisions respecting interrelationship or will Excise use the Excise Tax Act in making its own decisions as to whether or not there is a relationship?

Answer

Since the Minister of National Revenue has responsibility for both income tax and sales tax legislation, it seems reasonable that the interpretation of "related person" would be the same under the two acts.

TIMING

16. **Question**

When can we expect Ways and Means Motions to implement the interim sales tax measures announced on June 18, 1987?

Answer

It is anticipated that Ways and Means Motions to implement the interim sales tax measures will be tabled in the fall.