WITHHOLDING TAXES

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PART I

The first part of this paper deals with withholding taxes in general without particular reference to non-residents although to some extent the sections of general application also apply to non-residents.

The concept of making employers tax gatherers for the Department of National Revenue has a long history. The basic provision now appears as s. 47 of the Income Tax Act of which s.s. (1) is as follows:

> 47. (1) Every person paying
> (a) salary or wages or other remuneration to an officer or employee,
> (b) a superannuation or pension benefit,
> (c) a retiring allowance,
> (d) an amount upon or after the death of an officer or employee, in recognition of his service, to his legal representative or widow or to any other person whatsoever,
> (da) an amount as a benefit under a supplementary unemployment benefit plan,
> (e) an annuity plan,
> (f) fees, commissions or other amounts for services, or
> (g) a payment under a deferred profit sharing plan or a plan referred to in section 79C as a revoked plan,
> at any time in a taxation year shall deduct or withhold therefrom such amount as may be prescribed and shall, at such time as may be prescribed, remit that amount to the Receiver General of Canada on account of the payee's tax for the year under this Part.

Sub-section 2 provides that if the remuneration from which amounts have been deducted is three-quarters or more of the individual's income for the year he will pay the balance of the tax by April 30 in the next year. If the remuneration from which tax is deducted is less than three-quarters of his income he must make quarterly payments of tax on the balance of income.[1]

Sub-section 3 provides that tax withheld is deemed to have been received by the person from whom it is withheld and, accordingly, forms part of his income although not received by him.

Sub-section 4 provides that if brokers receive dividends on shares and cannot determine the beneficial owner of such dividends they must deduct 25% and remit it to the Receiver General.

Sub-section 5 provides that the amount deducted and remitted by a broker is deemed to have been received by the beneficial owner of the dividends.

In general, compliance with s.s. 1 is a function of the accounting department, and in most businesses there will be few occasions for reference to the legal department. This is borne out by the almost complete lack of reported cases on this section. However, the corresponding enforcement section, (s. 123), has received considerable judicial interpretation.

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1 Income Tax Act, R.S.C. 1952, c. 148, s. 49.

This section provides:

(1) No action lies for withholding in compliance or intended compliance with the Act;

(2) An employee must file a return of personal exemptions with his employer;

(3) If no such return is filed the employee is treated as a single person without dependents;

(4) Amounts deducted are deemed to be held in trust for the Crown;

(5) Amounts withheld are to be kept separate and apart and are excluded from the control of a liquidator or trustee in bankruptcy;

(6) Sub-section 6, repealed in 1956, had provided that an amount withheld constituted a first charge on the assets of the withholding party (except in case of bankruptcy) and ranked ahead of all other claims including claims of a provincial government.[2]

(7) If under Part III (which relates to withholding tax qua non-residents) an excessive amount is withheld an application for refund can be made within two years after the end of the calendar year in which the deduction was made, subject to the Minister's right of offset.[3]

(7a) If an application is made for a refund under s.s. 7 and the Minister is not satisfied that the refund is payable the Minister must make an assessment and Division F of the Income Tax Act (which relates to appeals from assessments) is applicable.[4]

(8) Any person failing to deduct an amount required under s. 47 (1) with respect to a resident or under s. 109 with respect to a nonresident is liable to a penalty of 10% of the amount that should have been deducted with interest thereon at 10% per annum. A broker failing to deduct under s. 47 (4) is liable for the full amount and interest at 10%.

(9) Any person making a deduction and failing to remit is liable for the amount plus a penalty of 10% and interest at 10% on the amount deducted but not on the penalty.[5]

(10) The Minister may make an assessment for any amount payable under Part III, this section (s. 123) or s. 129[6] and Division F of the Income Tax Act is applicable.[7]

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[2] This section received very little support from the courts. *Workmen's Compensation Board* v. *Graham and M.N.R.*, 2 D.T.C. 679; *Boothe* v. *Town of Simcoe*, 1951 O.R. 831; *Sandberg* v. *Meurer and Sigurdson and M.N.R.*, [1949] 1 W.W.R. 117. While no doubt the object could be accomplished by appropriate legislation it would have to take such form as would clearly result in the expropriation of property belonging to others. Since the repeal of ss. 6 it would appear that the Crown has no priority over other execution creditors unless it is an execution creditor in which event it has a common law priority. *Miller* v. *Harron*, 1956 Ont. S.C.) 56 D.T.C. 1053.

[3] The right of offset does not operate in favour of the taxpayer. In *Queen* v. *Lamonthe*, (1957 Ont. S.C.) 58 D.T.C. 1057 an employer was convicted of failing to remit amounts deducted which he had offset against a refund in the same amount due to him from the Minister.

[4] Prior to the enactment of s.s. 7a in 1962, if the Minister refused to refund an amount improperly withheld and paid to the Minister the only recourse was by Petition of Right.

[5] A conviction for failing to remit is not a bar to proceedings for recovery of the penalty and interest if the assessment is made prior to the laying of the charge. *M.N.R.* v. *Durocher*, (1951 Ex. Ct.) 51 D.T.C. 497. The theft from an employer of money withheld does not, under the corresponding section of the English Act (Income Tax Act 1943, c. 45, s. 2(1)(a), relieve the employer from his obligation to remit. *A.-G.* v. *Antoine* [1949] 2 All E.R. 1000.

[6] Section 129 provides for a daily penalty of $10 up to a maximum of $2,500 for failure to file certain returns.

[7] *Cable Mines & Oils Limited* v. *M.N.R.* (1961 App. Bd.) 61 D.T.C. 641. In 1960 the Minister assessed the company under s. 123(10) for failing to withhold 15% of the interest paid to non-residents in 1954. The Company raised as a defence a nil assessment issued in 1955 and pleaded the four year limitation under s. 46(4). It was held that an assessment under s. 123(10) was separate and distinct from an assessment under s. 46 and that the limitation period did not apply.

(11) Provincial governments and the government of Canada are subject to the withholding provisions.
(12) An agreement not to withhold is void.[8]
(13) The receipt of the Minister for an amount withheld and paid is a sufficient discharge of the liability of the party withholding to the person from whom the amount is withheld.[9]

Reference should also be made to s. 125, which, while of general application, is pertinent to the role of the employer as tax collector. This section provides that every person carrying on business in Canada must keep proper books and records in Canada, or at such other place as the Minister designates, containing sufficient information to determine the taxes which are payable and the amounts required to be deducted.[10] If a person fails to keep adequate records the Minister can specify what records he is to keep. The Minister's written permission must be obtained to the disposition of such books and records.

The departmental practice with respect to a small business is to permit the keeping of books outside Canada by a branch of a foreign corporation or by a subsidiary of a foreign corporation, if the books are made available in Canada on request of the Department, or if the expense of an assessor in attending at the place where the books are kept, is paid.

Sections 100 to 108 of the Income Tax Regulations which set forth the mechanics involved in withholding will now be considered briefly.

Section 100 (1) defines "employer", "employee", "exemptions" and "remuneration". You will observe that remuneration includes, but is not limited to, salary or wages, a superannuation or pension benefit, a retiring allowance, a death benefit, a benefit under a supplementary unemployment plan, a deferred profit sharing plan or a revoked plan.

Section 100 (3) provides that amounts contributed by an employee under a registered pension fund or plan are excluded from remuneration.

Section 100 (4) provides that an employee not required to report for work at a particular establishment of the employer, is deemed to report at the establishment from which the remuneration is paid. The reason for this provision is that the withholding tax is not the same in each province and the withholding tax applicable to such an employee is the rate in effect for the province from which he is paid.

Section 101 provides that a person making a payment described in s. 47 (1) of the Act is to deduct and remit to the Receiver General in accordance with the provisions of Part I of the Regulations. Section 102 sets forth the applicable table of Schedule A to the Regulations for the purpose of determining the amount to be withheld from an employee's pay.

This procedure will cover most cases. There are, however, special cases to be considered. While no mention is made of holiday pay or pay in lieu of holidays CCH Canadian Tax Reporter indicates that there is a

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8 The void provision of the agreement is severable and the remainder of the agreement is enforceable. *Talbot-Lehman* v. *Ryall*, (B.C.S.C.) [1948] 2 W.W.R. 78.

9 The fact that the party from whom the amount is withheld may still sue and recover in a foreign jurisdiction does not affect the withholding requirement. *B.C. Electric* v. *The King*, (1946 P.C.) 2 D.T.C. 839, *Meyer* v. *M.N.R.*, (1959 App. Bd.) 59 D.T.C. 197.

10 In *Freitag* v. *M.N.R.*, (1951 App. Bd.) 51 D.T.C. 350 it was held that the books and records of a small shopkeeper were adequate in relation to the size of the business and an arbitrary assessment based on inadequacy of the books and records was vacated. In *Levine* v. *M.N.R.*, (1951 App. Bd.) 50 D.T.C. 337 an arbitrary assessment against a bookmaker who did not keep any books and records was upheld.

directive which requires the deduction to be made. If an employer uses mechanical or electronic calculating equipment he may use a specific formula for calculating tax deductions rather than the withholding tables. If the pay period is not covered by the tables the Minister determines the amount of the deduction. If the employee's pay fluctuates from pay period to pay period the employer can, with the approval of the Minister, estimate the employee's annual remuneration and average the deductions.[11]

Section 103 makes special provision for bonuses, retroactive increases and payments to a resident of Canada described in s. 36 of the Income Tax Act. The payments described in s. 36 are single payments out of pension funds, or on retirement in recognition of long service, or out of profit sharing or deferred profit sharing plans, or on retirement in respect of loss of office, or a death benefit. It will not be necessary to go into the detailed formulae applicable to these lump sum payments. In brief, if the total remuneration for the year including a lump sum payment by way of bonus or retroactive pay increase is $5,000 or less then the deduction is 15%. If the total is more than $5,000 then the remuneration including the lump sum payment is averaged for the year and the additional withholding tax is taken out of the lump sum payment. With respect to payments described in s. 36 of the Act if the total remuneration including the payment is $5,000 or less, then the deduction from the lump sum payments is 10%. If the total is more than $5,000 then the deduction is 15%.

Section 104 provides that no deduction is to be made if an employee will not receive remuneration in excess of his deductions, provided a TD1 form is filed. Section 104 (3) provides that no deduction is required with respect to an employee who is neither employed nor resident in Canada at any time in the year.

Section 105 provides that a person paying to a non-resident, fees, commissions or other amounts for services rendered in Canada, of any nature whatsoever, shall deduct 15% of such payment. Two examples come to mind: (1) a United States geologist or engineer is engaged to give evidence at an Alberta Conservation Board hearing; (2) a United States lawyer is engaged to prepare a Securities Exchange Commission Form S1 and does most of the work in Canada.
However, if the individual is present in Canada less than 183 days in the year and earns less than $5,000 Article VII of the Canada-U.S. Tax Convention would apply.[12] It would be dangerous to rely on Article VII, however, as the individual may return to Canada for some other company and if his total remuneration from both companies exceeds $5,000, each company would be obligated to withhold 15% of the amounts paid to him.

Section 105 also provides that a payment of the kind described in paragraph (c) of s. 31A of the Income Tax Act is subject to deduction of 10% if the payment does not exceed $5,000 and 15% if the payment exceeds

[11] In *Investors Limited* v. *M.N.R.* (1959 App. Bd.) 59 D.T.C. 437 an unsuccessful defence was raised against an assessment of a penalty on amounts not withheld. The defence was that as the payment to the company director was by way of lump sum withdrawals and payment of personal bills there was no "amount prescribed" which was applicable to such irregular payments.

[12] *Banister Construction Ltd.* v. *M.N.R.* (1956 App. Bd.) 56 D.T.C. 436. The appellant employed four non-residents to work in Canada temporarily on the expectation that they woud be employed for less than 183 days in the year and would earn less than $5,000 each. Under such circumstances no deduction was required. The employees each earned in excess of $5,000 and the employer was held liable for the amount that should have been deducted plus interest.

$5,000. Section 31A paragraph (c) deals with payments to a non-resident who was formerly a resident. These are payments under a pension plan, upon retirement in recognition of long service, under a profit sharing plan in full satisfaction of the rights of the payee under the plan and under a deferred profit sharing plan on death, withdrawal or retirement. However, it would appear from the concluding words of s. 31A that a lifetime pension or annuity payable to a non-resident is not income and any part withheld is refundable on application by the individual. If these concluding words were a part of paragraph (c) no deduction would re required. It should be noted here that Article VI A of the Canada-U.S. Tax Convention provides that pensions and lifetime annuities payable by a Canadian to a resident of the United States are not taxable by Canada.

Section 106 authorizes the Minister to reduce or eliminate the amount to be deducted if he is satisfied that undue hardship would result.

Section 108 provides that amounts deducted from remuneration are to be remitted to the Receiver General by the fifteenth of the following month accompanied by a return in prescribed form. Amounts deducted by brokers are to be remiteed within sixty days after the taxation year following the year in which the deductions are made.

Sections 200 to 214 prescribe the information returns to be filed by the employer or other person required to withhold tax.

The application of the withholding provisions of the Income Tax Act and the Income Tax Regulations to directors fees is rather complicated. It would appear that directors who are residents of Canada and not employees are subject to withholding to the extent that the fees exceed the exemptions. This is so because of the definition of "employee" in regulation 100, the definition of remuneration in regulation 100 which "includes" but is not restricted to the specified items; the reference to an officer in s. 47(1) (a) of the Income Tax Act and the definition of "officer" in s. 139(1) (ab) of the Income Tax Act which includes a corporation director. Directors fees paid to a resident director who is also an employee will be subject to withholding tax in the same manner as a bonus. With respect to non-resident directors who are not employees it would appear by reason of s. 105 of the Income Tax Regulations that directors fees are subject to withholding of 15% to the extent that they relate to services performed in Canada. However, under Article VII of the Canada-U.S. Tax Convention, compensation for personal (including professional) services performed by a U.S. resident in Canada is not taxable if it does not exceed $5,000 and he was not present in Canada for 183 days in the year. If the fees are paid for services which can be considered personal or professional this Article of the Convention will govern. Directors fees payable to a director who is resident in the United States for attending directors meetings in the United States are exempt from Canadian withholding tax under Article XIII B of the Convention.. The Calgary Income Tax Office is of the opinion that such directors fees can be classed as management and administration fees and as such are subject to a withholding tax of 15%. However, it is submitted that the exemption created by article XIII B of the Convention would prevail.

PART II

Withholding of Non-Resident Tax
Secs. 105D-109 *of the Income Tax Act, the* 1964
Budget Resolutions and Bill C-91 *of* 1964

Before referring to the sections of the Act which impose a withholding tax of 15% on certain payments made by a resident to a non-resident, the tests which determine whether a corporation or an individual is a resident of Canada, will be briefly reviewed.

With respect to corporations the cases have clearly established that the residence of a corporation is where its central management and control are to be found.[13] With respect to individuals, s. 139(3) of the Income Tax Act provides that a person who sojourns in Canada for periods aggregating 183 days in a year is a resident of Canada throughout the year. A person who has been outside Canada for more than 182 days of the year will still be classed as a resident of Canada if he is likely to return, for example, if his wife and children remain in Canada.[14]

Dividends

Perhaps the most significant provisions in relation to withholding tax are those dealing with dividends. The significance lies not in the amounts involved, or in the rate of tax, but in the concept that penalties (i.e. an increased rate of tax) may be employed to discourage foreign ownership of Canadian companies. In Canada, we have now moved half-way from the age old concept that every one carrying on business in Canada can do so on equal terms, to the prevalent concept in some countries of Central and South America that at least 51% of any business being carried on in the country must be owned by the citizens of that country. This change in concept was effected by the 1963 amendments[15] to the Income Tax Act. These amendments added ss. 106(1a), 106(1b) and 139A(1) to the Act.

Section 106(1a) provides that a non-resident person shall pay an income tax of 15% on any dividend paid or credited to him or deemed to be paid or credited to him prior to January 1, 1965 by a corporation resident in Canada, and a tax of 20% on any dividends thereafter if the resident corporation does not have the required degree of Canadian ownership. There are exemptions relating to investment corporations and personal corporations owned by non-residents. Where the resident corporation has the required degree of Canadian ownership the withholding tax on dividends paid or credited or deemed to be paid or credited is 10%.

Section 106(1b) provides in a somewhat complicated manner that if a company has a sufficient degree of Canadian ownership to qualify in its first taxation year after 1966, then the additional tax withheld in prior years because of non-qualification is deemed to relate to the year 1967 so that under s. 123(7) application for refund of the excess can be made up to the end of 1969.

Section 139A(1) provides the test for the required degree of Canadian ownership. In brief, either (i) 25% of the voting stock must be owned by residents of Canada during the sixty day period preceding the year or (ii)

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13 *B.C. Electric* v. *The King* (1946 P.C.) 2 D.T.C. 839.
14 *Thomson* v. *M.N.R.* [1946] S.C.R. 209.
15 S.C. 1963, c. 21.

the shares having full voting rights must be listed on a prescribed Canadian stock exchange and no one non-resident shareholder or a related group of non-resident shareholders may own more than 75% of the full voting shares and, with respect to any year commencing after December 31, 1964, at least 25% of the directors must be residents in Canada, or (iii) the corporation must be a wholly owned subsidiary of a corporation that meets the requirements of this section.[16]

In order to forestall the possibility that excessive dividends would be paid prior to the effective date of the increase by companies not having the required degree of Canadian ownership, s. 105D was inserted. This section provides that dividends paid during the period June 14, 1963 to December 31, 1964 which exceed the greater of 5/4 of the dividends paid during the equivalent period preceding June 14, 1963 or 5% of the paid up capital are subject to an additional 5% tax.

At this point it is appropriate to consider the following portions of Article XI of the Canada-U.S. Tax Convention:

> 1. The rate of income tax imposed by one of the contracting States, in respect of income (other than earned income) derived from sources therein, upon individuals residing in, or corporations organized under the laws of, the other contracting State, and not having a permanent establishment in the former State, shall not exceed fifteen per centum for each taxable year.
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> 2. Notwithstanding the provisions of paragraph 1 of this article, income tax in excess of 5 percent shall not be imposed by one of the contracting States in respect of dividends paid by a corporation organized under the laws of the other contracting State, or of a political subdivision thereof; if . . . .
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> 3. Notwithstanding the provisions of Article XXII of the Convention, paragraph 1 or paragraph 2, or both, of this Article, may be terminated without notice on or after the termination of the three-year period beginning with the effective date of this Convention by either of the contracting States imposing a rate of income tax in excess of the rate of 15 percent prescribed in paragraph 1 or in excess of the rate of 5 percent prescribed in paragraph 2

Paragraph 2 of Article XI was terminated in 1961 by the repeal of s. 106 (3) (b) which had provided for a 5% tax on wholly owned subsidiary dividends. A question may arise as to whether paragraph 1 has been terminated by the 1963 amendments[16a] which raised the withholding tax to 20% on dividends paid by a company not having the required degree of Canadian ownership. It is submitted that the question would be whether the word "imposing" in paragraph 3 of Article XI relates to the date of passage of the tax legislation or to the date on which the increased rate is to come into effect. The 1964 budget resolutions indicate that the rate of withholding tax on dividends paid by companies not having the required degree of Canadian ownership will be reduced to 15%. Bill C-91 which has been introduced in the House of Commons and had its first reading on April 28, 1964 confirms the budget resolutions. There appears to be a serious question as to whether such reduction before the inincreased tax rate came into effect prevented the termination of paragraph 1 of Article XI of the Convention.

If paragraph 1 was terminated by the increased rate imposed by the 1963 amendments there is no longer any agreement between Canada and the U.S. with respect to withholding tax on dividends and the withholding rate in the United States, which is 30% (except as modified by Tax Con-

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16 Bill C-91 of 1964 provides certain leeway with respect to the sixty day period at the election of the corporation.

16a Ibid.

ventions) would apply to dividends paid by U.S. companies to Canadian residents.[17]

The required degree of Canadian ownership specified as "not less than 25% of the issued shares of the corporation having full voting rights" provided the legal profession with a considerable rash of corporate reorganizations. For example, Company A is a wholly owned Canadian subsidiary of Company B, the U.S. parent. There are 100 shares outstanding. Following the 1963 amendment it would be an obvious move on the part of Company A (and one which the framers of the legislation should have anticipated) to subdivide its stock into 1,000,000 shares of which 4 would be voting and 999,996 would be non-voting. Company B, the parent company, would then sell one voting share to a Canadian resident. Thus, with a Canadian resident owning 1/1,000,000 of the Company it would qualify for the 10% withholding rate rather than the 20%. Another means of accomplishing the same result would be through the issue of redeemable voting preferred shares to Canadian residents. The requirement that after January 1, 1965 one-quarter of the directors of Company A must be Canadian residents would not present any problem.

The 1964 Budget Resolutions proposed that s. 139A of the Income Tax Act be amended to tighten up the definition of the degree of Canadian ownership. In passing, one might well wonder what new avenues of approach may be opened up by the six pages of amendments to this one section. However, it is at least clear that the required degree of Canadian ownership is not satisfied by the ownership of 25% of the Company's voting shares by Canadian residents and/or companies controlled in Canada unless 25% of the equity shares (as defined) are also owned by Canadian residents and/or companies controlled in Canada. However, any dividend declared on or before March 16, 1964 would be subject to withholding tax at 10% if the company qualified under the 1963 definition of degree of Canadian ownership.

Assuming the 1964 amendments to the Income Tax Act, when passed, coincide with the 1964 Budget resolutions the result will be:

(a) Section 105D will be repealed;

(b) Dividends paid to non-residents after June 13, 1963 and prior to March 17, 1964 by a Company having the required degree of Canadian ownership as defined in the 1963 amendments were subject to 10% withholding tax. Dividends paid to a non-resident by a company not having the required degree of Canadian ownership as so defined were subject to 15% withholding tax;

(c) Dividends paid to a non-resident on or after March 17, 1964 by a Company having a degree of Canadian ownership as defined in the 1964 amendments will be subject to 10% withholding tax. Dividends paid to a non-resident by a company not having the required degree of Canadian ownership as defined by the 1964 amendments will be subject to 15% withholding tax;

(d) If a company does not attain the required degree of Canadian ownership specified in the 1964 amendments until its first taxa-

[17] See *In Re Mackenzie Co. Ltd.* (1927) 8 C.B.R. 509 in which it was held that a tax was "imposed" when it became due and payable. In the United States there are decisions which appear to conflict. A decision which may be of significance is *Westhus* v. *Union Trust Co.* 164 Fed. 795 in which it was held that a tax was "imposed" by the passage of the legislation without regard to when the tax became due and payable.

tion year commencing after 1966, the non-resident recipient of the dividend may apply for a refund, up to the end of 1969, of the tax withheld in excess of the amount which would have been withheld if the Company had had the required degree of Canadian ownership when the dividend was paid.

With respect to the words "or is deemed by Part I to pay or credit" appearing in s. 106(1a), reference should be made to the combined effect of:

Sections 8(1) *and* 108(5) which provide that certain benefits received by a non-resident shareholder from a resident corporation shall be deemed to be dividends.

Sections 8(3) and 108(5) which deems interest received on income bonds to have been *paid* as a dividend if received by a non-resident; *Sections* 8(2) *and* 108(5) which deems certain shareholder's loans to have been paid as a dividend if received by a non-resident shareholder.

The necessity for s. 108(5) arises out of the wording of s. 106(1) which refers to the nature of the payment and not the nature of the receipt. To the extent that certain payments are deemed to be *received* as dividends they are by s. 108(5) deemed to be *paid* as dividends.

The net effect of the voluminous additions, amendments and repeals of 1963 and 1964, is to reduce the withholding tax on dividends to non-residents that is paid by some companies from 15% to 10%. This reduction has no appreciable benefit to the majority of non-residents in view of the foreign tax credits available to them in their own countries. Just how this manoeuvering is going to increase equity participation in Canadian companies by Canadians, which was the expressed objective, is not readily apparent.

Management Fees

The sections of the Income Tax Act dealing with management fees came into effect on June 13, 1963 and are as follows:

s. 106. (1) Every non-resident person shall pay an income tax of 15% of every amount that a person resident in Canada pays or credits, or is deemed by Part I to pay or credit, to him as, on account or in lieu of payment of, or in satisfaction of,

(a) a management or administration fee or charge; . . .

s. 106.(1c) For the purpose of paragraph (a) of subsection (1), "management or administration fee or charge" does not include any amount paid or credited or deemed by Part 1 to have been paid or credited to a non-resident person as, on account or in lieu of payment of, or in satisfaction of,

(a) a service performed by the non-resident person if, at the time he performed the service

(i) the service was performed in the ordinary course of a business carried on by him that included the performance of such a service for a fee, and

(ii) the non-resident person and the payer were dealing with each other at arm's length, or

(b) a specific expense incurred by the non-resident person for the performance of a service that was for the benefit of the payer,

to the extent that the amount so paid or credited was reasonable in the circumstances.

In introducing the Budget Resolution the Minister of Finance said:

There has been a suggestion that when the rate of the withholding tax was increased to 15% a year or two ago [on dividends of Canadian subsidiaries to U.S.

parents] some companies may have avoided it by the payment of management fees .... Payments to non-residents will be taxed in circumstances in which the label of management fees is being used as a facade for the withdrawal of profits which should be subject to the full non-resident tax.[18]

and subsequently in the House of Commons the Minister gave this explanation:

It is the Government's intention that a management or administration fee or charge is to be regarded as an amount paid for advice or direction pertaining to the operation or administration of a company, not including an amount paid for services to an independent firm and not including specified amounts paid for identifiable services such as transportation, insurance, advertisnig, accounting and research.[19]

On January 27, 1964 the Deputy Minister (Taxation) issued Bulletin No. 23 as follows:

Management or administration fees or charges paid or credited by a resident of Canada to a non-resident person after the 13th June, 1963 are taxed at the rate of 15% of the payment, collected by withholding by the Canadian resident payer, and remitted on Form NR7.

Management or administration fees or charges paid or credited to an independent firm are not subject to tax under Part III of the Act, but such amounts paid in respect of services rendered in Canada will continue to be subejct to a deduction of 15% under Section 105 of the Income Tax Regulations on account of the recipient's liability for the tax under Part I of the Act.

An amount paid by a corporation resident in Canada to a related corporation resident outside Canada is not a management or administration fee or charge subject to tax under Part III of the Act if:

(a) it was in reimbursement of a specific expense incurred by the non-resident corporation for a service that was for the benefit of the payer, and

(b) the amount was reasonable in the circumstances.

To the extent that these conditions are not met, the amount will be taxed as a management or administration fee or charge.

If an amount paid is a contractual amount based on a period of time, a prorating of expenses, or percentage of sales, the onus will be on the Canadian corporation to provide a breakdown of the contracted amount into the Canadian corporation's share of its components by specific expenses, at their cost to the non-resident related company. If these components total at least the amount of the charge, and are allowable expenses, to the Canadian corporation, the amount will not be taxed as a management or administration fee or charge.

Salaries paid to non-resident persons direct from Canadian corporations will not be considered management or administration fees or charges under Part III of the Act.

It is apparent that there are some inconsistencies between the language in the Statute and that in the Bulletin. The Bulletin indicates that all amounts of an inter-company service charge in excess of actual cost are to be treated as a management fee and are subject to withholding tax. However, in order to come within s. 106(1) (a) the charges must be for "management" or "administration" and as these words are not defined they must be given their ordinary meaning which C.C.H.[20] suggests is "direction, control, guidance or supervision". There is a wide range of services which might be provided by a United States parent company to a Canadian subsidiary company which would not come within the language of the section and which, it is suggested, can be charged at more than actual cost without attracting withholding tax. The Minister's own examples in his explanation of the Bill, namely, charges for scientific research, accounting, advertising, transportation and insurance, do not appear to be management or administration charges.

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18 C.C.H.—*Canadian Tax Reporter*.
19 Hansard, July 22, 1963, p. 2487.
20 C.C.H. *Canadian Tax Reporter*, Vol. 1-A, p. 3206.

Interest

Section 106 (1) (b) of the Income Tax Act provides for a tax of 15% on interest paid by a resident to a non-resident with certain exceptions. These exceptions are with respect to interest on:

(1) bonds of or guaranteed by the Government of Canada issued on or before December 20, 1960;

(2) bonds of or guaranteed by the Government of Canada issued after December 20, 1960 the interest on which is payable to the government or central bank of another country or any prescribed organization or agency.[21]

(3) arm's length transactions where interest is payable in a foreign currency and relating to:

(i) obligations issued before December 20, 1960;

(ii) obligations issued after December 20, 1960 if the obligation was entered into pursuant to an agreement before that date. If the obligation contains a right of prepayment the tax exemption ends on the date of such right, whether or not exercised, and if the obligation is payable on demand the exemption applies only to interest paid prior to December 1, 1961;

(iii) bonds, debentures and similar obligations issued after December 20, 1960 pursuant to written arrangements made before that date with a dealer in securities;

(iv) deposits held by a chartered bank repayable in a foreign currency;

(v) obligations entered into in the course of carrying on business in a foreign country;

(vi) obligations entered into after December 20, 1960 with respect to the purchase of property arising from a mortgage or other charge on the property purchased, where the mortgage or charge existed before December 20, 1960 provided the purchaser assumes the mortgage or charge without any change in principal or interest. If the interest on the mortgage or charge is to be computed by reference to Canadian currency the exemption does not apply.

It would appear that in Alberta the purchaser of the property would have to enter into an assumption agreement with respect to the mortgage or charge to come within this exemption.

(4) bonds, debentures or similar obligations issued after June 13, 1964 to a person holding a certificate of exemption under s. 106 (9).

Subsection (9) authorizes the Minister to give a certificate of exemption to a non-resident who establishes that there is an income tax levied by the country in which he resides and that he is exempt under the laws of such country from payment of income tax.

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[21] The following organizations have been prescribed:
Bank of International Settlements
European Fund
International Bank for Reconstruction and Development
International Development Association
International Finance Corporation, and
International Monetary Fund

The Minister of Finance gave the following explanation in introducing this provision in the House of Commons:

> The objective . . . is to broaden the market for Canadian securities in other countries and in this way to help in the policy of keeping interest rates in Canada at as low a level as possible . . . Non-resident persons such as pension trustees or charitable foundations that are exempt in their country of residence (will) be granted an exemption from this withholding tax.

Reference should be made to s. 132A of the Income Tax Act which provides that interest coupons on bonds or debentures issued after June 13, 1963 must have the letters "AX" marked thereon. The purpose of this provision is to permit simple identification of interest coupons which are not subject to withholding tax if they are cashed by a non-resident holding a certificate of exemption granted under s. 106(9).

Now that the exemptions have been considered, there are several observations which might be made with respect to withholding tax on interest. Consideration must be given to the combined effect of ss. 7(1) and 108(3) of the Income Tax Act. A blended payment of principal and interest made to a non-resident is subject to a withholding tax to the extent that the payment can reasonably be regarded as a payment of interest. As to the rate of interest there is no guide as to what is reasonable. However, in several instances the Calgary Income Tax Office has accepted a rate of 5%. Section 108(3a) provides that where a non-resident buys a treasury bill at a discount the amount of the discount is in part deemed to be a payment of interest and as such is subject to withholding tax. Finally, the effect of ss. 24 and 108(7) is that where a security on which interest is owing is exchanged for a security of greater principal amount than the principal amount then owing (i.e. the interest is capitalized) there is deemed to be a payment of interest to the extent of the amount capitalized. If the security is issued to a non-resident, the deemed payment of interest is subject to withholding tax.

Estate or Trust Income

Section 106(1)(c) provides for a withholding tax of 15% on income paid by a resident to a non-resident arising from an estate or trust.[22]

[22] *O'Connor* v. *M.N.R.* (1943 Ex. C.) 2 D.T.C. 637. A testator provided in his will for the payment of semi-annual legacies out of the capital of his estate. The Income Tax Act as it then read included in income "annuities or other annual payments . . . under a will . . . nothwithstanding that the annuity or annual payments . . . are . . . paid out of capital . . . and whether the same is received in periods longer or shorter than one year". It was held that for a payment to be an annuity for income tax purposes the capital that went into its purchase must have ceased to exist as such.

Kemp v. *M.N.R.* (1947 Ex. C.) 3 D.T.C. 1078. The appellant was entitled to monthly payments out of her late husband's estate which were charged on a trust fund consisting of Dominion of Canada tax free bonds. There was an accumulation of income in the hands of the trustees. When the bonds matured the proceeds were invested in other securities which were not tax free. Thereafter the monthly payments were made for 4 years out of the accumulated tax free income. It was held that the payments during the four years were tax free as the trustees were a mere conduit pipe through which the tax-free income flowed from the original investment to the appellant.

Pan-American Trust Company v. *M.N.R.* (1949 Ex. C.) 49 D.T.C. 672. A company was formed in Canada to hold shares in an N.R.O. investment corporation on behalf of Swiss shareholders. The Minister claimed dividends received by the company and credited to the shareholders were income from a Canadian trust accruing to non-residents. It was held that the dividends received and credited to the non-residents did not lose their character as dividends and become income accruing from a Canadian trust.

Brown v. *M.N.R.* (1950 App. Bd.) 4 D.T.C. 218. The appellant was entitled to an annuity of $6,000 per year under her husband's will. It was not payable out of any specified fund and in 1946 is was paid out of capital. The estate showed no taxable income for 1946 as deductions including depreciation exceeded the revenue. The depreciation claimed by the estate was disallowed and this resulted in the estate having income to distribute. It was held that the annuity was in fact paid out of capital. Per W. S. Fisher, K.C., "I have yet to find a case in which it has been held that the Minister of National Revenue or his officials can direct that a trustee must resort to the funds derived from a particular source for the payment of a particular legacy unless there is some specific provision in the will or under the law which makes a particular legacy payable out of a specific fund."

This provision must be related to s. 106 (4), (5) and (6) of the Income Tax Act and Article XIII E of the Canada-U.S. Tax Convention. Subsection (4) provides that interest or dividends received from an N.R.O. investment corporation by a trust, resident in Canada, and then paid to a non-resident is not subject to withholding tax if the interest or dividends would have been exempt income to the non-resident had they been paid directly to him by the N.R.O. investment corporation. Subsection (4) also provides that income paid to the non-resident that is derived from copyrights on certain specified items is not subject to withholding tax. Subsection (5) creates a special exemption with respect to trusts established before 1949 and is limited to cases where all the income is derived from a country other than Canada and all of the beneficiaries reside in such other country. Subsection (6) provides that any payment to a non-resident is income regardless of the source of the funds unless it is a distribution or payment of capital. Article XIII E of the Canada-U.S. Tax Convention provides that a beneficiary of a Canadian estate or trust, resident in the United States, is not subject to a withholding tax in Canada on amounts paid to the United States resident which were derived by the estate or trust from sources outside Canada.

Rents, Royalties, Etc.

Section 106 (1) (d) provides for a withholding tax of 15% on payments made by a resident to a non-resident consisting of rent, royalty or a similar payment,[23] including, but not so as to restrict the generality of the foregoing, any such payment

(i) for the use in Canada of property,

(ii) in respect of an invention used in Canada, or

(iii) for any property, trade name, design or other thing whatsoever used or sold in Canada,

but not including

(A) a royalty or similar payment on or in respect of a copyright, or

(B) a payment in respect of the use by a railway company of railway rolling back . . .

This subsection must be considered in the light of s.s. (7), (8) and s. 110. Subsection (7) provides that if by s. 21, 22 or 23 the payment to the non-resident is deemed to be income of the resident because of a transfer of the resident's property to his spouse, a minor or any other person with

[23] *United Geophysical Company* v. *M.N.R.* (1961 Ex. C.) 61 D.T.C. 1099. United Geophysical Company of Canada was formed as a wholly owned subsidiary of a U.S. Company to carry out the Canadian portion of the parent company's business. The parent company leased to the subsidiary the geophysical equipment required for the Canadian operation. It was contended that payments under the lease were not rent and alternatively that the business carried on was in reality the parent company's business and it should be taxed on the income under Part I (presumably the rent was equivalent to depreclaiton so that there would be no tax under Part I if this argument prevailed). It was held that the business carried on was the business of the subsidiary and that the payments were payments for the use of property in Canada similar to rent, if not in fact rent.

J. H. Warsh & Co. Ltd. v. *M.N.R.* (1962 App. Bd.) 62 D.T.C. 247. A dress manufacturer in Canada acquired for exclusive use in Canada the dress designs of a U.S. Company. It was contended that the dress designs were useless without the services that went with them and that the payments were really for services. It was held that the payments were subject to withholding tax as royalties or similar payments.

See also with respect to the broad meaning of royalties:
Ross v. *M.N.R.* (1950 Ex. C.) 4 D.T.C. 775.
M.N.R. v. *Wain-Town Gas & Oil Co. Ltd.* (1952 S.C.C.) 52 D.T.C. 1138.

whom he is not dealing at arm's length, then the payments to the non-resident which are income from such property are not subject to withholding tax.

Subsection (8) provides that a payment by a non-resident to a non-resident of rental for the use of property in Canada is subject to withholding tax. Except for this provision payments of surface lease rental to a non-resident by an American oil company carrying on business in Canada as a branch operation would not be subject to withholding tax. However, oil royalties are not considered to be paid for the use of property in Canada and if paid by a non-resident to a non-resident are not subject to withholding tax.

Section 110 of the Income Tax Act provides that a non-resident receiving rent for real property in Canada or a timber royalty may elect to treat the amount received as income under Part I and if such treatment by reason of depreciation and allowable expenses results in a tax less than the 15% withholding tax he may apply for a refund. If he makes such an election and subsequently sells the property and recaptures depreciation the amount of recapture is subject to income tax under s. 20(1), or if he has filed returns under Part I for 5 years preceding the year of recapture at the lower rates provided in s. 43.

The non-resident tax provisions relating to timber royalties (15%), alimony (15%), patronage dividends (15%), motion picture films and video tapes (10%), and provincial government bonds (5%) are of minor consequence for the purpose of this discussion.

Brief consideration should be given to the provisions of the Income Tax Act which relate to the collection of the tax which is imposed by s. 106. Section 108(1) provides that the tax payable under s. 106 is payable without any deduction whatsoever. It is clear from this provision that no depletion allowance is available on oil royalties paid to non-residents.[24] Section 109(1) obligates the paying party to deduct the applicable tax and remit it to the Receiver General together with a statement in prescribed form. Section 109(2) provides that where an amount on which non-resident tax is payable is paid or credited by an agent on behalf of the debtor, the agent shall withhold and remit the tax. Section 109(3) provides that where an amount on which non-resident tax is payable is paid or credited to an agent on behalf of the non-resident the agent shall withhold and remit the tax. Finally, s. 109(5) provides that a person required to deduct a tax on a payment to an non-resident who fails to do so is liable for the amount of the tax and has a right of recovery, including a right of offset, against the non-resident.

[24] *National Trust Company Limited and Gorman Estate* v. *M.N.R.* (1954 App. Bd.) 54 D.T.C. 33. The Trustee was trustee under a gross royalty trust under which certain of the beneficiaries were non-residents. On receipt of royalty the trustee first deducted depletion and then applied the 15% withholding tax to the balance payable to the non-residents. The amount deducted for depletion was paid to the non-residents without deduction. It was held that the words in Section 97(1) of the 1948 Income Tax Act (now Section 108(1)) prevailed and the Trustee was assessed the amount it failed to withhold.