

TAX AND FISCAL COMMENTARY



GARDINER ROBERTS LLP
Lawyers

June 2007

Ronald J. Farano, Q.C.

Why Hong Kong is an Interesting Tax Jurisdiction

- Hong Kong was colonized by the British in 1841
- Many of China's wealthy took what they had with them during the unsettling events of the cultural revolution and moved to Hong Kong
- Many became wealthy during the 1960s and 1970s through manufacturing and export
- There was rapid population growth through the 80s and 90s which became the basis for a well educated workforce requiring goods and services
- More than 1% of Hong Kong's population are now US dollar millionaires and there are more than 1,100 having wealth in excess of US \$30 million
- According to Forbes magazine, there are 18 Billionaires in Hong Kong
- Most of Hong Kong's wealth is based upon real estate with property prices being some of the highest on earth
- Hong Kong has no barriers to trade with no tariffs, no quotas, no restrictions on investment in-bound or out-bound, no foreign exchange controls, no nationality restrictions on corporate or sectorial ownership
- Corporate tax in Hong Kong is 17.5% and the personal tax is 16% at maximum
- There is no estate tax and no information

agreements with any countries with respect to assets or income held by foreign nationals or residing in Hong Kong

- With respect to the European Union's July 2005 Savings Directive (which attempts to tax the interest of European citizens having offshore savings) Hong Kong questioned the European Union that it will unlikely agree to demands to provide information on the finances of Foreigners
- When Hong Kong was handed over by the British to China some 10 years ago, China promised to

Contents

WHY HONG KONG IS AN INTERESTING TAX JURISDICTION	1
THE FEDERAL BUDGET - MARCH 19, 2007	2
PRENUPTIAL AGREEMENTS AND DISCRETIONARY TRUST VALUATION ISSUES	3
YEAR-END FISCAL TRAP – UNEXPECTED MULTIPLE YEAR ENDS	3
WHEN STOCK DIVIDENDS BECOME A SERIOUS PROBLEM	4
FOREIGN POWERS OF ATTORNEY	5
RESTRICTIVE COVENANTS – NON-COMPETITION PAYMENTS	5
NIGHTMARE ON TAX STREET	6
OUR FIRM	8

allow self rule and governance (there is 40 years to run of the 50 year agreement)

- Hong Kong entered into an agreement with China, “Closer Economic Partnership Agreement”, to allow free trade between the Chinese and Hong Kong
- The Economic growth in China has expanded at an annual average rate of 9% per annum over the past 20 years
- Hong Kong’s taxes are levied only on Hong Kong’s source income
- There are no sales taxes, no value added tax, no annual net worth taxes and no cumulative earnings taxes on companies that retain earnings rather than distribute them
- Individuals pay no tax on investment income or capital gain, whether resident or not
- Hong Kong operates under a “territorial principle” under which only income arising or derived from Hong Kong is taxable in the jurisdiction
- Hong Kong has tight secrecy and minimal corporate disclosure and administrative requirements
- Hong Kong has a new tax agreement with China under which Hong Kong firms with manufacturing operations in China are allowed to split their profits equally between the two jurisdictions, while individuals are granted relief from double taxation

increase in program spending for the 2006/07 fiscal year

- Total program spending has increased by \$24.4 billion or 13.9% since the Conservative Party formed the government
- From a spending perspective, it seems that there has been an attempt to provide something for everyone
- The share of the economy represented by federal program spending will increase from 12.8% in 2005/06 to 13.3% in 2007/08
- The critical item of the budget was \$39 billion increase in transfer to the provinces over the next 7 years to correct the so called “fiscal imbalance” [Note that a large chunk of the increased transfer to Quebec to correct the fiscal imbalance, ostensibly to foster social programs, went to lower personal tax levels - so much for fiscal imbalance]
- Although the transfer to the provinces was suppose to deflect provincial criticism, a number of the provincial governments had already voiced their concerns and disapproval of the plan
- There was very little tax relief notwithstanding that revenues for 2006/07 were over \$5 billion more than expected (\$232.3 billion versus \$227.2 billion as budgeted)
- Canadians had great expectations for serious tax relief, such as income splitting, personal income tax rate reductions and the possibility of the deferral of capital gains taxes
- There will be no personal or business tax changes in 2007/08
- Certain industries were identified as winners that warranted tax relief
- The 2007 federal budget expects revenues to increase by \$4.4 billion in 2007/08 to a total of 236.7 billion

The Federal Budget - March 19, 2007

No tax relief, but lots of spending

The federal budget seemed to lose sight of the fact that we are in a time when the focus should be on creating the right environment to promote and encourage economic activity. Instead, what we were handed was much increased spending and no tax relief:

- Program spending of \$200 billion in 2007/08 which is a \$10.6 billion a year increase from the previous year
- This increase is in addition to the \$13.8 billion

Prenuptial Agreements and Discretionary Trust Valuation Issues

When a spouse suppresses financial information at the time that a pre-nuptial agreement is executed, the court will be quick to reject the validity of the marriage agreement as occurred in the 2006 decision in *LeVan v. LeVan* [2006] O.J. No. 3584. The facts in this case were somewhat bizarre. Following separation, the wife discovered that her husband, whose assets at the date of marriage were not properly disclosed, was in fact worth \$14.6 million at the time of the marriage, and \$33 million when the parties separated in 2003. The court found that the husband had “deliberately breached his disclosure obligations and interfered with the wife’s attempts to receive independent legal advice....” In surrendering virtually all of her rights and agreeing to contract out of the provisions of the Family Law Act she did so “without any meaningful information about the husband’s assets and income, coupled with seriously misleading information about his net worth”.

The more interesting aspect of the case is the manner in which the court dealt with the interest of the husband in an inter vivos trust that had been established for the husband and his siblings in the LaVan Family Trust. The husband had a discretionary interest in this trust, and although it was discretionary, the court placed a value on that interest which was somewhat surprising. Conventional legal wisdom has concluded that the value of a discretionary interest approaches a negligible amount since the discretionary beneficiary does not have an absolute right to share in the trust property or enforce payment, unless and until the trustees exercise their discretion to distribute/appoint income or capital to the discretionary beneficiary.

This basic accepted valuation interpretation of discretionary trusts has been somewhat “bent out of shape” by recent decisions in matrimonial disputes where the courts have attempted to find value where for general commercial and trust law purposes, value does not exist.

In *Sagl v. Sagl* (1997), 31 R.F.L. (4th 405), the court found that, notwithstanding the discretionary interest of the spouse, that interest must be given a value for purposes of an equalization claim in a matrimonial

dispute. In that case, the husband was one of seven discretionary beneficiaries and the court in an arbitrary decision concluded that the husband had a 1/7th interest in the value of the trust fund.

In *Kachur v. Kachur* (2000), 274 A.R. 323 (Alta. Q.B.), the husband and his children were named beneficiaries of a discretionary trust. Since the establishment of the trust distributions had been confined to the children in equal proportions. The court accepted the unchallenged evidence that the trust was settled solely for the benefit of the children and only the children had an interest in the trust property. The Court concluded that the spouse’s interest in the trust was nil. Effectively the court concluded that the children were the only individuals who had an interest in the trust property.

In the *LeVan* situation, the husband’s parents were co-trustees. The trust had been established before the husband’s marriage. At the time of the marriage the trust assets were estimated to have a value of \$30 million. There was testimony from one of the trustees that it was their intention to treat all four children (including the husband) in an equal manner.

There was no analysis by the court as to the issue of the valuation of an interest in a discretionary trust, but the court went on to find favour with the evidence of the wife’s valuator, who concluded that the midpoint value of the husband’s interest in the discretionary trust at the date of marriage was \$3.4 million (after applying significant discounts and contingent liabilities for tax and related matters).

In addition, the husband’s minority shareholder interests in various companies resulted in valuation discounts accepted by the court in the range of 40% to 60%. The same discount was applied to the discretionary interest in the trust.

Year-End Fiscal Trap – Unexpected Multiple Year Ends

With the advent of the new eligible dividend and the calculation of a corporation’s GRIP and LRIP pools, complex issues triggering fiscal year-ends when not

expected have come into play. The concept of eligible dividends lowers the overall tax on dividends paid out of earnings taxed at the higher corporate tax rate. There is, of course, the long standing rule under subsection 249(4), which results in a deemed taxation year-end when there is an acquisition of control. Under the new subsection 249(3.1), a corporation is deemed to have a new taxation year when it becomes or ceases to be a Canadian Controlled Private Corporation (“CCPC”). Subsection 249(3.1) is important in the determination of the amount of eligible dividends and the impact thereon of the GRIP and LRIP pools.

Subsection 249(3.1) requires that, when a corporation ceases to be a CCPC there is a deemed year-end.

It is to be noted that under paragraph 251(5)(b), a person who has a right to acquire shares is deemed to be in a position of control with respect to those shares as if he owned the shares. A right arising under an agreement of purchase and sale would constitute a right to acquire within the meaning of paragraph 251(5)(b). In the context of determining the status of qualified small business corporation, paragraph 251(5)(b) allows that a right to acquire shares is not created under an agreement of purchase and sale, for purposes of determining CCPC status.

Notwithstanding 251(5)(b), a new year-end is triggered by subsection 249(3.1) on the signing of an agreement of purchase and sale. Technically, based upon the provisions as drafted, there could be a year-end at the time of signing the agreement of purchase and sale and another year-end when the shares are actually acquired by virtue of the acquisition of control. This premature year-end could cause problems in the context of shareholders’ loans and unpaid amounts, which generally are otherwise resolved during the period leading up to the closing of an agreement of purchase and sale involving shares of a corporation.

◆

When Stock Dividends Become a Serious Problem

The Tax Court decision in *Alcatel Canada Inc. v. The Queen*, [2005] D.T.C. 387, set off a chain reaction of

amendments to the Income Tax Act which placed stock dividend utilization in a bad light. In the *Alcatel* decision the taxpayer included in its calculation of expenses in determining scientific research and experimental development tax credits the value of stock option benefits derived by its employees. The court concluded that the employee benefits resulting from the stock options constituted expenditures made by the taxpayer in respect of salary or wages.

As a result of this decision, the Act is to be amended such that new section 143.3 of the Act, will provide that if a corporate obligation is satisfied by the issuance of shares, this may not result in a recognized expenditure.

The proposed amendments to section 143.3 are related to the amendment to paragraph 52(3)(a) and paragraph 53(1)(b). Under paragraph 52(3)(a) if a stock dividend is received by a corporation the cost of those shares to the recipient will be nil if the dividend is a tax-free inter-corporate dividend under subsection 112(1). Prior to the proposed amendment the cost of such shares to the recipient would be the “amount” of the dividend which, in the normal course, would be the amount that is added to the paid up capital (“PUC”) of the shares of the class that resulted from the issuance of the stock dividend.

In the case of paragraph 53(1)(b), the amendment will provide that there will be no increase to the adjusted cost base of shares from the conversion of contributed surplus into PUC where the dividend is deductible under subsection 112(1). Prior to the proposed amendment, a stock dividend to which subsection 84(1) applied, would automatically increase the adjusted cost base by an amount equal to the “amount” of the dividend.

These amendments will impact stock dividends received on or after November 9, 2006.

The proposed amendments will not allow any cost base to be attributable to a stock dividend which arises from retained earnings, however, a transfer of retained earnings to PUC will result in an increase in the adjusted cost base of those shares to which the PUC is ascribed. One process involves the issuance of shares and the other does not.

Stock dividends are commonly used in capitalizing

(“crystallizing”) safe income on hand.

Heretofore, crystallizing safe income on hand has generally involved (1) capitalizing surplus by transferring retained earnings to PUC, resulting in a deemed dividend under subsection 84(1) equal to the amount of safe income on hand, or alternatively (2) issuing a stock dividend having a paid up capital and an “amount” equal to the safe income on hand.

The object of the exercise is to increase the adjusted cost base of shares that are the subject matter of a disposition and in the result reduce the capital gain by the amount of the safe income on hand, which is a generally accepted safe income extraction procedure under subsection 55(2) of the Income Tax Act.

If stock dividends are employed, the proposed amendments will result in no increase in the adjusted cost base and the safe income on hand will not be crystallized.

Where it is contemplated that there be a disposition of the shares of an operating corporate subsidiary, it will not be possible to utilize stock dividends from the subsidiary to the parent, but rather it will be necessary to capitalize retained earnings.

It may not always be possible to capitalize safe income on hand by transferring retained earnings to PUC before a disposition occurs.

Some Alternative Procedures

1. In the Holdco/Opco situation where Holdco has no retained earnings, then if the assets so warrant, it may be possible to have Holdco pay an actual dividend to a corporation created by the vendor for the purpose of rolling over the Holdco shares to the new corporation. The dividend would be equal to the safe income on hand in the Sub/Opco. A note would be issued equal to the amount of the dividend declaration. The Holdco shares would be sold, together with the note to the purchaser, or alternatively, the purchaser could invest funds into Holdco.
2. Purchase all of the Holdco shares for cancellation prior to the sale in return for a note, that would be sold to the purchaser, together with the Holdco shares which have a nominal value (utilizing a new corporation above Holdco). It would be

necessary to file paragraph 55(5)(f) designations to identify the safe income on hand portion of the deemed dividend which results from the application of subsection 84(3).

3. Prior to the disposition to the purchaser, the Holdco shares would be rolled over into a new corporation on a tax deferred basis and the shares of Holdco would be purchased for cancellation for a promissory note equal to safe income on hand and shares of a slightly different class with a low paid up capital. The note would be sold to the purchaser, together with the Holdco shares. An election could be filed under subsection 85(1) with an agreed amount equal to the promissory note.

Foreign Powers Of Attorney

In the case of many vacationers who spend time in Florida, it is accepted that powers of attorney drawn in Ontario will satisfy Florida requirements. It is advisable, however, where a Florida vacationer owns real estate in Florida, to execute a Florida durable power of attorney. Although the laws of Florida would seem to be sufficiently broad to recognize foreign powers of attorney such as a power validly executed under the laws of the Province of Ontario, it is imperative that those powers contain a specific power to buy, sell and deal with real property in Florida.

Restrictive Covenants – Non-Competition Payments

What the new rules provide and how to avoid income inclusion

New subsection 56.4(2) prescribes new rules for income inclusion with respect to non-competition payments. A restrictive covenant is an agreement that is a waiver of a right by the taxpayer that is intended to affect the acquisition or provision of property or

services by the taxpayer or someone who does not deal at arm's length with the taxpayer. Where certain precautions are not taken the consideration paid for the restrictive covenant may become ordinary income.

Without delving into an analysis of the inclusions and exclusions there are certain basic guidelines that may be observed so as to avoid income inclusion.

Arm's Length Share Purchase

- Do not allocate any value to the non-competition covenants unless otherwise commercially dictated;
- No election will be needed and the subsection 56.4(8) exclusion will apply and there will be no reallocation to ordinary income under paragraph 68(c);
- The proceeds of disposition of the shares will be the full purchase price and with capital gains treatment;
- There should be a clear documentary statement that the covenant relates to the preservation of share value;
- Where commercial reasons dictate an allocation of an amount to the covenant then there should be documentary requirement to file an election under paragraph 56.4(3)(c);
- The result of the election is to treat the payment for the covenant as part of the proceeds of disposition for the shares;
- Note the elections are not available where the covenantor is a shareholder of a holding corporation the value of which is not 90% or more attributable to a single corporation.

Arm's Length Asset Purchase

- Ascribe no value to covenant unless otherwise commercially dictated;
- Provide for an election under subsection 56.4(7);
- The proceeds paid will be ascribed to the disposition and acquisition of goodwill and "eligible capital" treatment to the vendor and purchaser;
- There should be a clear documentary statement that the covenant relates to the preservation of goodwill;

- Ascribe no value to a covenant given to preserve assets other than goodwill which should preclude the filing of an election with respect to those assets [subsection 56.4(8) applies];
- The purchase price will be proceeds to the vendor and cost to the purchaser;
- Where the consideration is given to preserve the value of goodwill and other assets then a provision should be made to file an election under subsection 56.4(7);
- Without the elections being filed ordinary income could result;
- Where commercial reasons mandate a payment for the covenant where goodwill or other assets are sold an election should be prescribed by the agreement under paragraph 56.4(3)(b);

Non-Arm's Length Transactions

- Subsection 56.4(2) could result in an ordinary income inclusion where a restrictive covenant is given in non-arm's length transactions involving shares, goodwill or other assets;
- No elections are available;
- Where consideration for the covenant flows to a party not dealing at arm's length with the taxpayer, file an election under subsection 56.4(9) which results in the amount paid being treated as proceeds of goodwill or other property.

Nightmare on Tax Street

(The Globe and Mail - May 15th, 2007)

[Jim Flaherty has put his foot in the bucket]

Once known as a straight shooter, Jim Flaherty is in danger of becoming a parody of Ottawa politics at its most convoluted.

In his March budget, the Finance Minister made what was billed as a small tweak to the tax system. When that small tweak turned out to be a huge blow to the international competitiveness of Canada's corporate heavyweights, he at first vowed to stick with it anyway. Then he hinted at changes in the implementation date. Then he changed his original policy to deal only

with two tax strategies that he did not specifically mention in the budget. Those clarifications came with coloured charts and formulas that could flummox an accountant. Finally, late last week, he admitted that companies would find a way around the two tax ploys that his clarified plan was designed to thwart – but he was sticking with his plan.

“There are other ways, I’m sure,” he conceded. “Lots of people get paid lots of money to develop tax avoidance schemes, and that’s to be expected. This will be a continuing effort by the Department of Finance.” Please stop, Minister.

The original tax change, relegated to a mere eight paragraphs in the budget, was designed to end the deductibility of interest on money borrowed at home to finance business operations abroad. The change would be relatively painless, the budget said, costing only \$10-million this year and rising to \$40-million in 2008-09. Reaction was swift. Groups such as the Canadian Council of Chief Executives and the Canadian Chamber of Commerce warned Mr. Flaherty that the change could erode Canada’s global competitiveness. The tax impact, they added, could run to billions of dollars. The disparity between his lowball estimate and the reality was astonishing, if only because the Finance Department has a reputation for competence.

How could this happen? Insiders say that when officials examined their longer-term revenue prospects last January, they were taken aback. There was no surplus cash in the kitty beyond 2008-09, except for the \$3-billion set aside as a contingency reserve. But Ottawa needed to find almost \$6-billion in extra cash to shave another percentage point off the goods and services tax in 2011-12. So officials set out to scrounge more money, and pounced on the elimination of the interest deduction as one source. They argued that, in an ideal tax system, companies should not be allowed to effectively subsidize their ventures abroad by deducting the interest costs of their borrowing at home. After all, the money that a foreign affiliate pays to its Canadian parent – its so-called exempt surplus dividends – is not taxable.

The problem with this argument is that other countries do allow somewhat similar schemes. So the deduction does allow Canadian companies to

compete relatively evenly. And those companies, after all, do not live in a tax theoretician’s universe. Such considerations were overlooked. Before the budget, no one could make a good case to stop the change; now, everyone is blaming someone else.

In the circumstances, Mr. Flaherty should have tactfully withdrawn the measure, citing the need for further study. Instead, for two months, he has only contrived to make matters worse. Early last week, in a speech that flabbergasted his Toronto audience, he said the budget measure was really intended as an anti-tax haven initiative. Firms would no longer be able to claim two deductions, at home and abroad, for a single transaction – a practice known as double-dipping. As well, they could no longer deploy a “tower structure” to exploit different legal definitions in Canada and the United States to arrange two deductions for a single investment. These changes, he added, would not take effect for five years. Experts would look at the fine print. Another expert panel would examine the fairness of the whole tax system. Within hours, experts in most accounting firms had already found a way around Mr. Flaherty’s proposed anti-tax-haven measures.

Now what? In Ottawa terms, Mr. Flaherty has successfully handled the issued, spinning out the problem in time and dumping it on somebody else’s desk. In the real world, Mr. Flaherty has complicated the tax system, endowing the tax-avoidance specialists. Why couldn’t he just admit his error?

Cav. RONALD J. FARANO, Q.C., TEP
Senior Tax Counsel

Gardiner Roberts LLP
Barristers & Solicitors
Suite 3100, Scotia Plaza
40 King Street West
Toronto, Ontario M5H 3Y2

TEL: (416) 865-6600 FAX: (416) 865-6636
WEB: www.gardiner-roberts.com
Ronald J. Farano - Direct Line: (416) 865-6633
E-Mail rfarano@gardiner-roberts.com



GARDINER ROBERTS LLP
Lawyers

Agility. Depth. Access.

Gardiner Roberts LLP serves the diverse legal needs of growing companies and the dynamic people who run them. Our overriding aim is to help our clients reach their goals.

We are a strategically placed, mid-sized law firm – large enough to offer a full range of legal services, yet small enough to be flexible and responsive to our clients' individual needs. Our team of lawyers provides expert advice and legal services in corporate, commercial, real estate, tax, litigation and health law areas.

We are proud to represent some of Canada's largest banks and financial institutions, and several medium to large-sized municipalities. We counsel agencies, boards and commissions and other government entities, high tech and software companies, real estate developers, lenders and investors and Ontario's health care professionals and providers.

GARDINER ROBERTS LLP

Suite 3100, Scotia Plaza, 40 King St. W.

Toronto, ON, Canada, M5H 3Y2

Telephone: 416 865 6600

www.gardiner-roberts.com

A MEMBER OF



A WORLDWIDE NETWORK OF
INDEPENDENT PROFESSIONAL FIRMS