

# TAX ALERT

## TAX ALERT - IMMEDIATE ACTION MAY BE REQUIRED

Several recent tax developments might have an impact on your business and/or your investments. We have outlined the significant changes in this *Tax Alert*. If you think that these changes might affect you, please contact us as soon as possible so that we can best advise you.

### DOMESTIC ALERT

#### GST

There will be a reduction in the GST rate by 1% (i.e. from 6% to 5%) effective January 1, 2008. Please refer to the attached article for more information about how this rate may affect your business and/or real estate purchases.

#### Ontario and Federal Corporate Tax Harmonization

For taxation years ending after December 31, 2008, the Canada Revenue Agency (CRA) will administer Ontario's corporate income tax and minimum tax. This harmonization will result in the corporate taxpayer's requirement to file a joint federal/Ontario income tax return with CRA. Furthermore, there will be changes to Ontario pool balances (such as undepreciated capital cost [UCC]) and Ontario income tax measures (such as a replacement calculation for Ontario Scientific Research and Development Expenditures [SR & ED]).

#### *Important change regarding corporate tax instalments:*

The single income tax administration will apply to taxation years ending in 2009. As a result of this harmonization, taxpayers will be required to remit both federal and Ontario corporate income tax instalments directly to CRA starting in 2008. Some corporations will be responsible for remitting combined income tax instalments as early as **February 2008** (a corporation with a January 2008 year end will be required to remit combined federal and Ontario income tax instalments in February 2008 towards its January 2009 taxation year).



## INTERNATIONAL ALERT

There are important changes resulting from:

- The Fifth Protocol (“Protocol”) to the Canada - U.S. Tax Treaty (“Treaty”) which amends certain provisions of the Treaty. For further information, please refer to our 2007 issue of Tax Talk, which can be found by clicking on the following address: <http://www.soberman.com/imageLibrary/Tax%20Talk%20Nov%202007.pdf>
- Department of Finance announcements in October and November which propose changes to domestic law affecting business transactions with non-residents.

Some of the most noteworthy tax issues resulting from these announcements are described below.

### **Withholding tax on interest payments to non-residents**

#### *Is the interest payment to an arm’s length person?*

Effective January 1, 2008, a Canadian withholding tax exemption is proposed for certain eligible arm’s length interest payments made to non-residents of Canada, regardless of the lender’s country of residence.

The proposal will likely be passed into law shortly. If enactment occurs sometime in 2008, the existing withholding tax rules would technically still apply during the period from January 1, 2008 to the date the new rules become law. In that case, foreign lenders should be entitled to claim a refund for any withholding taxes remitted on their behalf during the period between January 1, 2008 and the date of enactment.

#### *Is the interest payment to a related person?*

Canadian withholding tax will also be phased out for certain non-arm’s length interest payments made by a Canadian to a U.S. resident recipient. Based on announcements from the Minister of Finance, if Canada and the U.S. ratify the Protocol in 2008, the first reduction in the withholding tax rate to 7% in respect of interest paid or credited to related persons is expected to apply retroactively to amounts paid or credited after December 31, 2007.

## **Transactions with U.S. persons**

As a result of the changes announced in the Protocol, certain U.S. persons who have historically benefited from the Canada - U.S. Tax Treaty may no longer receive this beneficial tax treatment. Conversely, there may be situations where U.S. persons will be entitled to treaty benefits where they currently are ineligible.

Canadians conducting business with non-resident persons will need to re-examine the applicable withholding tax rates for certain types of payments, such as interest, dividends, royalties and management fees made to the non-resident recipient. The new rules will apply shortly after the Protocol is ratified (expected in early 2008; however the date appears to depend on the nature of the income tax involved).

## **Limited Liability Corporations (LLCs) and Unlimited Liability Corporations (ULCs)**

Although the Protocol provides for the anticipated extension of treaty benefits to LLCs, the benefits under the Treaty will only be available in respect of members who are U.S. residents. The effect of the Protocol to Canadian investors holding an interest in LLCs may result in an even greater level of taxation than the current treaty provides.

Certain other structures involving hybrid entities and reverse hybrid entities appear to lose treaty benefits. A hybrid entity refers to an entity which is treated as a corporation for Canadian tax purposes and as a partnership or disregarded entity for U.S. tax purposes. An example of a hybrid entity is a ULC incorporated in Nova Scotia, Alberta or British Columbia. Reverse hybrid entities, which are treated as partnerships for Canadian tax purposes and as corporations for U.S. tax purposes, also seem to face denial of treaty benefits as a result of the changes outlined in the Protocol.

A review of the viability of certain hybrid arrangements will be required. Fortunately, these measures will not be applicable until 2010 (at the earliest).

## **Interest in non-resident corporations, partnerships and trusts**

Proposed draft legislation containing significant changes to the computation of income relating to interests in foreign investments held by Canadian residents is expected to pass into law shortly. These changes are expected to affect some taxpayers' 2007 tax returns. Please speak to us about any ownership you have in foreign entities.

## WHAT DO I NEED TO KNOW ABOUT THE GST RATE REDUCTION?

As you may recall, the federal government reduced the GST rate from 7% to 6%, effective July 1, 2006. The GST rate will now be reduced again to 5%, effective January 1, 2008.

### Getting Your Business Ready for Another GST Rate Reduction

You will have to make substantial changes to your systems (e.g. cash registers or sales systems, purchase order and account payable systems, employee expense reports, taxable benefit calculations, etc.) to reflect the rate reduction effective January 1, 2008.

- If GST becomes payable (i.e. is invoiced) or is paid before January 1, 2008, the 6% GST rate will apply.
- If GST becomes payable (i.e. is invoiced) after December 31, 2007 without having been paid before that day, the 5% GST rate will apply.
- If GST is paid after December 31, 2007 without having become payable (i.e. is not invoiced) before that day, the 5% GST rate will apply.

You should also ensure that your systems have the capacity to deal with transactions after December 31, 2007 which were originally taxed at the 6% rate, to accommodate such issues as price adjustments, returns, etc.

In addition to the above general transitional rules, certain types of transactions will be subject to specific transitional rules, as described below.

### *Sale of New Housing*

For sales of houses, apartment buildings and other residential complexes, the applicable GST rate is as follows:

<i>Date of Transaction</i>	<i>GST Rate</i>
Ownership or possession of real property under the agreement of purchase and sale is transferred to the buyer before January 1, 2008:	
▪ Agreement of purchase and sale entered into after May 2, 2006	6%
▪ Agreement of purchase and sale entered into on or before May 2, 2006	7%
Ownership or possession of real property under the agreement of purchase and sale is transferred to the buyer after December 31, 2007:	
▪ Agreement of purchase and sale entered into after October 30, 2007	5%
▪ If purchase and sale agreement was entered into on or before October 30, 2007 but after May 2, 2006	6%
In both of these circumstances, the purchaser will be entitled to file a claim for a transitional rebate from the Canada Revenue Agency (CRA) that reflects the GST rate reduction to 5%, net of any corresponding rebate adjustment.	
▪ If purchase and sale agreement was entered into on or before May 2, 2006	7%

### *Quick Method of Accounting*

The quick method rates will be changed to reflect the reduced rate of GST. The reduced rates will apply for reporting periods beginning on or after January 1, 2008 as outlined below:

	<i>Permanent establishment in a non-participating province (i.e. Ontario)</i>			
	For a Business that Purchases <b>Goods for Resale</b>		For a Business that Provides <b>Services</b>	
	Current Rate	Reduced Rate	Current Rate	Reduced Rate
Supplies made in a non-participating province (i.e. Ontario)	2.2%	1.8%	4.3%	3.6%

### *Other Transitional Rules*

- **Imported goods** - GST at the rate of 5% will apply to goods that are either imported or released from customs control after December 31, 2007.
- **Automobile operating benefit and other taxable benefits** - The prescribed rate for calculating GST on automobile operating expense benefit will be reduced to 3% for 2008. GST deemed to be collected on other taxable benefits will be reduced to 4/104 of the value of the taxable benefit for 2008.

We can help. Your Soberman LLP advisor can help you determine the impact of the above-mentioned changes on your business affairs.

*The information contained in this Tax Alert is of a general nature and should not be acted upon without appropriate professional advice following a thorough examination of the particular situation.*

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