



Income Tax Technical News

No. 8

September 30, 1996

www.cra.gc.ca



Canada Customs and
Revenue Agency

Agence des douanes et du
revenu du Canada

Canada

In This issue

Publication of Advance Income Tax Rulings

Bankrupt Corporation – Change of Fiscal Period

Proceeds of Sale of a Condominium – First Closing Date or Second Closing Date

Pre-delivery service of new vehicles – Interpretation Bulletin IT-145R

Treatment of United States Unitary State Taxes

The INCOME TAX TECHNICAL NEWS is produced by the Policy and Legislation Branch. It is provided for information purposes only and does not replace the law. If you have any comments or suggestions about the matters discussed in this publication, please send them to:

Director, Business and Publications Division
Income Tax Rulings and Interpretations Directorate
Policy and Legislation Branch
Revenue Canada Ottawa ON K1A 0L5.

The INCOME TAX TECHNICAL NEWS can be found on the Revenue Canada Internet site at: www.rc.gc.ca

Publication of Advance Income Tax Rulings

Further to our announcement in Income Tax Technical News No 7 of February 21, 1996, that all advance income tax rulings would be published, the Department has decided to publish, in severed electronic format, all rulings issued after January 1, 1996. The procedures for this new process will be outlined in Information Circular IC-70-6R3 which will be released shortly. In the interim, the following will occur. After the ruling requested is issued, a severed version will be forwarded to the taxpayer or representative for approval. We will ask for confirmation that the severed ruling does not directly or indirectly reveal the identity of the taxpayer and that the taxpayer is satisfied that the confidentiality of the taxpayer's information has been protected. After approval is granted, the severed ruling will be released in electronic format to publishers of tax information and will also be available for viewing in the reading rooms of Revenue Canada tax services offices.

Bankrupt Corporation – Change of Fiscal Period

Paragraph 128(1)(d) of the INCOME TAX ACT (the "Act") deems the taxation year of a corporation to have ended on the day immediately before the day on which the corporation became a bankrupt and deems a new taxation year to have commenced on the day the corporation became a bankrupt. Pursuant to subsection 248(1) of the Act, "bankrupt" has the meaning assigned by the BANKRUPTCY AND INSOLVENCY ACT.

Unlike paragraph 249(4)(d) and subparagraphs 128.1(1)(a)(ii) and 128.1(4)(a)(ii) of the Act, the deeming provision in paragraph 128(1)(d) of the Act does not deem the fiscal period of the corporation to end. There is also no provision in the Act which deems a corporation that becomes a bankrupt not to have established a fiscal period before that time. Therefore the fiscal period previously established pursuant to the definition thereof in subsection 248(1) of the Act (subsection 249.1(1) for fiscal periods that begin after 1994) will continue to be the fiscal period of the corporation for taxation years subsequent to it becoming a bankrupt. Effective the date of this Newsletter, a corporation that becomes a bankrupt must obtain approval from the Department to change its fiscal period as outlined

in paragraph 4 of Interpretation Bulletin IT-179R, CHANGE OF FISCAL PERIOD.

Since subparagraph 5(c) and paragraph 10 of IT-179R no longer reflect the Department's view with respect to the fiscal period of a corporation that has become a bankrupt, IT-179R will be revised.

Proceeds of Sale of a Condominium – First Closing Date or Second Closing Date

It is common practice for condominium developers to allow purchasers to occupy condominium units prior to the registration of the building under the relevant condominium statute. This practice generally involves two closings: one at the time the purchaser occupies the unit and another at the time of registration of the building.

In response to Question 25 of the 1987 Round Table of the Canadian Tax Foundation Annual Conference, the Department stated that income should be reported in accordance with accepted commercial practice as used in computing income for financial statement purposes, provided that practice is legally permissible and not

contrary to a specific provision in the INCOME TAX ACT. The Department further stated that, in the absence of convincing arguments to the contrary, income from the sale of the condominiums should be reported at the first closing.

Further to the decision in 141224 CANADA LTD. V. THE QUEEN, 95 DTC 385, [1995] 1 C.T.C. 2947, the Department is now of the view that if the vendor does not have the right to the payment of the sale price before the second closing date, the amounts do not have the characteristics of revenue and, therefore, these amounts will not be taxable until they are legally receivable. This new interpretation will take effect as of the date of this Newsletter.

If the seller has a legal right to receive the proceeds at the first closing date, the Department is still of the view that income from the sale of the condominiums should be reported at the first closing date.

Pre-delivery service of new vehicles – Interpretation Bulletin IT-145R

Paragraph 49 of IT-145R, Canadian Manufacturing and Processing Profits – Reduced Rate of Corporate Tax, mentions that, in the case of new vehicles, the pre-delivery service activities would qualify for the manufacturing and processing profits deduction under section 125.1 of the INCOME TAX ACT.

This interpretation was based on FEDERAL FARMS LTD., 66 DTC 5068, [1966] C.T.C. 62. Since that case, other cases have dealt with the meaning of "manufacturing" or "processing," including TENNECO CANADA INC., 91 DTC 5207, [1991] 1 C.T.C. 323 in which the Court indicated or reaffirmed:

- (a) with regard to the meaning of manufacturing, whether raw or prepared material was used to produce articles "by giving these materials new forms, qualities or properties;"
- (b) with regard to the meaning of processing, that:
 - (A) "processing occurs when raw or natural materials are transformed into saleable items. Such raw or natural

materials are unsaleable, or would sell for a lesser price, in their unprocessed state," and

- (B) "the two tests for determining whether a taxpayer processes goods are:
- (i) whether there is a change in the form, appearance or other characteristics of the goods subject to the operation, and
 - (ii) whether the product becomes more marketable."

The Court in *TENNECO CANADA INC.* indicated, at DTC 5209-5210, C.T.C. 327, what type of operations come within the meaning of "manufacturing" or "processing":

"The nature of the modern commercial world is that goods often pass through many hands before they reach consumers. At each stage, minor alterations may be made to the goods, before they progress through the commercial chain. The benefit of the incentive cannot be claimed by each of the handlers merely because they altered the goods in some small way. Only those operations which significantly change the characteristics of the goods can truly be

described as "manufacturing" or "processing" so as to qualify for the special tax incentives."

Based on the above, the Department has reviewed its position and is now of the view that in the case of pre-delivery service of new vehicles where there is no real change in the form, appearance or characteristics of the vehicles, the pre-delivery service does not create a new product, nor make vehicles more saleable, usable or marketable. Accordingly, this service cannot be considered to come within the meaning of "manufacturing or processing." Consequently, the pre-delivery service activities will no longer qualify for the manufacturing and processing deduction for taxation years commencing after the date of this Newsletter. The sentence in paragraph 49 of IT-145R ". . . in the case of new vehicles the pre-delivery services activities would also qualify" will be deleted in the next revision of IT-145R.

Treatment of United States Unitary State Taxes

Canadian corporations with U.S. affiliates can be liable for a state's unitary tax on its sales in that particular state whether the Canadian

corporation has or does not have a permanent establishment in the U.S.

It is the Department's view that a particular state's unitary tax may only be reasonably regarded as an income or profits tax in respect of the income of the taxpayer from any business carried on by the taxpayer in the business country within the meaning of "business-income tax" as defined in subsection 126(7) of the INCOME TAX ACT if the unitary tax is computed on the net business income of the Canadian corporation attributable to that state from carrying on business in that state. For instance, if the unitary tax paid represents the annual minimum franchise tax or is computed on a basis which does not attempt to allocate income to the particular state, such tax would not satisfy the requirements of subsection 126(2) of the Act. However, such tax would likely be deductible in computing the taxpayer's income pursuant to subsection 9(1) of the Act as an expense for the purpose of earning income.

A decision as to whether a particular state's unitary tax can be regarded as an income or profits tax can only be taken after a review of the applicable state legislation.

The Department has several concerns relating to this issue. For instance, for purposes of foreign tax credits, in order for a tax to qualify as a "business-income tax" as defined in subsection 126(7) of the Act, the tax must be **paid** by the Canadian corporation. This would not be the case if the actual liability for payment of the unitary tax lies with an affiliated corporation. Where the Canadian corporation would not be liable to the unitary tax on its sales into a particular state were it not for the activities of its U.S. affiliate(s) in the state, it would be arguable that the tax is in respect of the Canadian corporation's investment in its U.S. affiliate(s) rather than from any business carried on by the taxpayer in the foreign country.