

**TRANSITIONING TO FEDERAL TAX POOLS UNDER FEDERAL
ADMINISTRATION OF ONTARIO'S CORPORATE INCOME TAX**

**ONTARIO MINISTRY OF FINANCE
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INTRODUCTION

In late 2004, Ontario and the federal government began working on designing a system for federal administration of Ontario's corporate taxes. The design of that system has been guided by several objectives, including:

- Eliminating duplication and streamlining tax collection so that Ontario businesses are more competitive because of reduced compliance costs;
- Reducing government administration; and
- Preserving the policy and administrative flexibility that Ontario needs to achieve its fiscal and economic objectives, while respecting the federal government's national objective of building a more integrated tax system.

On October 6, 2006, Ontario and the federal government signed a Memorandum of Agreement that describes the main elements of federal tax administration. In particular, Ontario has agreed to enter into a corporate income tax collection agreement with the federal government that is substantially similar to the agreements the federal government has with most other provinces.¹

A key feature of the corporate income tax collection agreements is the requirement that participating provinces parallel the federal definition of taxable income. Achieving this common tax base requires that federal tax attributes, such as balances in loss pools and unclaimed depreciation, also apply in determining taxable income for provincial corporate income tax purposes.

At present, a corporation's federal and Ontario tax attributes may not be identical due to differences in corporate income tax provisions and/or differences in the extent to which the corporation has utilized discretionary deductions for Ontario and federal purposes. In order to harmonize Ontario tax attributes with federal attributes, transitional provisions are required. The purpose of this paper is to set out for discussion a proposal (the "Transitional Proposal") to provide an appropriate transition to the use of federal tax attributes.

THE PROBLEM ADDRESSED BY THE TRANSITIONAL PROPOSAL

The Transitional Proposal sets out a tax credit and debit mechanism to offset the effects of the tax gains and losses caused by the use of federal tax attributes for Ontario purposes.

¹ Currently, all provinces and territories except Ontario, Quebec and Alberta have entered into corporate income tax collection agreements with the federal government. Under these agreements, the Canada Revenue Agency collects and administers the provincial corporate income tax on behalf of the participating provinces.

Without the Transitional Proposal, corporations that have higher federal tax attributes than Ontario tax attributes would realize a tax gain because the excess represents amounts already deducted in computing income for Ontario purposes. Conversely, corporations that have higher Ontario tax attributes than federal tax attributes could suffer a loss of Ontario tax deductions.

This problem is illustrated in Examples 1 and 2. Consistent with the terms of the Memorandum of Agreement, it is assumed throughout this paper that federal administration of the common tax base takes effect for taxation years ending after 2008.

X Co. has a single permanent establishment in Ontario. Its taxation years end on December 31. Its only tax attribute as of January 1, 2009 that is determined differently for Ontario and federal purposes is its undepreciated capital cost ("UCC") of depreciable property.

EXAMPLE 1

X Co.'s UCC for federal purposes on January 1, 2009 is \$100 million and its UCC on that date for Ontario purposes is \$70 million (i.e., a federal excess of \$30 million).

ANALYSIS

The \$30 million federal excess would result in an Ontario tax gain for X Co. This is because X Co., in computing income for Ontario purposes for prior taxation years, would already have deducted an amount equivalent to the \$30 million federal excess.

EXAMPLE 2

X Co.'s UCC for federal purposes on January 1, 2009 is \$70 million and its UCC on that date for Ontario purposes is \$100 million (i.e., an Ontario excess of \$30 million).

ANALYSIS

The Ontario excess would result in a loss of \$30 million in future Ontario tax deductions. By adopting the federal UCC balance, the UCC pool that would otherwise have been available for future Ontario deductions is reduced from \$100 million to \$70 million.

GUIDING PRINCIPLES AND OBJECTIVES

The Transitional Proposal is guided by the following principles and objectives:

- The Transitional Proposal is not intended to affect net Ontario tax revenues. It should be revenue neutral (preferably on both an aggregate and individual firm basis).
- The Transitional Proposal must be consistent with the single administration of Ontario corporate income tax. It would be impractical to calculate transitional credits and debits with reference to the extent to which Ontario tax attributes would have been used if Ontario administration of Ontario corporate income tax had continued.
- The Transitional Proposal should be designed in a manner that minimizes compliance and administrative complexity.
- The Transitional Proposal should be symmetrical, in so far as transitional credits provided in cases where Ontario tax attributes exceed federal tax attributes should correspond to transitional debits in cases where federal tax attributes exceed Ontario tax attributes.
- The Transitional Proposals should minimize opportunities to manipulate the amount of the transitional credits/debits, particularly with regard to transactions involving related corporations with permanent establishments in Ontario and elsewhere.
- The Transitional Proposal should provide for appropriately neutral rules to accommodate corporate amalgamations and windings-up for which rollovers are currently provided.

There is some conflict among these principles and objectives, which required that certain trade-offs be made in developing the Transitional Proposal. For example, the use of a single corporate income tax rate in calculating debits and credits supports the objective of minimizing complexity, but in some cases could result in overcompensating or undercompensating certain corporations (e.g., those in the manufacturing or resource sectors).

OUTLINE OF THE TRANSITIONAL PROPOSAL

A corporation's liability or relief under the Transitional Proposal is determined using a temporary 5-year tax credit or debit mechanism. The 5-year period recognizes the potential significance of differences in federal and Ontario tax attributes for particular corporations and that it is reasonable to adjust for these differences over a number of years.

The Transitional Proposal would apply to a corporation whose taxation year includes January 1, 2009, and has a permanent establishment in Ontario at the beginning of that taxation year. For each taxation year ending after 2008 and before 2014, a corporation's liability or relief under the Transitional Proposal would generally be determined as follows:

1. Calculate the total of the corporation's specified federal tax attributes as of the beginning of the corporation's first taxation year ending after 2008 (which time is referred to in this paper at the corporation's "Transition Time").
2. Calculate the total of the corporation's specified Ontario tax attributes as of the Transition Time.
3. Determine the amount by which the total specified federal tax attributes exceed the total specified Ontario tax attributes. If the amount is positive, this excess (a "Federal Excess") will give rise to transitional debits over time. If the Ontario total exceeds the federal total, this excess (an "Ontario Excess") will give rise to transitional credits over time.
4. The transitional credit/debit for each taxation year ending after 2008 and before 2014 would normally be determined by multiplying the Ontario Excess/Federal Excess by the product of:
 - the corporation's basic corporate income tax rate (currently 14%);²
 - the percentage of the corporation's taxable income allocated to Ontario under federal rules³, and
 - the percentage that the number of days in the taxation year included in the corporation's "amortization period" is to the total number of days in the corporation's "amortization period". A corporation's "amortization period" would normally be the period starting at the beginning of a corporation's first taxation year ending after 2008 and ending five calendar years afterwards. Consequently, the percentage would typically be 20%.
5. The transitional credit would not be refundable. If the transitional credit for a taxation year cannot be fully used, the unused portion could be carried forward to one or more subsequent taxation years in the amortization period.

² It should be noted that the Ontario corporate rate for small business of 5.5% would not be an appropriate rate to use in calculating the tax credit/debit because the Ontario small business deduction (both before and after federal administration) is generally determined with reference to taxable income calculated under the *Income Tax Act* (Canada).

³ Where a corporation is in a loss position, its Ontario allocation factor would be determined on the assumption that it had positive taxable income.

6. Despite the above rules, an election would be available for a corporation to accelerate the payment of its debits in a taxation year so that no debits would apply for its subsequent taxation years. The election for the taxation year would be available only if the Federal Excess is less than \$10,000 or the corporation's Ontario allocation factor for the year is at least 90%. Conversely, the Ontario Minister would be provided with the discretion to accelerate the payments of credits where the total accelerated credits are small (less than \$1,000).

The credit/debit would be applied after all other Ontario corporate income tax calculations, except for Ontario's refundable tax credits and the tax credit for Ontario's corporate minimum tax. The Ontario corporate minimum tax would also be calculated with reference to Ontario income tax after taking into account the credit/debit. Tax instalment calculations would also take into account the credit/debit.

Example 3 illustrates the operation of the Transitional Proposal.

EXAMPLE 3

Y Co. is resident in Canada and has a permanent establishment only in Ontario. It has a taxation year that begins on July 1, 2008 and ends on June 30, 2009. Y Co.'s total specified federal tax attributes as of July 1, 2008 are \$100 million and its total specified Ontario tax attributes as of that time are \$80 million.

Y Co.'s next four taxation years end on June 30, 2010, June 30, 2011, June 30, 2012 and June 30, 2013. At all relevant times, Y Co. is situated exclusively in Ontario and does not participate in any corporate reorganizations. Y Co.'s basic Ontario income tax rate for all relevant years is assumed to be equal to 14%.

ANALYSIS

1. Y Co.'s Federal Excess as of July 1, 2008 is equal to \$20 million (\$100 million – \$80 million), and its amortization period is equal to 1,825 days (i.e., 5×365).⁴
2. The Federal Excess gives rise to additional Ontario tax under the Transitional Proposal for Y Co.'s taxation years ending in 2009, 2010, 2011, 2012 and 2013.
3. The additional tax for Y Co. in each of its taxation years ending in 2009, 2010, 2011, 2012 and 2013 is equal to \$560,000, calculated as 20% (i.e., $(365/1,825) \times 14\% \times \20 million).

⁴ February 29 of leap years would be ignored for the purposes of the Transitional Proposal.

ADDITIONAL DETAILS OF THE TRANSITIONAL PROPOSAL

Specified Federal and Ontario Tax Attributes

One of the key challenges of the Transitional Proposal is to use appropriate Ontario and federal attributes. There are a number of considerations in this regard:

- The *Income Tax Act* (Canada) (the “Federal Act”) and the *Corporations Tax Act* (Ontario) (the “CTA”) provide for many different types of types of tax attributes. The extent to which these tax attributes are taken into account in the Transitional Proposal requires considerations such as balancing compliance and administrative complexity against the materiality of the tax attributes in question.
- In some cases differences in tax attributes between the CTA and the Federal Act are due to differences in tax policy in the Federal Act and the CTA and not due to differences in claims from tax pools – for example, costs of foreign resource property are deductible (within limits) under the Federal Act whereas these costs are generally considered to be of a capital nature for the purpose of the CTA.
- In some cases, attributes have been provided under provisions of the Federal Act and CTA that are no longer generating new tax attributes (e.g., depletion provisions for resource corporations). Typically, the unused portion of these attributes would not be material.

It is proposed that the Ontario and federal tax attributes described in the Appendix be taken into account for the purposes of the Transitional Proposal. The manner in which these attributes are computed reflects, in part, the numerous different restrictions under the CTA and the Federal Act that can substantially reduce the real value of tax attributes. For example, there are rules affecting the computation of tax attributes where there has been an acquisition of control of a corporation.⁵ In addition, the CTA and the Federal Act also contain continuation rules relevant in the computation of tax attributes, applying to amalgamations and windings-up.

In the case of corporations not resident in Canada, the tax attribute balances described in the Appendix would only be those that relate to Canadian-source income. This is appropriate given that non-resident corporations are only taxed on their Canadian-source income. A non-resident corporation would thus only include attributes that are relevant in determining the corporation’s taxable income earned in Canada and would

⁵ See the following provisions of the Federal Act which are also adopted for CTA purposes: subsection 111(4) (items 10 and 13 of the Appendix), subsection 111(5.1) (item 1 of the Appendix), subsection 111(5.2) (item 2 of the Appendix), paragraph 37(1)(h) (item 5 of the Appendix) and subsection 66.7(10) (items 6 to 8 of the Appendix).

not include attributes in respect of treaty-protected businesses or treaty-protected properties.⁶

Similarly, life insurers resident in Canada are generally only subject to federal and Ontario income tax on their Canadian-source insurance income, their worldwide non-insurance business income and their taxable capital gains from dispositions of designated insurance properties and other property not used or held in the course carrying on an insurance business.⁷ Life insurers would only include tax attributes relevant to those sources.⁸

For simplicity, tax attribute balances will not be affected by subsequent events. For example, acquisitions of control or dispositions of property after the Transition Time will not change the calculation of the tax attribute balances.

Treatment of Transitional Credits

The transitional credits are aimed at offsetting the loss of tax deductions caused by the use of federal tax attributes for taxation years ending after 2008. As such, these credits would be an integral element in the calculation of Ontario taxes and are not designed to provide a net economic advantage to any firm or economic sector.

The Canada Revenue Agency has confirmed that the transitional credits would not be treated as taxable government assistance for purposes of the Federal Act.

Acceleration of Transitional Debts

Normally, the transitional debts would be payable by a corporation over 5 years. However, subject to the continuation rules for amalgamations and windings-up described below, it is proposed that the transitional debts be accelerated if certain transactions or events occur (“acceleration transactions”). There are two categories of acceleration transactions. In some cases, transactions could be included in both categories.

First, an acceleration transaction for a corporation will occur in the event that the corporation ceases to have a permanent establishment in Ontario.

Second, an acceleration transaction will occur in the event that a corporation is party to a transaction or event (a “tainting transaction”) one of the purposes of which is to reduce transitional debts or establish or increase transitional credits, for either itself or a

⁶ Under the Federal Act, a “treaty-protected business” refers to a business the income from which is exempt from tax under Part I of the Federal Act under the terms of a tax treaty. Similarly, a “treaty-protected property” is a property any income or gain from the disposition of which is exempt from tax under Part I of the Federal Act under the terms of a tax treaty.

⁷ Subsection 138(2) of the Federal Act.

⁸ This restriction would not apply, however, to any differences in federal and Ontario gift balances. See item 11 of the Appendix.

successor corporation. In this context, transitional debits and transitional credits might be affected by the manipulation of Ontario allocation factors determined under provincial allocation rules. A tainting transaction could include:

- the transfer of Ontario assets to a corporation with an Ontario Excess and a low Ontario allocation factor, and
- the transfer of non-Ontario assets to an corporation with a Federal Excess and a high Ontario allocation factor.

If a party to a tainting transaction has a Federal Excess, its debits will be accelerated so that they are payable for the taxation year in which the transaction occurred.

Use of Transitional Credits

The transitional credit of a corporation for a taxation year would be deductible up to a specified limit equal to the corporation's Ontario income tax for the year.

The portion of a transitional credit that cannot be deducted because of the specified limit would be carried forward to any of the corporation's subsequent taxation years in the five year amortization period. It would be deductible up to the amount by which the specified limit for the subsequent year exceeds the transitional credit deductible in respect of the subsequent taxation year.

In cases where any of the days in that taxation year are not included in the corporation's amortization period due to a short taxation year, the specified limit would be pro-rated to reflect the percentage that the number of days in the taxation year included in the corporation's amortization period is of the number of days in the year.

It is proposed that a transitional credit generally not be permitted for a taxation year beginning after an acceleration transaction. This restriction reflects that corporations party to acceleration transactions would typically have been less likely to have fully used their excess Ontario tax attributes had there been no harmonization of the Ontario and federal corporate income tax systems.

However, a mechanism would be provided that could accelerate a transitional credit if the acceleration transaction is not a tainting transaction. This acceleration would only be available to the extent of the specified limit for the taxation year in which the acceleration transaction occurs. In addition, where this mechanism applies, unused portions of transitional credits could also be carried forward for use in the five year amortization period.

Special Rules Dealing with Amalgamations and Windings-Up

For the purposes of the transitional credits/debits, it is proposed that a successor corporation formed on an amalgamation in the amortization period to which section 87 of the Federal Act applies be treated, in conceptual terms, as a continuation of each of its predecessor corporations.

The application of this continuation rule to a predecessor corporation and its successor corporation would be subject to two principal restrictions. First, the successor corporation must have a permanent establishment in Ontario immediately after the amalgamation. Second, neither the amalgamation nor any other prior event can be a tainting transaction for the predecessor corporation or the successor corporation.

Where the continuation rule applies in respect of a predecessor corporation, the successor corporation would assume the federal and Ontario tax attributes of the predecessor corporation (adjusted to reflect the portion of the attributes already used up by the predecessor corporation). Unused transitional credit balances from the predecessor corporation could be carried forward to the successor corporation, where the successor corporation's first taxation year begins before 2014 and the predecessor corporation's amortization period has not expired.

Similar rules would apply to windings-up of subsidiary corporations in circumstances to which subsection 88(1) of the Federal Act applies.

Consultation Process

Comments on the proposed transitional rules must be received by November 17, 2006, and should be submitted to:

Ministry of Finance
Corporate and Commodity Taxation Branch
95 Grosvenor Street
Toronto ON M7A 1Z1

Fax: (416) 314-8635

Contact:

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APPENDIX:

ONTARIO AND FEDERAL ATTRIBUTES CALCULATED UNDER THE TRANSITIONAL PROPOSAL

Item	Ontario/Federal Tax Attributes	Description
1	UCC	- the total UCC of each class of the corporation's depreciable property determined at the Transition Time for the purposes of the CTA or the Federal Act, as the case may be
2	cumulative eligible capital – s.14 of the Federal Act	- the total of the corporation's cumulative eligible capital in respect of each of its businesses, determined at the Transition Time for the purposes of the CTA or the Federal Act, as the case may be
3	reserves under paragraphs 20(1)(l), (l.1), (m), (m.1), (n) and (o), subsection 32(1), section 61.4 and subparagraphs 138(3)(a)(i), (ii) and (iv) of the Federal Act	- the corporation's total reserves claimed under the CTA or the Federal Act, as the case may, in respect of the Federal Act provisions specified, for the corporation's last taxation year ending before the Transition Time <i>Note: Reserves represent negative tax attributes. The Transitional Proposal would deal accordingly with differences in these reserves.</i>
4	capital gains reserve under subparagraph 40(1)(a)(iii) and 44(1)(e)(iii) of the Federal Act	- 50% of the corporation's reserve claimed under the CTA or the Federal Act, as the case may be, in respect of subparagraph 40(1)(a)(iii) or 44(1)(e)(iii) of the Federal Act, for the corporation's last taxation year ending before the Transition Time - only 50% of this reserve would be factored in because the reserve reduces capital gains, only 50% of which are included in income <i>Note: These reserves also represent negative tax attributes. The Transitional Proposal would deal accordingly with differences in this reserve.</i>
5	scientific research and development pool under subsection 37(1) of the Federal Act	- this pool would be determined, for the purposes of the CTA or the Federal Act, as the case may be, at the Transition Time
6	cumulative Canadian exploration expense under subsection 66.1(6) of the Federal Act	- these pools would be determined, for the purposes of the CTA or the Federal Act, as the case may be, at the Transition Time
7	cumulative Canadian development expense under subsection 66.2(5) of the Federal Act	
8	cumulative Canadian oil and gas property expense under subsection 66.4(5) of the Federal Act	

Item	Ontario/Federal Tax Attributes	Description
10	adjusted cost base of partnership interests	<ul style="list-style-type: none"> - 50% of the adjusted cost base to the corporation of its partnership interests, determined at the Transition Time, under the CTA or the Federal Act, as the case may be - only 50% of this attribute is taken into account, since the adjusted cost base of property is used in determined capital gains and only 50% of capital gains are included in computing income - where partnership withdrawals cause the adjusted cost base of the partnership to be nil as of the Transition Time, the so-called negative adjusted cost base of the partnership interest would be factored into the calculation of the Federal Excess or the Ontario Excess (much like reserves)
11	carryforward of undeducted gifts under subsection 110.1(1) of the Federal Act	<ul style="list-style-type: none"> - undeducted gifts would be determined, for the purposes of the CTA or the Federal Act, as the case may be, at the Transition Time - the computations could be affected by the five year limit in the carryforward of such amounts to the Transition Time - the balances for non-residents would be deemed to be nil
12	carryforward of undeducted non-capital losses	<ul style="list-style-type: none"> - non-capital loss carryforwards would be determined, for the purposes of the CTA or the Federal Act, as the case may be, at the Transition Time - the computations would be reduced as of the Transition Time to reflect portions of the carryforward pool in respect of pre-2009 taxation years that are subsequently carried back to reduce taxable income for CTA or Federal Act purposes, as the case may be - the computations would also be reduced so that they did not reflect amounts carried forward from taxation years ending before any acquisition of control of the corporation before the Transition Time - the computations might also be affected by the applicable limit in the carryforward of undeducted amounts
13	carryforward of undeducted net capital losses	<ul style="list-style-type: none"> - net capital loss carryforwards would be determined, for the purposes of the CTA or the Federal Act, as the case may be, at the Transition Time - the computations would be reduced as of the Transition Time to reflect portions of the carryforward pool in respect of pre-2009 taxation years that are subsequently carried back to reduce taxable income for CTA or Federal Act purposes, as the case may be - the computations would also be reduced (as necessary) so that they did not reflect amounts carried forward from taxation years ending before the any acquisition of control of the corporation before the Transition Time

