CANADIAN TAX focus

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ECP Planning: Some Practical Considerations

The changes to the eligible capital property (ECP) regime, set to take effect on January 1, 2017, have prompted many taxpayers to undertake planning prior to year-end in order to crystallize any accrued gains on ECP held by a CCPC. The typical planning involves a taxable transfer of ECP to a related entity. A gain on ECP will give rise to a business income inclusion pursuant to subsection 14(1) to the extent that a taxpayer has received certain amounts on account of capital in respect of the underlying business to which the ECP relates. The gain in excess of the ECP income inclusion is added to the capital dividend account (CDA).

The most common types of assets that constitute ECP are goodwill, knowhow, key long-term contracts, quotas, unlimited life licences, brand names, and trademarks. Because of the nature of these assets, taxpayers should keep some practical issues in mind when implementing these tax-planning strategies.

One such issue is whether goodwill can be transferred without also transferring the business. The view of the courts (*Herb Payne Transport Ltd. v. MNR*, 1963 CTC 116 (Ex. Ct.)) is that goodwill is inseparable from the business to which it adds value. Accordingly, the accrued gain on goodwill cannot be realized apart from a disposition of the business.

A similar issue arises with respect to the transferability of knowhow. Knowhow is usually the knowledge, experience, and ideas of a corporation's employees. Courts have reached conflicting decisions about whether knowhow constitutes property that can be disposed of (see, for example, *Roth v. The Queen*, 2005 TCC 484, and *289018 Ontario Limited v. MNR*, 87 DTC 38 (TCC)). The general rule is that knowhow will be considered to have been disposed of only if the transferor can no longer avail itself of the knowledge in question—for example, when it sells the business to which the knowledge relates. An exception may exist if the knowhow is of a type that can be clearly documented and separated from the employees who developed it. Such a situation may account for the CRA's statement that "proceeds from the outright sale of knowledge are considered to be from the disposition of EC property" (*Interpretation Bulletin* IT-386R, "Eligible Capital Amounts," paragraph 2(d); archived). This statement appears to contemplate the feasibility of transferring knowledge.

When an entire business must be transferred in order to crystallize any accrued gains in respect of goodwill or knowhow, the implications of disposing of other types of business assets must also be considered. For example, a disposition of real estate may give rise to land transfer tax, and a transfer of employment or supplier contracts may require the renegotiation of terms or the seeking of third-party approvals. Other issues include changing the CRA payroll number for employees, dealing with CCA limitations following transfer to a related company, informing customers and suppliers that they are dealing with another entity, and providing notice as required by certain contracts and banking arrangements.

However, if these non-tax issues prove too difficult to address, it may still be possible to realize the gain on goodwill and knowhow. Instead of transferring the entire business, the seller could transfer only the beneficial ownership of the business's assets to a related entity. The seller would continue to hold legal title, retain the employees, and act as agent for the purchaser. The two entities could also enter into the necessary services and rental agreements.

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A series of tests has been developed by the courts and the CRA for assessing whether an agency relationship exists (see *General Motors Acceptance Corp. of Canada Ltd. v. The Queen*, 2000 CanLII 223 (TCC); *Merchant Law Group v. The Queen*, 2008 TCC 337; and *GST/HST Policy Statement* P-182R, "Agency"). The three principal requirements are (1) evidence of the consent of both the principal and the agent, (2) authority of the agent to affect the principal's legal position, and (3) the principal's control of the agent's actions.

Another challenge that arises in respect of the disposition of ECP is the determination of its FMV—a step that is essential in order to avoid adverse implications pursuant to section 69. And consideration in respect of goodwill, for example, must be reasonably allocated pursuant to section 68. Owing to their inherently intangible nature, assets such as goodwill, trademarks, and knowhow should be valued by an independent professional business valuator in order to substantiate tax positions in the event of a future CRA audit.

When documented knowhow or trademarks are transferred on a standalone basis to a related party, an intercompany licence will likely have to be established to substantiate the continuing value of the transferred asset for the transferee, as well as to preserve the transferor's ability to carry on its business uninterrupted. The licensee must also consider whether the licence constitutes the acquisition of ECP.

Finally, when it comes to ECP planning, a key motivation is to increase the taxpayer's CDA; therefore, it is important to remember that the addition to the corporation's CDA arising as a result of the disposition of ECP is not made until year-end. Corporations should avoid paying out capital dividends until the taxation year following the year in which the ECP in question is transferred.

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Specific Anti-Avoidance Rules Trump GAAR

In *Oxford Properties Group Inc. v. The Queen* (2016 TCC 204), the TCC concluded that GAAR did not apply—after analyzing the policy intention of each relevant provision and deciding that it could not find a broad policy statement without attaching the policy to specific provisions of the Act. Because specific anti-avoidance rules existed but did not apply, no abuse occurred.

In *Oxford Properties*, pursuant to an agreement with a potential purchaser, the predecessor of the taxpayer transferred real estate assets into newly formed limited partnerships (LPs) under subsection 97(2). After the acquisition, the predecessor amalgamated with the purchaser to form the taxpayer. Upon the amalgamation, the cost of the LPs' interest was bumped up under paragraph 88(1)(d). Following the amalgamation, the LPs transferred the real estate assets to a second level of LPs under subsection 97(2). The first-level LPs were then wound up, and the cost of the second-level LPs' interests was bumped up under paragraph 98(3)(c). The taxpayer eventually sold the interests in the second-level LPs to tax-exempt entities after the three-year period referenced in subsection 69(11).

The minister sought to apply GAAR, saying that the taxpayer had abused subsections 97(2), 88(1), 98(3), and 100(1) by indirectly bumping up the cost of depreciable properties. The TCC focused its analysis on whether the transactions were abusive, and it followed a two-step approach: (1) an examination of the object, spirit, and purpose of the provisions and (2) the application of the case facts.

The TCC noted that specific anti-avoidance provisions address each transaction, and that the legislative intention behind each provision is clear and unambiguous. Thus, the court should not engage in judicial innovation by imputing a legislative intention that does not exist. Specifically, because subsection 69(11) denies a tax-free rollover under subsection 97(2) if a subsequent transfer takes place within three years, Parliament had clearly considered transfers that were made to tax-exempt entities outside the three-year period, and it intended to allow taxpayers the benefit of a tax-deferred rollover if a taxpayer waited for three years after a subsection 97(2) rollover to transfer an asset. As to paragraphs 88(1)(c) and 88(1)(d), the bump-denial rules in subparagraph 88(1)(d)(ii.1) indicate that Parliament had intentionally enacted the relevant rules to allow a bump in some cases but not in others.

The non-application of a specific anti-avoidance rule distinguishes *Oxford Properties* from *Copthorne* (2011 SCC 63), in which the impact of a specific anti-avoidance rule was not a factor. In *Oxford Properties*, the TCC looked at subsections 97(2) and 69(11) as a set of rules grouped together and at the paragraphs under subsection 88(1) as another set of rules, and it concluded that the parliamentary intention for each set of rules was not violated.

Oxford Properties leaves two major questions unanswered:

1) If a specific anti-avoidance rule does not apply, in what circumstances will GAAR apply to augment or extend the application of the specific anti-avoidance rule beyond its textual application? Seemingly, *Lipson* (2009 SCC 1) remains valid in holding that a specific anti-avoidance rule can be abused.
2) How liberally can the intention of Parliament be interpreted to bolster the application or non-application of GAAR?

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Reorganization Following Arm's-Length Purchase Found Abusive

In *Univar Holdco Canada ULC v. The Queen* (2016 TCC 159; under appeal), the TCC concluded that GAAR applied to a reorganization that relied on subsection 212.1(4); a recent budget amendment was used as evidence of the policy intention of the subsection. The TCC does not appear to have given appropriate consideration to the arm's-length context of the reorganization, which occurred shortly after the privatization of Univar NV, a Netherlands public company.

Subsection 212.1(1) prevents the avoidance of non-resident withholding tax on dividends through a non-arm's-length internal reorganization that results in a treaty-exempt gain. Subsection 212.1(4) provides an exception: section 212.1 does not apply when the non-resident is controlled by the Canadian corporation that purchased the subject corporation's shares immediately before the transaction.

In 2007, CVC Capital Partners, a UK private equity firm, acquired all of the shares of Univar NV. CVC indirectly acquired Univar Canada, the shares of which had a fair market value of approximately $889 million. Univar Holdco Canada ULC (the taxpayer) was established on September 21, 2007 to facilitate the reorganization. The arm's-length acquisition by CVC occurred on October 4, 2007. The post-acquisition reorganization occurred between October 12 and October 19, 2007. The taxpayer's pleadings stated that commercial credit restrictions placed on Univar NV, in addition to commercial practicalities, necessitated that CVC acquire Univar NV as opposed to Univar Canada directly. The CRA reassessed the taxpayer to deem a dividend to have been paid, resulting in withholding tax of about $29 million.

The sole issue before the TCC was whether the reorganization resulted in abusive tax avoidance within the meaning of subsection 245(4). The TCC concluded that it did, holding that the reorganization circumvented the application of section 212.1 in a manner that frustrated or defeated the object, spirit, or purpose of section 212.1 in general and subsection 212.1(4) in particular. The TCC found that subsection 212.1(4) was aimed at a narrow circumstance and, as a result, it could not be used to defeat the application of section 212.1. The TCC stated that Parliament's intention when enacting subsection 212.1(4) could not have been to allow non-resident shareholders to reorganize their corporate structure to ensure that subsection 212.1(1) never applied.

One may question this view: as a relieving provision, subsection 212.1(4) is designed to override subsection 212.1(1) when the non-resident is controlled by the Canadian corporation that purchases the subject corporation's shares. The language of subsection 212.1(4) clearly indicates that it overrides subsection 212.1(1) when its requirements are met.

The TCC referred to the federal government's 2016 budget, which was introduced months after the trial concluded, as support for the underlying rationale of subsection 212.1(4). The 2016 budget announced an amendment that would prevent the transactions giving rise to this appeal.

There is reason to query this analysis: in *Oxford Properties Group Inc. v. The Queen* (2016 TCC 204), the TCC treated an amendment to paragraph 88(1)(d) as the adoption of a new policy by Parliament, rather than clarifying the existing objective of the provision. The 2016 budget similarly narrowed the application of subsection 212.1(4), a change that also might have been viewed as the adoption of a new policy. Instead, the TCC relied on the 2016 budget change to infer a statutory intention that arguably did not exist at the time of the transaction (that is, a requirement for a Canadian-resident parent corporation). Further, the TCC did so without allowing the taxpayer (or the Crown) to make submissions regarding this issue. (As noted above, the trial had already concluded.)

The taxpayer argued that the result obtained by CVC could have been realized by using an alternative structure under which CVC would have acquired Univar Canada through a fully capitalized Canadian holding company. The TCC rejected this argument because the alternative structure was not implemented. Respectfully, it is difficult to understand why one approach is unacceptable and the other is acceptable when both approaches result in the same tax attributes.

In the broader context, extensive jurisprudence has held that surplus stripping does not inherently abuse the Act as a whole (see, for example, *Copthorne Holdings Ltd. v. Canada*, 2011 SCC 63; *Collins & Aikman Products Co. v. The Queen*, 2009 TCC 299, aff'd. 2010 FCA 251; and *Gwartz v. The Queen*, 2013 TCC 86). The CRA, however, has maintained that there is an overall scheme of the Act that prohibits surplus stripping (see CRA document nos. 2012-0433261E5, June 18, 2013, and 2014-0547401C6, December 2, 2014). Perhaps the FCA's decision in *Univar* will resolve this apparent inconsistency.

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Why Don't Ride-Sharing Drivers Charge GST/HST?

Is a driver who uses a personal vehicle to earn income from fares through a peer-to-peer ride-sharing service conducting a self-employed taxi business for GST/HST purposes? If the answer is yes, then GST/HST registration is mandatory regardless of the amount of income earned (ETA subsection 240(1.1)). The driver must collect and remit tax on all fares and either disclose the amount and rate of tax invoiced or inform the customer that GST/HST is included in the total fare. If the driver is self-employed but is not operating a taxi business, he or she is not required to register for GST/HST, provided that his or her income over four consecutive quarters does not exceed the

$30,000 small supplier exemption threshold. Ride-sharing drivers usually do not charge GST/HST, thus providing a benefit relative to conventional taxis for the driver and for most customers. However, the legal basis for this position is unclear, and drivers face a potential liability for tax that should have been collected and remitted.

ETA subsection 123(1) defines a "taxi business" as a "business carried on in Canada of transporting passengers by taxi for fares that are regulated under the laws of Canada or a province." (The term "taxi" is not defined.) Thus, GST/HST registration is not mandatory for a self-employed ride-sharing driver if (1) he or she does not operate a taxi, or (2) the fares are not regulated under the laws of Canada or a province.

Regarding the first condition, the courts have held that Uber drivers in Quebec operate a taxi business and must therefore register for GST and QST (*Uber Canada inc. c. Agence du revenu du Québec*, 2016 QCCA 1303; leave to appeal to SCC being sought). The QST rules on taxi drivers (in section 407.1 of An Act Respecting the Quebec Sales Tax) are similar to the ETA rules.

Regarding the second condition, ride-sharing drivers may operate without a commercial taxi licence, and many municipalities have ignored or banned peer-to-peer ride-sharing services altogether. Some observers might argue that the services in such areas are therefore unregulated and beyond the scope of ETA subsection 123(1). On the other hand, the CRA maintains that when a province delegates the authority to regulate taxi fares to a municipality, the province has exercised its authority in that area, whether or not the municipality has passed a bylaw on the subject of taxi fares (CRA Headquarters Ruling RITS no. 55206, November 9, 2004). Therefore, it appears that the CRA will consider fares to be regulated under the laws of a province for the purposes of ETA subsection 123(1) if such a delegation has been made, regardless of whether locally enacted bylaws specifically address the issue. In Ontario, the legal basis for the claim that unlicensed drivers are regulated is part IV of the Municipal Act, 2001, which grants municipalities the authority to regulate businesses. Specifically, section 156(1) of the Municipal Act gives the municipality the power to establish rates and fares for taxicabs.

Uber appears to take the position that GST/HST registration is not mandatory, at least for its uberX service; on Uber's Ontario website, drivers are advised as follows:

> Canadian [sic] Revenue Agency (CRA) rules require any independent contractor who earns more than $30,000 in a calendar quarter and over the last four consecutive calendar quarters to collect and remit HST. If you fall below this threshold, as most part-time uberX partners do, you qualify as a "small supplier" and do not have to collect HST.

Further, in *Uber Canada inc. c. Agence du revenu du Québec* (2016 QCCS 2158), which involved a decision to issue a search warrant for Uber's offices in Montreal, Cournoyer J noted that the Uber app (which processes payment for all rides) produced customer invoices that did not show the driver's registration number or the amount of tax applied to a fare. It is difficult to see how such invoices comply with GST/HST rules unless registration is not mandatory and all drivers qualify as small suppliers. As the judge concluded in *Uber Canada* (QCCS), "I have reasonable grounds to believe Uber has made gestures to help drivers avoid the payment of taxes" (paragraph 72; my translation). However, this decision involved only the issuance of a search warrant, not a ruling on the question of tax evasion.

Another possibility is that ride-sharing drivers are not independent contractors, but instead are employees of the ride-sharing service (Labor Commissioner of the State of California, case no. 11-46739 EK, June 3, 2015). If so, the ride-sharing service would be the entity responsible for charging GST/HST. There appears to be no basis for not charging GST/HST in this circumstance, since the ride-sharing service could not be a small supplier.

For drivers, not registering for GST/HST reduces their compliance burden. For customers, not being charged GST/HST reduces the cost of the service: most ride-share passengers are not GST/HST registrants, and are thus unable to recover GST/HST paid on purchases through an input tax credit.

From a policy point of view, the question is one of consistency in the taxation of all industry participants (which motivated the mandatory registration of taxis, a move supported by the industry, when the GST was introduced: see "Further Streamlining of the GST Announced," *News Release*, Department of Finance, December 18, 1990). The GST/HST question is relevant to participants in other areas of the sharing economy; similar issues will almost certainly arise, for example, in connection with short-term residential rentals arranged through peer-to-peer networks.

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Review Trusts Holding Principal Residences Before End of 2016

According to draft legislation released on October 3, 2016, only certain qualifying trusts will be able to claim a principal residence exemption on dispositions occurring after 2016. Taxpayers whose principal residence is held by a non-qualifying trust should review their structures before the end of 2016. If a tax-deferred rollout of the property is contemplated, it may be desirable to have that happen before the new year. Where possible, consideration can be given to resettling the property on one of the qualifying trusts described below.

Under existing legislation, a trust can claim the principal residence exemption in respect of a qualified dwelling if certain eligibility criteria are met. In general, this requires that

1) the trust properly designate the property as its principal residence on form T1079 ("Designation of a Property as a Principal Residence by a Personal Trust"), which includes identifying each "specified beneficiary" (generally, a beneficiary who ordinarily inhabited the property, or whose current or former spouse or common-law partner or child ordinarily inhabited the property) of the trust, and
2) no partnership or corporation (excluding registered charities) be beneficially interested in the trust at any time in the year.

Once made, the designation essentially precludes the beneficiaries (and their spouses and minor children) from claiming a principal residence exemption of their own for the years in which the trust claimed the exemption.

Proposed subparagraph (c.1)(iii.1) of the definition of "principal residence" in section 54 provides that for dispositions occurring after 2016, a trust will be entitled to designate a qualified dwelling as a principal residence only in the narrow circumstances where

1) the trust is one of the trusts described in paragraph 104(4)(a) and subparagraph 104(4)(a)(iii) (spousal trusts or common-law partner trusts) and the spouse or common-law partner is still alive;
2) the trust is an alter ego trust described in subparagraphs 104(4)(a)(ii.1) and 104(4)(a)(iv) and the taxpayer is still alive;
3) the trust is a "pre-1972 spousal trust" and the spouse or common-law partner is still alive;
4) a trust acquired the property in circumstances described in section 73 or subsection 107.4(3) and the acquisition did not result in a change in the beneficial ownership of the property, and the transferor is still alive;
5) the trust is a "qualified disability trust" as defined in subsection 122(3) in which an "electing beneficiary" is both a resident of Canada and a specified beneficiary of the trust; or
6) the trust was settled by one of the deceased parents of a minor who is a specified beneficiary of the trust and resident in Canada.

In each case, the terms of the trust must provide the relevant specified beneficiary with a right to the use and enjoyment of the qualified dwelling as a residence throughout the period in the year in which the trust owns the property.

Other than a vague reference in the explanatory notes stating that the changes are intended to align the rules for dwellings held by trusts more closely with those for dwellings held by natural persons, there is no statement about what mischief this change seeks to avoid. However, ordinary inter vivos trusts established for bona fide reasons (for example, to exclude the value of a home from a net family property determination on the breakdown of a marriage) are severely and negatively affected.

For structures in which a trust other than those described above owns a residential property, the end of 2016 has become a critical deadline. Any non-qualifying trust that retains ownership of a qualifying dwelling past 2016 will not be able to claim the exemption for post-2016 appreciation. The draft legislation provides for a deemed disposition at fair market value at the end of 2016, which enables a trust to shelter accrued gains to that date.

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Payroll Withholding Relief May Cause Sales Tax Pain

Although it is widely accepted that the new payroll withholding relief available to certain non-resident employers that send employees to Canada on a short-term basis is beneficial in many circumstances, the CRA could use the information provided to determine that the non-resident is carrying on business in Canada. In one situation, the CRA appeared to use the presence of an employee in Canada for 21 days or more to make that determination.

GST/HST registration is generally required of a non-resident only if the non-resident is carrying on business in Canada. The concept of "carrying on business" is not defined in the ETA, and *GST/HST Policy Statement* P-051R2, "Carrying On Business in Canada," says that this determination must be made on a case-by-case basis and requires judgment. Twelve separate criteria are listed, one of which is the place where services are performed.

When a qualifying non-resident employer seeks to send qualifying non-resident employees to Canada without the requirement to withhold income taxes, the CRA requires the provision of certain information in the application for certification (see "Regulation 102 Withholding Relief for Non-Resident Employers," *Canadian Tax Highlights*, March 2016). On form RC473, "Application for Non-Resident Employer Certification," question 18 asks the non-resident employer, "Are you sending employees to Canada with respect to a contract you have to provide services in Canada?" A "yes" answer could trigger an inquiry from the CRA asking how many days the employees are providing services in Canada, which in turn could lead to a determination that the employer is carrying on business in Canada, based on the criterion noted above regarding the place where services are performed.

This is precisely what happened in one particular situation of which I am aware. Further, the CRA agent appeared to use a previously undisclosed administrative guideline based on

the question 18 response to make this determination: a non-resident that sends employees into Canada for 21 days or more is considered to have provided services in Canada for a significant period of time, indicating that the employer is carrying on business here. I see no basis for the use of this single-factor, highly specific criterion; 12 factors are listed in the policy statement cited above, and the case law developed for income tax (which should be relevant in the absence of an ETA definition) does not support the CRA's conclusion.

Such a carrying-on-business determination can have a significant impact, since many non-residents conduct their activities in Canada without registering for the sales tax. A requirement to register, possibly imposed unilaterally by the CRA (under ETA subsections 241(1.3) to (1.5)), might cause the non-resident to have to change its invoicing systems and be thrown into a whole new sales tax system with additional collection, remittance, and reporting requirements with which it has no experience. In the worst-case situation, the non-resident could be assessed for tax not collected, interest, and penalties. Also, there may be instances where the tax due is not recoverable—for example, when a customer agreement states that consideration is "tax-included, if applicable."

One possible response in this situation is to request a GST/HST ruling based on the taxpayer's presence and ongoing activities in Canada and the sales tax implications of the taxpayer's situation. This response might be appropriate if the exposure is material and the conclusion is unclear. However, if the facts of the situation change, the GST/HST ruling may no longer be valid.

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Tricks and Traps in T1 Adjustment Requests

Requesting a T1 adjustment (a change in a filing position taken by an individual on a previous T1 return) is not always as simple as filling out CRA form T1-ADJ ("T1 Adjustment Request") and sending it in. The possibility of the CRA's rejection of the request, and the impact of the request on additional adjustments, suggests that the taxpayer should consider precautionary strategies.

The date on which the taxpayer receives a notice of assessment in respect of a tax return determines two important dates: (1) date A, the last day for filing a notice of objection (including the legislated period for which an extension of time to object is available), and (2) date B, the last day of the normal reassessment period (defined in subsection 152(3.1)).

On or before date A, a taxpayer who wants to make an adjustment to his or her return has a choice between simply filing form T1-ADJ and filing a notice of objection. (After date A, form T1-ADJ is the only choice.) Filing form T1-ADJ saves the taxpayer time, and is therefore a good choice for a straightforward adjustment that the CRA is certain to accept (for example, claiming an additional charitable receipt). No reasons need be given to the CRA to support such a filing. However, the filing of a notice of objection better preserves a taxpayer's appeal rights: the CRA's response can be challenged on the basis of correctness rather than just on the narrower ground of whether the CRA has acted unreasonably (pursuant to judicial review in the FC).

When a taxpayer files form T1-ADJ, it is prudent to indicate on the form that the submission should not be interpreted as a waiver of (that is, permission for the CRA to extend) the normal reassessment period. This precaution is suggested by the result in *Remtilla v. The Queen* (2015 TCC 200), in which the court decided that a form that included all the elements of a waiver should be interpreted as such. If this indication is not given on the form and the CRA attempts to apply the *Remtilla* principle, the taxpayer can point to *DouangChanh v. The Queen* (2013 TCC 320), in which the court decided that a request made within the normal reassessment period should be treated as a request only to reassess within that period, even if there is a long CRA delay in processing the request.

After date B, the CRA considers adjustment requests to be requests for taxpayer relief pursuant to subsection 152(4.2). Thus, the adjustment request should include any factors that would generally be used to support a taxpayer relief request, such as extraordinary circumstances, actions of the CRA, or financial hardship (see *Information Circular* IC07-1, "Taxpayer Relief Provisions"). It is easy to omit this information, since the form instructions do not mention the difference between filing within—versus filing beyond—the normal reassessment period. If the request is denied on that basis, the taxpayer's best alternative might be to apply to have a second review of the request completed by another CRA officer; the additional information can be included in the second review request.

T1 adjustment requests made after date B should be submitted only after the return is scrutinized to ensure that all possible issues have been considered—not just the one that initially caused the taxpayer to consider an adjustment request. An assessment issued under subsection 152(4.2) is final and cannot be the subject of a notice of objection, so an incomplete request can harm the taxpayer.

Paragraph 87 of IC07-1 states that the CRA will not reassess under subsection 152(4.2) to effect a change in the law due to a court decision. However, there may be a way to reframe the situation to avoid the application of this rule. Suppose that, on the basis of this rule, the CRA denies an adjustment request for an additional deduction that a court had provided in the "Jones" decision. Suppose further that the taxpayer was told by the CRA prior to the release of "Jones" that the amount was not deductible. If it is possible to find a "Smith" decision that

says the same thing and was decided prior to the CRA's advice, the taxpayer could apply for relief on the basis of bad CRA advice.

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Non-Deductibility of Legal Fees for Child Support Payers

Grenon (2016 FCA 4; leave to appeal denied by SCC) has re-established the asymmetrical treatment adopted by *Nadeau* (2003 FCA 400) regarding legal fees incurred to obtain or establish child support, allowing a deduction to the recipient of child support but denying it to the payer. The case is an example of the high bar to a successful Charter challenge in tax matters, and it can be viewed as a renewed call from the bench to Parliament to address the question of deductibility of legal fees in what is already a stressful situation for taxpayers.

The taxpayer appealed against an assessment denying the deductibility of legal fees incurred to contest demands for child support. He contended that if paragraph 18(1)(a) of the Income Tax Act does not allow the deduction, it discriminates on the basis of gender contrary to section 15 of the Charter (arguing that this rule discriminated against men because on a statistical basis 92.8 percent of child support payers are men).

The TCC (2014 TCC 265) denied the claim, considering itself bound by *Nadeau*. (For the details on the tangled history of the case law prior to *Nadeau*, see Gabrielle St-Hilaire, "Extinguishing One Controversy While Stoking Another in Nadeau," *Canadian Current Tax*, July 2004.)

The FCA affirmed the TCC's decision:

> The combined effect of subsections 18(1) and 248(1) of the *ITA*, judicially interpreted, is to allow the deduction of legal fees and costs incurred by a taxpayer in obtaining, enforcing or varying child support payments, but to deny the deduction of the expenses incurred by taxpayers who pay child support payments.

This treatment differs from that under section 336(e.1) of the Quebec Taxation Act, which explicitly allows the deduction of legal fees for both payers and recipients of support payments.

Grenon overturns the findings of two informal procedure cases subsequent to *Nadeau* (*Mercier*, 2011 TCC 427, and *Trignani*, 2010 TCC 209), which found that ultimate payers of child support should be entitled to a deduction for legal fees incurred to obtain child support payments when they had a bona fide case or a reasonable expectation of becoming the recipients of such payments. The FCA acknowledged concerns about its asymmetrical treatment, including the strange results illustrated in paragraph 34 of the TCC decision, but concluded that "[t]hese concerns are policy matters for Parliament, and do not bear on the legal question."

With regard to the first part of the section 15 Charter test—whether the law creates a distinction that is based on an enumerated or analogous ground—the FCA held that the Act is replete with different treatments that depend on the type of income or expenditure; however, allowing deductions only when there is a right to income from a property is not discriminatory on the basis of the first part of the test. The FCA further found that the fact that most support payers (who are incidentally denied a deduction) are men was extrinsic to the Act and their gender, and therefore was not a discriminatory effect of the application of paragraph 18(1)(a) of the Act.

With regard to the second part of the section 15 Charter test—whether the distinction creates a disadvantage by perpetuating prejudice or stereotyping—the court did not need to examine this point in as much detail, given its finding on the first test. The public perception of defendants in support payment cases as deadbeat dads was presented as part of the taxpayer's argument in respect of this part of the test.

The FCA emphasized the importance of the Crown presenting evidence of fact at trial, not only for both parts of the section 15 test but also for the saving provisions under section 1 so that an appellate court would have access to the necessary background information if required.

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Non-déductibilité des frais de justice pour les payeurs d'une pension alimentaire pour enfants

L'arrêt *Grenon* (2016 FCA 4; demande d'autorisation d'appel rejetée par la CSC) a rétabli le traitement asymétrique adopté par l'arrêt *Nadeau* (2003 CAF 400) quant aux frais judiciaires pour l'obtention ou l'établissement d'une pension alimentaire pour enfants — permettant la déduction au bénéficiaire d'une pension alimentaire, mais la refusant au payeur. Ce arrêt est un exemple du seuil élevé pour le succès d'une contestation fondée sur la Charte canadienne des droits et libertés en matière fiscale. Il peut également être considéré comme un nouvel appel des juges au Parlement à aborder la question de la déductibilité des frais de justice dans le contexte d'une situation déjà stressante pour les contribuables.

Le contribuable en appelait d'une cotisation refusant la déductibilité des frais de justice engagés pour la contestation de demandes de pension alimentaire pour enfant, alléguant que si l'alinéa 18(1)a) ne permet pas la déduction, cet alinéa constitue une discrimination fondée sur le sexe en violation de l'article 15 de la Charte (alléguant que cette règle défavorise

les hommes, puisque statistiquement 92,8 % des payeurs de pension alimentaire pour enfants sont des hommes).

La CCI a rejeté l'appel, se considérant liée par l'arrêt *Nadeau* (2003 CAF 400). (Pour plus de renseignements sur la tortueuse histoire de la jurisprudence avant *Nadeau*, consulter Gabrielle St-Hilaire, « Extinguishing One Controversy While Stoking Another in Nadeau », *Canadian Current Tax*, juillet 2004.)

La CAF a confirmé la décision de la CCI, jugeant que l'effet combiné des paragraphes 18(1) et 248(1) de la LIR, interprétés judiciairement, est de permettre la déduction des frais et dépenses juridiques engagés par le contribuable dans l'obtention, l'exécution ou la modification des paiements de pension alimentaire pour enfants, mais de refuser la déduction des dépenses engagées par les contribuables payant des pensions alimentaires pour enfants. Ce traitement fédéral diffère de celui appliqué en vertu de la *Loi sur les impôts* du Québec, où le paragraphe 336(e.1) permet expressément la déduction des frais juridiques à la fois pour le payeur et le bénéficiaire des paiements de pensions alimentaires.

Grenon infirme les conclusions de deux décisions de la CCI issus de la procédure informelle survenues après *Nadeau* — *Mercier* (2011 CCI 427) et *Trignani* (2010 CCI 209) — où la Cour avait conclu que les payeurs ultimes de pension alimentaire pour enfants devraient avoir droit à une déduction pour les frais juridiques engagés pour l'obtention de paiements de pension alimentaire pour enfants lorsqu'ils avaient un dossier de bonne foi ou une attente raisonnable de devenir des bénéficiaires de tels paiements. La CAF reconnaît les difficultés posées par ce traitement asymétrique, y compris les étranges résultats exposés au paragraphe 34 de la décision du CCI, mais elle conclut que ces difficultés sont des questions de politique qui appartiennent au Parlement et sont sans influence sur les questions de droit.

En appliquant le premier volet de l'analyse fondée sur l'article 15 de la Charte — la loi crée-t-elle une distinction sur un motif énuméré ou analogue? — la CAF conclut que la LIR regorge de traitements différents en fonction du type de revenus ou de dépense; néanmoins, permettre des déductions uniquement là où existe un droit à un revenu d'un bien n'est pas une discrimination fondée sur un motif énuméré ou analogue. De plus, la CAF considère que le fait que la plupart des payeurs de pensions alimentaires (à qui la déduction est d'ailleurs refusée) sont des hommes comme extrinsèques à la LIR et à leur sexe — par conséquent, il ne s'agit pas d'un effet discriminatoire de l'application de l'alinéa 18(1)a).

Quant au second volet de l'analyse au titre de l'article 15 cette distinction crée-t-elle un désavantage par la perpétuation d'un préjugé ou l'application de stéréotypes? — la Cour n'a pas eu besoin de l'étudier en détail, étant donné ses conclusions quant au premier volet. Le contribuable alléguait la perception du public des défendeurs dans les affaires de paiements de pension alimentaire comme étant des « pères mauvais payeurs » parmi ses arguments concernant ce volet de l'analyse.

La CAF a insisté sur l'importance pour la Couronne de produire des preuves d'éléments factuels lors du procès en première instance quant aux deux volets de l'analyse fondée sur l'article 15, mais également quant à la justification des dispositions en vertu de l'article 1 afin que la cour d'appel ait accès aux renseignements nécessaires quant au contexte au cas de besoin.

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Bonuses to Owner-Manager Not Exempt Under Indian Act

In *Bell v. The Queen* (2016 TCC 175), Woods J held that bonuses paid to a status Indian who performed management and administrative functions on-reserve did not qualify for the exemption in section 87(1)(b) of the Indian Act because the bonuses did not have sufficient connection to business operations carried out on-reserve. This decision highlights the importance of properly drafted services agreements between owners and their operating companies that reflect the owner's contributions to the business. It also clarifies the limits on locating administrative and management personnel on-reserve in the context of a First Nation's business.

Bell was the majority (51 percent) owner, sole director, and president of Opco, which carried on business as a subcontractor specializing in installing rebar in high-rise buildings. Bell, a status Indian, was responsible for the supervision and management of the business and its financial activities. Her husband owned 49 percent of Opco and was not a status Indian. During the years under appeal (2005-2008), neither Bell nor her husband resided on-reserve. Opco carried on its business mostly off-reserve; however, Bell conducted the majority of her business-related duties in an office located on-reserve.

Bell was paid a combination of salary and lump-sum bonuses. According to a services agreement signed in 1997, the bonuses were to approximate 50 percent of Opco's estimated annual income. In the years under appeal, however, Bell received bonuses approximating 97 percent, 119 percent, 102 percent, and 104 percent of Opco's annual net income. Bell's husband did not receive any bonuses during the years under appeal. For all the years except one, Bell was also paid a six-figure annual salary (as was her husband).

Woods J began her analysis by stating that the analysis of section 87(1)(b) proceeds in accordance with the framework provided by *Bastien Estate v. Canada* (2011 SCC 38) and *Kelly v. Canada* (2013 FCA 171). Woods J focused on the issue of whether there were significant substantive connections

between the bonuses and the reserve in question. Her conclusion that the bonuses were not substantively connected was predicated on the following points:

- The bonuses received by Bell were unreasonable: Bell and her husband provided effectively equal services to the business of Opco, but Bell's husband did not receive any bonuses.
- Bell's on-reserve employment was not a strong connecting factor for the bonuses because it would run counter to the purpose of the Indian Act exemption—"to insulate the property interests of Indians in their reserve lands from the intrusions and interference of the larger society so as to ensure that Indians are not dispossessed of their entitlements": *Kelly*, at paragraph 42, quoting *Mitchell v. Peguis Indian Band*, 1990 CanLII 117(SCC)—to give weight to remuneration in excess of the reasonable on-reserve salary already received by Bell.
- Opco's operations occurred predominantly off-reserve; its customers were predominantly off-reserve; and its business primarily came to it without significant effort on the part of the owners (Bell and her husband) to obtain contracts.
- There was no significant connecting factor to the reserve from the on-reserve payment of the bonuses or from the residences of Opco (as determined by central management and control) and Bell, both of which were off-reserve.

The analysis and holding in *Bell* are consistent with the *Bastien Estate* framework and its companion case, *Dubé v. Canada* (2011 SCC 39), which focused on the purposes of the exemption, the type of property, and the nature of the taxation of the property in question. In those cases, monies relating to a contractual obligation arising on-reserve were held to fall within the Indian Act exemption.

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Discretionary Trusts and Ontario Net Family Property

A recent Ontario Superior Court decision (*Tremblay v. Tremblay*, 2016 ONSC 588; under appeal) has suggested that a beneficial interest in a discretionary trust can be as valuable as the trust property itself for the purposes of calculating net family property (NFP)—the value of property that will be divided among the parties upon marital dissolution under Ontario's Family Law Act.

In 2009, Michael Tremblay implemented an estate freeze for his family business, permitting some of the future growth of the family business to accrue to his son, Jeff. To this end, a holding company (Nictor) was incorporated to retain Jeff's share of surplus distributed from the Tremblays' various operating companies. Jeff was Nictor's sole director. A fully discretionary family trust was settled to hold Nictor's common shares for the benefit of Jeff, Jeff's former spouse Catherine, and their children. Jeff, Michael, and Heather (Jeff's mother) were appointed trustees of the family trust. As trustee, Jeff held the power to unilaterally appoint and remove other trustees.

When Jeff and Catherine separated years later, the court was faced with assigning an appropriate monetary value to Jeff's beneficial interest in the family trust to be included in his NFP. The court held that Jeff's extensive influence over Nictor and the family trust resulted in the value of his beneficial interest equalling that of the Nictor shares owned by the family trust. The court said that Jeff's ability to appoint a majority of trustees elevated the possibility of trust distributions to Jeff as a beneficiary into "something more like a certainty." Presumably, in the court's view, this certainty was just as valuable to Jeff as direct ownership of the Nictor shares.

Further, the court found that Jeff's beneficial interest did not qualify for the exclusion from NFP for property owned on the valuation date acquired by gift after marriage, on the ground that Jeff did not hold complete title to the trust property. Thus, the relevant "property" was not "owned" by him, as required for the exclusion in section 4(2) of the Family Law Act. (Interestingly, the court did not refer to the fact that the NFP definition in section 4(1) provides that property must also be "owned" to be included in NFP. Query whether property can be owned for the purpose of its inclusion in NFP but not for the purpose of its exclusion therefrom.)

Tremblay suggests that to reduce the value of a beneficial interest included in NFP, a beneficiary's control over trust property, whether direct or indirect, should be minimal. *Tremblay* also suggests that the distribution of trust property to a spouse in satisfaction of her beneficial interest prior to the valuation date may be required to exclude its value from NFP as property that was acquired by gift after marriage or as property traceable thereto.

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Quebec Day-Care Plan Raises Parents' Effective Marginal Tax Rates

Quebec's subsidized day-care program requires parents to pay (1) a basic contribution ($7.55 a day for 2016) to subsidized child-care providers and (2) an additional contribution collected with the tax return of the parent who is party to the child-care agreement (section 88.2 of the Educational Childcare Act

[ECA]). Because the latter contribution rises with Quebec net income, it increases the effective marginal tax rate of the household by as much as 3.9 percent (one child) or 5.85 percent (two or more children). (This is an "effective" marginal tax rate because it includes not just income taxes but all payments to government.)

The calculation of the additional contribution is based on the "individual's income," which ECA section 88.1 defines as the combined net income for Quebec income tax purposes (line 275 of the Quebec personal tax return) of the parent or legal guardian of the child in care and his or her spouse or common-law partner (if any). The relevant net income amounts are those for the reference period, which is the year before the year for which an additional contribution is being calculated. The relevant levels of income for calculating the additional contribution are subject to indexation. The additional contribution for 2016 tax returns for one child in care is the sum of two amounts:

1) a flat contribution of 70 cents per day of care for parents with combined net income over $50,545 (see ECA section 81.3 and sections 2.1 and 5 of the Reduced Contribution Regulation under the ECA), and
2) an income-related amount per day of care of 1/260 of 3.9 percent of combined net income exceeding $75,820 but less than $158,820. For a family with combined net income equal to or greater than $158,820, this amount will be $12.45 ((1/260) × 3.9% × ($158,820 − $75,820)) per day.

For a second child in care, the additional contribution was cut by 50 percent in the 2016 Quebec budget. Thus, the maximum additional contribution is $13.15 ($0.70 + $12.45) a day for the first child and $6.575 for the second child. (Also see this calculator.)

Point 2 of the additional contribution (set out above) implies that the use of subsidized day care raises each parent's effective marginal tax rate. Therefore, provided that the household's children were enrolled in day care throughout the year (260 days), RRSP contributions for the 2015 taxation year applied to the bracket of household income between $75,820 and $158,820 will result in additional savings equivalent to 3.9 percent (one child in care) or 5.85 percent (two or more children in care) of the RRSP contribution amount when one is calculating the additional day-care contribution for the 2016 tax return. (For RRSP contributions for the 2016 taxation year, the bracket of household income to which the additional savings apply will change because of the indexing used for the 2017 tax return, but the details have not yet been announced.)

The CRA has accepted that the additional contribution will be deductible as a child-care expense for federal income tax purposes in the year for which it is paid (CRA document no. 2015-0614231E5, October 23, 2015).

The additional contribution has been criticized as unfair to higher-earning households, which are already paying higher taxes through a progressive tax system. At the same time, it provides an example of how an income-based user fee may be administered and collected through the tax system.

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Le programme de garderies du Québec augmente le taux d'imposition marginal effectif des parents

Le programme de garderies subventionnées du Québec exige le versement par les parents d'une contribution de base (7,55 $ par jour pour l'année 2016) au service de garde subventionné ainsi que d'une contribution additionnelle perçue au moment de la déclaration de revenus du parent partie à l'entente de services de garde (article 88.2 de la Loi sur les services de garde éducatif à l'enfance [LSGEA]). Cette dernière contribution augmentant avec le revenu net au Québec, elle accroît le taux d'imposition marginal effectif du foyer d'un pourcentage pouvant aller jusqu'à 3,9 % (un enfant) ou 5,85 % (deux enfants ou plus). (Il s'agit d'un taux d'imposition marginal « effectif » puisqu'il comprend non seulement les impôts sur le revenu, mais tous les paiements au gouvernement.)

La contribution additionnelle est calculée sur la base du « revenu d'un particulier ». Celui-ci est défini par l'article 88.1 de la LSGEA comme l'ensemble des revenus nets aux fins de l'imposition sur le revenu au Québec (ligne 275 de la déclaration de revenus québécoise) du parent ou du tuteur légal de l'enfant gardé et de son époux ou conjoint de fait (le cas échéant). Les montants de revenus nets pertinents sont ceux pour la période de référence, soit l'année qui précède l'année pour laquelle la contribution additionnelle est calculée. Les niveaux de revenu pertinents pour le calcul de la contribution additionnelle sont indexés. La contribution additionnelle pour l'année 2016 pour un enfant gardé est la somme de deux montants :

1) Une contribution uniforme de 70 sous par journée de garde pour les parents ayant un revenu net combiné supérieur à 50 545 $ (voir l'article 81.3 de la LSGEA et les articles 2.1 et 5 du Règlement sur la contribution réduite pris en application de cette loi).
2) Un montant par journée de garde calculé en fonction du revenu de 1/260 de 3,9 % de leur revenu net combiné qui est supérieur à 75 820 $, mais est inférieur à 158 820 $. Pour une famille ayant un revenu net combiné supérieur ou égal à 158 820 $, ce montant sera de 12,45 $ par jour ([1/260] × 3,9 % × [158 820 $ − 75 820 $]).

La contribution additionnelle pour le second enfant a été diminuée de 50 % dans le budget québécois pour l'année 2016. Ainsi, la contribution additionnelle maximale pour une journée de garde est de 13,15 $ (0,70 $ + 12,45 $) pour le premier enfant et 6,575 $ pour le second. (Consultez également cette calculatrice.)

Le point 2 de la définition de la contribution additionnelle (ci-dessus) signifie que l'utilisation d'un service de garde subventionné augmente le taux d'imposition marginal effectif de chaque parent. Ainsi, sous réserve de l'inscription des enfants du foyer à un service de garde pendant toute l'année (260 jours), les cotisations aux RÉER pour l'année d'imposition 2015 appliquées à la tranche de revenus du foyer entre 75 820 $ et 158 820 $ entraîneront des économies additionnelles équivalant à 3,9 % (un enfant gardé) ou 5,85 % (deux enfants gardés ou plus) du montant cotisé au RÉER, lors du calcul de la contribution additionnelle aux frais de garde pour la déclaration fiscale de 2016. (En ce qui concerne les cotisations RÉER l'année fiscale 2016, la tranche du revenu du foyer à laquelle les économies additionnelles seront applicables est sujet au changement puisque le taux d'indexation pour calculer la contribution additionnelle pour la déclaration d'impôt de 2017 n'a pas encore été communiqué par le Ministère de Finances.)

L'ARC a accepté que cette contribution additionnelle soit déductible au titre des frais de garde d'enfants aux fins de l'imposition fédérale sur le revenu l'année pour laquelle elle a été payée (document de l'ARC 2015-0614231E5, 23 octobre 2015).

La contribution additionnelle a été critiquée comme étant injuste envers les foyers ayant des revenus supérieurs, qui paient déjà plus d'impôts dans un système d'imposition progressif. En même temps, elle sert d'exemple pour un système de participation aux frais selon le principe d'utilisateur payeur basé sur le niveau de revenu, qui est gérée et perçue par le système fiscal.

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Hybrid Sale of Goodwill: Benefit Ending

One accepted form of planning for the sale of goodwill (as part of the sale of a business operated by a CCPC) has been a hybrid sale, which involves both a sale of assets and a sale of shares (*Geransky v. The Queen*, 2001 CanLII 480 (TCC)). A hybrid sale achieves the objectives of both the vendor and the purchaser: the vendor can use his or her capital gains exemption (CGE), and a purchaser achieves a step-up in the tax cost of the business assets. However, the benefits of hybrid sales for goodwill will no longer be realized starting January 1, 2017, because a sale of eligible capital property at a gain will now result in a capital gain rather than in active business income to the corporation; as a result, the vendor will find this tax-planning option unattractive.

Consider Opco, a CCPC whose shares are owned by Mr. X. Mr. X has not used his lifetime CGE, and his shares are qualified small business corporation (QSBC) shares. An arm's-length purchaser (Purchaseco) has offered to purchase the assets of Opco for $5 million, which (for the purposes of illustration) consist exclusively of goodwill having zero cost. The shares have a nominal ACB.

To effect a hybrid sale, Mr. X exchanges his shares of Opco for preferred shares and one new common share by way of a subsection 85(1) rollover, with an elected amount of $800,000. Mr. X shelters the corresponding gain by using his lifetime CGE. Mr. X then sells the preferred shares of Opco to Purchaseco for $800,000 in cash. Opco subsequently redeems the preferred shares for an $800,000 promissory note. Finally, Opco sells its assets (100 percent goodwill) to Purchaseco for gross proceeds of $5 million, consisting of $4.2 million in cash and the cancellation of the $800,000 promissory note. Mr. X is a top-bracket (53.53 percent) taxpayer living in Ontario, and the transactions take place in 2017.

The accompanying table illustrates a vendor's problems with a hybrid sale. Note in particular the corporate tax on the gain at more than 50 percent (19.50 percent and 30.67 percent).

Hybrid Sale Under Proposed Capital Gain Regime

	$ millions
Proceeds from sale of shares	0.8
ACB	(0.0)
Gain	0.8
Taxable capital gain (50%)	0.4
Lifetime CGE	(0.4)
Personal taxes at 53.53%	0.0
Proceeds from sale of goodwill	5.0
Cost of goodwill	(0.0)
Capital gain	5.0
Taxable capital gain (50%)	2.5
Corporate taxes at 19.50% (non-refundable)	0.5
Corporate taxes at 30.67% (refundable)	0.8
Dividend refund at 38.33%	(0.3)
Cash distributed to shareholders[a]	3.2
Dividend from CDA	2.5
Non-eligible dividends	0.7
Personal taxes at 45.3%	0.3
Combined corporate and personal taxes	1.3
Total after-tax cash proceeds received by Mr. X	3.7
Tax deferral if proceeds retained by Opco	0.0
RDTOH not recoverable by non-eligible dividends[b]	0.5

[a] $4.2 – $0.5 – $0.8 + $0.3.
[b] $0.8 – $0.3.

Relative to the pre-2017 eligible capital property regime (calculations not shown), the tax results are much less attractive: the after-tax cash proceeds received by Mr. X are substantially less (due to the higher corporate tax), and he has no potential for tax deferral by retaining the proceeds in the corporation. Further, because only a portion of the sales consideration is received in cash by Opco, there are insufficient funds to pay the amount of dividends required to recover the full RDTOH balance.

If a hybrid sale is used in spite of the above complications, care must be taken in designing the rights of the preferred shares to avoid part IV and part VI.1 tax. Also, Opco should ensure that it does not have an RDTOH balance prior to the redemption of the preferred shares.

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More Documentation Required for FTC Claims

At the June 10, 2016 STEP Canada CRA round table, the CRA clarified its stricter documentation requirements for foreign tax credit (FTC) claims, particularly in respect of providing proof of US taxes paid.

The CRA generally looks for a notice of assessment or equivalent document from the foreign tax authority; the foreign income tax return and attachments; and any other supporting documents that may be applicable (see form T2209, "Federal Foreign Tax Credits"). Although this requirement may seem straightforward, taxpayers should be aware that foreign countries' tax administration procedures may be different from Canada's. In particular, the foreign country's tax year may not coincide with Canada's tax year. Also, the foreign country may not provide any documentation when the foreign tax return is assessed. In such cases, a special request must be made to the foreign tax authority, and the taxpayer may not receive proper documentation for several months.

The CRA's response to question 9 at the STEP round table provides helpful background on this issue, particularly in respect of documentation required to prove the amount of US taxes paid (federal or state). (See CRA document no. 2016-0634941C6, June 10, 2016.) The CRA noted "an observed increase in the trend of incorrect reporting and incomplete submission of documents relating to [US-source income]"; it said that the increase was attributable to the lower level of documentation required for US-source income than for foreign-source income from other countries. Accordingly, the CRA decided in 2015 to make the level of documentation for US-source income consistent with that required for income from other jurisdictions.

It appears that this decision has resulted in some pushback owing to the difficulty of obtaining US documentation. As a result, the CRA has said (CRA document no. 2016-0634941C6, June 10, 2016) that if a notice of assessment or a similar document cannot be obtained, proof of payments made to (and/or tax refunds received from) foreign jurisdictions will now be accepted instead.

This may be in the form of bank statements, cancelled cheques (front and back), or official receipts. The following information has to be clearly indicated:

- that the payment was made to or received from the applicable foreign tax authority;
- the amount of the payment or refund;
- the tax year to which the payment or refund applies;
- the date that the amount was paid or received.

Taxpayers can request extensions of time to respond to the requests from the CRA. Certain steps can also be taken to request the account transcript in advance of the CRA's request, which could significantly reduce or eliminate issues arising from these reviews. Furthermore, a majority of US states have online account systems that allow taxpayers to print out their account statements as supporting documentation for the claim.

Ultimately, it is recommended that taxpayers and their representatives do not wait until the CRA asks for supporting documents for these claims, since it is clear that the CRA will be requesting them. Obtaining the documents after the request is received could lead to delays in processing.

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An Individual's Direct Ownership of a CFA

When an individual directly owns a controlled foreign affiliate (CFA) that earns foreign accrual property income (FAPI), problems can occur if there is a need to bring the income back to Canada (perhaps for reinvestment elsewhere): the tax rate on distributed income can approach 80 percent. Fortunately, a restructuring to interpose a Canco between the individual and the foreign corporation can often solve the problem.

Suppose that Forco, a foreign corporation (characterized as such on the basis of provisions such as article IV of the Canada-US treaty, which supersede the common-law test of location of mind and management) earns $1,000 of property income, pays foreign tax at 50 percent, and pays out the remaining $500 as a dividend.

If A (a top-bracket Ontario-resident individual) owns Forco directly, the total tax payable is $767.65 ($500 foreign tax + $0 Canadian tax on FAPI + $267.65 Canadian tax on the dividend), for a tax rate of almost 77 percent on the initial $1,000 earned in the foreign jurisdiction. The high tax rate is imposed because the dividend distribution is fully taxable as income without any tax relief for the taxes paid in the foreign jurisdiction. The calculations are as follows:

- A has a $1,000 FAPI inclusion because Forco is a CFA. However, the net taxable amount is $0 because this inclusion is fully offset by a $1,100 deduction for foreign accrual tax (FAT)—$500 foreign tax multiplied by the relevant tax factor (RTF) of 2.2 for individuals.
- A has $500 of ordinary income from Forco because the dividend does not receive the dividend gross-up and tax credit. The subsection 91(5) deduction available for dividends received—which is applicable because regulation 5900(3) deems a dividend paid to an individual to come out of taxable surplus—is $0. This deduction is computed as the lesser of the dividend ($500) and, essentially, the amount of FAPI that has been taxed in Canada ($0). The tax on $500 of ordinary income at 53.53 percent is $267.65.

Now suppose instead that A had the benefit of better tax-planning advice in the structuring of the foreign holding. Assume that A owns 100 percent of Canco, and Canco owns 100 percent of Forco. If the funds are to be reinvested by Canco, no Canadian tax arises, and the total tax payable is $500 of foreign tax, resulting in a tax saving of almost 30 percent of the original $1,000 of income ($767.65 versus $500). Canco's situation is as follows:

- Canco's net FAPI inclusion is $0 because the FAPI inclusion of $1,000 is fully offset by a $2,000 deduction under subsection 91(4) for foreign taxes paid (FAT of $500 multiplied by the RTF of 4 for corporations).
- Canco has ordinary income from the foreign dividend of $500. This amount is fully offset by the corporate deduction under paragraph 113(1)(b) for foreign taxes paid out of the taxable surplus of a foreign affiliate of $1,500 (FAT of $500 multiplied by the RTF of 4 less 1 [that is, 3]).

Admittedly, the tax saving is mostly a deferral advantage. If the funds are to be passed on to A as a dividend for reinvestment at the personal level (instead of the corporate level), the total tax burden is $696.70 ($500 foreign tax + $196.70 Canadian tax). This amount is still less than the tax imposed in the direct ownership situation ($70.95 less than the original $767.65), but not by as much as in the situation where the funds remain in Canco. The $196.70 in Canadian tax is calculated as 39.34 percent of the eligible dividend of $500.

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Subsection 55(2): The Reasonable Regular Dividends Exemption

At the 2015 Tax Executives Institute Liaison meeting (see CRA document no. 2015-0613821C6, November 17, 2015), the CRA stated that the new subsection 55(2) will not apply (in respect of the purpose test in paragraph 55(2.1)(b)) "[w]here a dividend is paid pursuant to a well-established policy of paying regular dividends and the amount of the dividend does not exceed the amount that one would normally expect to receive as a reasonable dividend income return on equity on a comparable listed share issued by a comparable payer corporation in the same industry." This interpretation, although not obvious from the wording of the legislation and not based on existing jurisprudence, may be helpful to taxpayers seeking to pay out dividends for normal commercial reasons without being concerned about whether the dividend will be recharacterized as a capital gain. (Note that dividends paid to remove value from an Opco for creditor-proofing purposes already meet the purpose test: CRA document 2015-0623551C6, November 24, 2015.) Dividend rates that satisfy the CRA criteria may be ascertained by using a database such as Capital IQ or Compustat.

For example, suppose that Opco is a private corporation based in Alberta that engages in oil and natural gas exploration and drilling. Its SIC (standard industrial classification) codes are 1381 (drilling oil and gas wells); 1382 (oil and gas exploration services); and 1389 (oil and gas services). An independent valuator has determined that the fair market value of Opco is $100 million.

To identify comparable companies, I searched Capital IQ for TSX-listed Canadian companies with a market cap below $300 million and a SIC code of 1381, 1382, or 1389. I used comparable company analysis, which follows the educational curriculum of the Canadian Institute of Chartered Business Valuators. This methodology first selects companies in an industry similar to that of the subject company, on the assumption that all firms within a given industry segment are subject to common risks. The list is then further refined to include companies that are similar in size (measured in terms of market capitalization, which can also be interpreted as the value of equity). Size is important because larger companies tend to enjoy a greater degree of market presence, financial stability, and economies of scale. Other filters could be applied, such as geographic coverage, profitability, degree of vertical integration, level of tangible assets, and historical and future growth rates.

I further restricted the search to companies with a positive dividend yield on their common shares. Although many companies that otherwise fit the parameters would pay no dividends, the CRA's use of the phrase "comparable listed share" seems to imply that only companies that pay dividends are comparable.

The search identified five companies that had an unweighted average dividend yield of 4.67 percent (using the latest data): the range was from 2.38 percent for North American Energy Partners Inc. to 6.51 percent for Black Diamond Group Limited.

The result derived from the comparable set forms a lower bound for the reasonable dividend yield. A prudent investor will require a higher rate of return on private company shares than publicly traded shares: private company shares are relatively illiquid, and there may not be a market for them. As a result, a modest 20-25 percent premium could be added. Therefore, a reasonable dividend yield for Opco would be in the range of 4.67 percent to 5.8 percent. Using the midpoint of 5.25 percent, Opco can pay a quarterly dividend in the amount of $1,312,500 ($100 million × 5.25%/4).

To create the "well-established" practice of paying regular dividends required by the CRA policy, the company could make a decision at its annual general meeting that from that time on it will pay a regular quarterly dividend of $1,312,500. (The quarterly payment seems appropriate, since public corporations usually pay dividends on a quarterly basis.) Whether this policy would have to be continued for some period of time to meet the CRA's requirements is unclear.

The payment of these regular dividends should not affect the company's ability to pay out a dividend equal to the safe income on hand. However, the amount of the regular dividends paid will reduce the safe income on hand.

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Back-to-Back Royalty and Character Substitution Rules

Editor's note: Revised draft legislation issued on October 19, 2016, as this issue was going to press, is not reflected in this article. The main change from the July 29, 2016 draft legislation described below is to restrict the application of these rules to situations where either (1) the non-resident third party to the transaction is not dealing at arm's length with the Canadian payer, or (2) one of the main purposes of the arrangement is to reduce part XIII tax.

The back-to-back royalty rules (subsections 212(3.9) and (3.91)) and royalty character substitution rules (subsections 212(3.92) and (3.93)) released in draft form on July 29, 2016 are effective as of January 1, 2017. Before that date, a Canadian payer of rent, a royalty, or a similar payment (referred to herein as a "royalty") to non-residents should examine the governing contracts to see whether part XIII withholding tax obligations (under paragraph 212(1)(d)) are created by these rules.

The back-to-back royalty rules are intended to prevent the avoidance or reduction of part XIII royalty withholding through the interposition of a non-resident intermediary between the Canadian payer of the royalty and the non-resident payee. In such arrangements, the non-resident intermediary is located in a more favourable jurisdiction than the non-resident payee; in particular, the payee might be located in a jurisdiction with which Canada does not have a tax treaty or in which the treaty withholding rate is higher than it is in other countries. For example, there can be an exemption from withholding only under certain treaties for the rights to use patented information, information concerning scientific experiments, and computer software. The royalty character substitution rules ensure that the back-to-back rules apply regardless of whether or not the interposed arrangements are in the form of a licence, share issuance, or loan.

As currently drafted, the proposed rules apply even when the parties are dealing at arm's length. They can also apply to commercial transactions in which there is no withholding tax avoidance purpose. There is little grandfathering; the rules apply to all royalty payments made after 2016.

In practice, after 2016 all payments of royalties to non-residents should be viewed as being subject to withholding tax at the domestic rate of 25 percent unless comfort to the contrary can be obtained. In certain cases, for example, the proposed rules could apply to royalty payments made by a Canadian for a licence of software from a non-resident licensor where the software had previously been purchased from a third-party non-resident seller and either (1) the licensor funded the purchase with a loan or share subscription, or (2) the purchase price included an earnout provision tied to the royalty revenues.

Where the rules apply, the licensor will be disregarded and the Canadian licensee will be treated for part XIII purposes as though it had instead paid the royalty to the lender, shareholder, or third-party seller, as the case may be. The Canadian licensee will then be required to remit withholding tax at the rates applicable to those parties instead of at the rate applicable to the licensor.

In instances where the Canadian licensee deals at arm's length with the licensor, the licensee will not be in a position to know how and on what terms the software was acquired. Therefore, it will be prudent for all Canadian licensees entering into royalty agreements to request a representation from the licensor that the proposed rules do not apply. Parties to such agreements should determine how the risk of non-compliance with part XIII obligations (tax, penalties, and interest) should be allocated among them.

Depending on the bargaining power between the parties, such representations may be difficult to obtain—the licensor may not be willing to assume any Canadian compliance risk—and the Canadian payer may have to bear the burden of the additional 25 percent withholding.

The CBA-CPA Joint Committee on Taxation made submissions to Finance detailing these concerns on July 25, 2016, just prior to the release of the rules, and again on September 27, 2016 as part of the usual commenting process. It is hoped that

revised rules will address the uncertainty and business risk noted above.

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Règles relatives aux mécanismes d'adossement pour les redevances et règles anti-remplacement

Note de l'éditeur : L'avant-projet de loi modifié émis le 19 octobre 2016, alors que cet article est mis sous presse, n'a pas été pris en compte dans la rédaction de cet article. Le principal changement apporté à l'avant-projet de loi du 29 juillet 2016 décrit ci-dessous est de restreindre l'application de ces règles aux situations dans lesquelles soit (1) le non-résident qui est un tiers à la transaction a un lien de dépendance avec le payeur canadien, ou (2) l'un des principaux objectifs du mécanisme est de réduire l'impôt de la partie XIII.

Les règles relatives aux mécanismes d'adossement pour les redevances (paragraphes 212(3.9) et (3.91)) et les règles anti-remplacement pour les redevances (paragraphes 212(3.92) et (3.93)) rendues publiques par voie de propositions législatives le 29 juillet 2016 entreront en vigueur le 1er janvier 2017. Avant cette date, les Canadiens payant des loyers, redevances et paiements semblables (les « redevances ») à des non-résidents devraient étudier les contrats régissant ces paiements pour vérifier si ces règles créent des obligations d'effectuer les retenues d'impôt de la partie XIII (alinéa 212(1)d)).

Les règles relatives aux mécanismes d'adossement pour les redevances visent à empêcher l'évitement ou la réduction des retenues de la partie XIII sur les redevances par le jeu d'un mécanisme d'interposition d'un intermédiaire non-résident entre le payeur de redevances canadien et le bénéficiaire non-résident. L'idée est que l'intermédiaire non-résident est situé dans une juridiction plus favorable que le bénéficiaire non-résident; plus particulièrement, le bénéficiaire peut se trouver dans une juridiction avec laquelle le Canada n'a pas conclu de convention fiscale ou dans laquelle le taux de retenue d'impôt établi par la convention est supérieur à celui applicable dans d'autres pays. Par exemple, une exonération des retenues existe uniquement en vertu de certains traités à l'égard du droit d'utiliser des renseignements brevetés, des renseignements relatifs à des expériences scientifiques et des logiciels.

Les règles anti-remplacement en matière de redevances permettent de veiller à ce que les règles relatives aux mécanismes d'adossement s'appliquent, que les mécanismes interposés prennent ou non la forme d'une licence, d'une émission d'action ou d'un prêt.

Telles qu'actuellement rédigées, les règles proposées s'appliqueront même lorsque les parties n'ont pas de lien de dépendance. Elles pourront également s'appliquer aux opérations commerciales qui n'ont aucun objectif d'évitement de retenue d'impôt. Il n'y a pas de droits acquis; ces règles s'appliqueront à tous les paiements de redevances effectués après 2016.

En pratique, après 2016, tous les paiements de redevances faits à des non-résidents devraient être considérés comme faisant l'objet d'une retenue d'impôt au taux interne de 25 %, à moins d'être satisfait que les règles ne trouvent pas application.

Par exemple, dans certains cas, les règles proposées pourraient s'appliquer à des paiements de redevances faits par un porteur de licence canadien pour une licence d'un logiciel acquis auprès d'un cédant de licence non-résident lorsque le logiciel avait antérieurement été acquis par le cédant auprès d'un vendeur tiers non-résident et que soit (1) le cédant de licence finançait l'achat par un prêt ou une souscription d'actions, ou (2) le prix d'achat comprenait une clause d'indexation sur les bénéfices futurs (« earn-out clause ») liés aux recettes en redevances.

Dans les cas où les règles s'appliqueront, le cédant ne serait pas pris en compte et le porteur de licence canadien serait traité, aux fins de l'application de la partie XIII, comme s'il avait versé la redevance au prêteur, à l'actionnaire ou au vendeur tiers, selon le cas. Le porteur de licence canadien devrait alors verser les retenues d'impôt aux taux applicables à ces parties plutôt qu'à celui applicable au cédant.

En l'absence de lien de dépendance entre le Canadien et son cédant de licence, le Canadien ne serait pas en mesure de savoir comment et à quelles conditions le logiciel a été acquis. Par conséquent, à l'avenir, il serait prudent pour tous les porteurs de licence canadiens qui concluent des accords de redevance d'exiger une déclaration du cédant de licence indiquant que les règles proposées ne s'appliquent pas. Les parties à de tels accords devraient prévoir la répartition du risque de non-conformité aux obligations de la partie XIII (impôts, pénalités et intérêts) entre eux.

Selon la distribution du pouvoir de négociation entre les parties, de telles déclarations pourraient être difficiles à obtenir — le cédant de licence pourrait ne pas être disposé à assumer le risque de conformité canadien — et le coût de la retenue additionnelle de 25 % pourrait reposer sur le payeur canadien (le porteur de licence).

Le Comité mixte de l'ABC et de CPA a fait part de ces inquiétudes au ministère des Finances juste avant la publication de ces règles, et de nouveau le 27 septembre 2016, dans le cadre du processus de commentaires habituel. Il est à espérer que les règles modifiées s'attaqueront à l'incertitude et au risque commercial mentionnés ci-dessus.

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