CANADIAN TAX focus

Editor: Alan Macnaughton, University of Waterloo
(amacnaug@waterloo.ca)

Volume 3, Number 2, May 2013

End-of-Year Salary-Dividend Planning: Paperwork Is Key

Many owner-managers want to withdraw cash from their corporations throughout the year and decide at the end of the year (or shortly after) whether the withdrawals should be characterized as salary, dividends, or a mix. The flexibility is convenient in that factors such as the amount of salary needed to support the desired level of RRSP contributions and the amount of dividends needed to eliminate CNILs may not be known until the year-end calculations are complete. There are various ways to implement this approach, some of which may be common although not legally effective.

One method that is not recommended is to characterize the payment, at the time of the withdrawal, as either a salary (with appropriate source deductions) or a dividend (through a directors' resolution)—and then, when the year-end numbers are determined, make journal entries that recharacterize the payments as something other than what was initially recorded. This approach is clearly disallowed by case law. For example, in *Irmen v. The Queen* (2006 TCC 475), the taxpayer received payments from the corporation as salary. Later, journal entries were recorded to reverse the salary payments and instead record them as reductions of the balance of the loan from the shareholder to the corporation. The court stated that a salary cannot be converted into something else after the fact. Earlier decisions in *C.G. Wood v. MNR* ([1988] 1 CTC 2312 (TCC)) and *Adam v. MNR* (85 DTC 667 (TCC)) support this conclusion.

The more effective way to preserve salary-dividend flexibility is to process cash withdrawals through the shareholders' loan account initially and then, near the end of the year, record an offsetting change in the loan account together with the desired salary or dividend payments. Consider two examples:

- If the corporation owes money to the owner-manager, any payments throughout the year could be recorded as reductions of the loan balance; given the direction of the loan, no tax consequences should occur. At the end of the year, the salary and dividend payments would be documented, with a corresponding increase in the loan balance. (Of course, it might be desirable to instead leave the amount as a loan repayment and avoid receiving amounts that would be taxed.)
- If the shareholder-employee is the debtor (that is, if he or she owes money to the corporation), payments throughout the year could be recorded as loans from the corporation. At the end of the year, salary or dividends could be documented together with a repayment of the loan. However, this approach creates an income inclusion under subsection 80.4(1) or (2) for the imputed interest benefit on the loan; if the shareholder is a non-resident, such a benefit is treated as a dividend subject to part XIII withholding. Although the extra tax is undesirable, it might be worth the value of flexibility in the salary-dividend choice.

The more common situation is to document the salary or dividend payment after the end of the year. The CRA has a policy that allows some delay in putting documents in place (CRA document no. 1991-224, April 1991) where the parties agreed, understood, or resolved at a particular time that transactions would occur in a particular manner. Thus, it seems that the CRA is prepared to allow transactions to be documented after the fact if the original intention is

IN THIS ISSUE

CTF CANADIAN TAX FOUNDATION
FCF FONDATION CANADIENNE DE FISCALITÉ

clear. Unfortunately, there is no CRA opinion on whether this policy applies to the salary-dividend payment issue.

In the more recent case of *Maxi Maid Services Ltd. v. The Queen* (2012 TCC 178), the issue was whether payments intended to be dividends but later recorded as salary were subject to source deductions. The court accepted that the corporation did not make salary payments and held that the penalty did not apply. Presumably no resolutions were created prior to each dividend payment, yet the court considered the draws to be dividends. The court also acknowledged the commercial reality that small businesses often decide at year-end how the owner-manager is to be paid. Perhaps this acknowledgment and the CRA's policy on delayed documentation form a basis for allowing owner-managers to determine the mix of salary and dividend after the year-end.

The law is that taxpayers must characterize (although not necessarily document) a payment as salary, dividend, or loan at the time it occurs and not recharacterize it later. In order to properly characterize a payment, the intention of the payment should be supportable at the time the payment occurs. For instance, if the intention is to pay a dividend on December 31, there should be some evidence (e-mails, letters, notes, etc.) in place on or before December 31 to support that intention.

Jody Wong
Cadesky & Associates LLP, Toronto
jwong@cadesky.com

Testamentary Trusts: The Downside of Consultations

The 2013 federal budget's approach to reforms of the taxation of trusts and estates is to identify the tax issue (with more detail to come in a consultation paper), call for consultations, and remain silent on both the details of the changes and the transitional rules (the phase-in). Although tax practitioners generally advocate consultation on the basis that it results in better tax laws, the difficulties that they are experiencing when advising clients show that post-budget consultation has its drawbacks. In particular, the reopening of grandfathering rules that have been in place since 1971 has created special uncertainties (as well as policy concerns).

Traditionally, most tax changes are announced in the budget in a reasonable amount of detail. Tax practitioners may or may not like the changes, but for the most part they know what they are dealing with and can proceed with transactions accordingly. The budget's approach to the taxation of trusts and estates leads to the opposite result: transactions entered into today will have unknown tax consequences in the future.

Currently, a testamentary trust—a trust created by will on the death of the settlor—is considered a separate taxpayer, and thus has access to the normal graduated tax rates. As a result, a portion of the income earned in the trust and distributed to beneficiaries bears a lower tax burden than it would if the income had been distributed directly to a beneficiary on the death of the testator. In other words, as the budget notes, the beneficiaries of those trusts are effectively allowed to access more than one set of graduated rates.

It is clear that this will not continue: the budget proposes to consult on possible measures to eliminate this tax benefit and the similar tax benefit realized by estates (but, in the case of estates, only after a reasonable period of estate administration). Suppose that the ultimate proposal treats a testamentary trust in the same way as a typical inter vivos trust—by taxing it at the top marginal rate on all income not allocated and taxed to beneficiaries. In that case, the tax advantage will likely be reduced or eliminated. In some cases, taxes could actually be higher than they would be if no trust existed; the taxpayer could save professional fees by giving away the property directly.

However, if the government chooses to delay the implementation of this proposal (or if it ultimately chooses not to legislate in this area), then creating a testamentary trust will often remain worthwhile. Non-tax benefits of trusts, such as the protection of spendthrift heirs and the provision for minors, further complicate the matter. Thus, optimal will planning is uncertain.

Practitioners also face difficulty in responding to clients' questions about testamentary trusts that have already vested (that is, the taxpayer has died). Will the new rules apply to those trusts? The government indicated in the budget that it intends to eliminate the application of graduated rates to inter vivos trusts created before June 18, 1971 (these trusts are an exception to the above-noted rule on the taxation of inter vivos trusts). If the government is so concerned about the application of graduated rates that it is reopening grandfathering that has been in place for more than 40 years, one might ask whether existing testamentary trusts, which form an important part of the estates of many Canadians, will also be subject to the new rules. At present, the answer is "Who knows?"

Sean Glover
Cox & Palmer, Halifax
sglover@coxandpalmer.com

Relying on Incorrect CRA Information

Suppose that a taxpayer relies to his or her detriment on incorrect information provided by the CRA. If the problem cannot be corrected by an amended tax filing, appeal, or rectification order, taxpayers can in some cases obtain relief from the courts or by application to the CRA itself.

If the issue in question is the interpretation of the law, the courts have no basis for granting relief: the law is the law. For example, in *Reid v. The Queen* (2008 TCC 421), a taxpayer in receipt of CPP benefits followed the guidance of the CRA and did not make CPP contributions. The taxpayer was reassessed because the statutory formula deems self-employment income to be earned evenly throughout the taxation year in the year in which a person starts receiving CPP benefits (section 13(1) of the Canada Pension Plan). Although the TCC could not grant relief to the taxpayer, costs were awarded, and the court suggested that the taxpayer apply for a remission order (as discussed below).

On the other hand, if the matter at issue is the application of a penalty, some relief may be possible. In *Dunlop v. The Queen* (2009 TCC 177), the taxpayer did not receive a T4 slip, so he reported this omission to the CRA in a letter. The taxpayer was assessed a penalty under subsection 163(1) on the unreported T4 income. The TCC held that the taxpayer had substantially complied with the CRA's policy (which, in 2006, was less strict in requiring an income estimate than the current policy) and that the due diligence defence applied, thus absolving the taxpayer of liability for the penalty. Although in this case the CRA did not directly provide incorrect information to the taxpayer, a similar due diligence argument might apply in that situation.

A taxpayer may also seek relief from penalties and from interest under subsection 220(3.1) (the taxpayer relief provisions, or TRP). *Information Circular* IC 07-1, "Taxpayer Relief Provisions" (May 31, 2007), states that interest and penalties may be waived where there are errors in CRA materials that are available to the public (at paragraph 26). In *Kerr v. Canada* (2008 FC 1073), the taxpayer's RRSP contribution limit shown on her notice of assessment from the CRA was too high, and so she overcontributed to her RRSP. Her request for relief from interest and penalties under the TRP was denied. Upon judicial review, the FC held that the decision should be quashed and referred back to the minister for reconsideration.

Relief from penalties and interest—and (unlike the TRP) from the taxes owed—may be obtained by applying for a remission order (section 23(2), Financial Administration Act, RSC 1985, c. F-11). One basis for a remission order is incorrect action or advice by CRA officials (*CRA Remission Guide*, July 2005, unpublished), although a review of remission orders granted over the last five years shows that only three such orders have been explicitly granted on the basis of misleading information provided by government officials; only one of those orders pertained to incorrect information provided by the CRA. Specifically, in 2009 a remission order was granted to Laurie's Recycling & Waste Services Inc. for GST that should have been collected because the taxpayer relied on "misleading advice on the part of a [CRA] official regarding the tax status of waste collection services" (SI/2009-58, July 8, 2009).

It is ironic that taxpayers are forced to rely on the minister's discretion, as exercised by the CRA, in respect of requesting relief under the TRP and on the discretion of the governor in council, on the recommendation of the CRA, for relief via a remission order; in other words, taxpayers must rely on the discretion of the party that originally provided the incorrect advice—the CRA.

Lisa Handfield
Calgary
lisahandfield@yahoo.com

Seniors' Home Renovation Tax Credits (Ontario and BC)

Ontario's healthy homes renovation tax credit and British Columbia's seniors' home renovation tax credit, both of which begin with the 2012 tax year, are provincial tax credits aimed at encouraging the aging population to make modifications to their homes that enhance safety and accessibility. Many types of expenditures are eligible for the credit, which is not limited to items purchased only by the disabled—for example, automatic garage-door openers and in-house elevators (which are reportedly becoming more common in newly built high-end homes) appear to qualify. Up to $10,000 of eligible expenses may be claimed in a year in respect of a particular home. No income or disability-credit eligibility test applies. The key test is that at least one person aged 65 or over ("the senior") must live in the home that is being modified. The credit can be claimed either by the senior or by certain other family members who live there, but other individuals may have paid for it.

The Ontario and BC credits differ in the rate that applies (15 percent in Ontario and 10 percent in British Columbia) and in the starting date for eligible expenditures (October 1, 2011 in Ontario and April 1, 2012 in British Columbia). In other respects, the wording of the legislation is almost identical (Taxation Act 2007, SO 2007, c. 11, schedule A, principally section 103.1.1, and Income Tax Act, RSBC 1996, c. 215, part 11), so they can be discussed together.

Eligible expenses are expenditures for improvements to the home or to the land on which the home is situated that meet either of two purposes: (1) they allow a senior to gain access to, or to be more mobile or functional within, the home or on the land; or (2) they reduce the risk of harm to a senior within the home or on the land. The first purpose might be read as requiring that the senior in question have some type of disability or physical problem, but in my view the law does not require this. On the other hand, the second purpose is broadly worded and covers items that simply reduce the risk of injury to seniors in good health (for example, an elevator will reduce the risk of falls).

The improvement must be of an enduring nature and integral to the home or land. An improvement is not eligible if its primary purpose is to increase the value of the residence or land or if it is specifically prescribed as ineligible. The home can be rented; although the legislation refers to the individual's "principal residence," this term does not carry the federal Income Tax Act meaning and is defined as the primary place of residence.

In some circumstances, the expenditure may qualify for the medical tax credit (for example, an exterior access ramp for a disabled person). In that case, the legislation specifically provides that both types of provincial credits can be claimed, without any reduction of either; medical expenses for federal purposes will be reduced if the renovation credit claimed is government assistance, but there has been no CRA opinion on this question.

CRA publications 5006-PC and 5010-PC cite an example of a senior claiming the credit even though the renovation expenses were paid by the senior's landlord; there is no mention of the senior incurring any cost. This makes one wonder exactly what the CRA would permit (can the credit be claimed in respect of seniors living in nursing homes or renting from corporate landlords?). However, the legislation specifically provides that the expense cannot be made or incurred for the purpose of gaining or producing income from a business or property. Thus, if the landlord deducts the renovation expense, query whether that would disqualify the expense for the credit. Also, there may be a problem with documentation, in that the person claiming expenses will have to have access to evidence of the amounts incurred—possibly including apportioned salaries of the landlord's employees who did the work.

Joseph Devaney
Video Tax News, Edmonton
joe@videotax.com

Denial of Capital Losses from Foreign Currency Fluctuations

New subsection 39(2), as proposed in Bill C-48 (first reading November 21, 2012), resolves a longstanding uncertainty about whether certain foreign exchange gains or losses are recognized for tax purposes under subsection 39(1) or under subsection 39(2). The new rules may trigger the application of stop-loss rules, which, in some foreign affiliate situations, may cause a real economic loss not to be recognized for Canadian tax purposes.

Current subsection 39(2) applies when a taxpayer makes a gain or sustains a loss from foreign exchange fluctuations, whereas subsection 39(1) applies when a taxpayer disposes of property. These two provisions seem to overlap when there is a capital gain or loss from a disposition of property and all or part of that capital gain or loss is derived from foreign currency fluctuations relative to Canadian currency. Is the capital gain or loss determined under subsection 39(1) or under subsection 39(2)?

This question is of little consequence if there is a gain. If there is a loss, however, a taxpayer may gain an advantage from the application of subsection 39(2): one could argue that the stop-loss rules in section 40 do not apply because the loss would be deemed to be a capital loss "from the disposition of currency of a country other than Canada" rather than from the disposition of the property itself. The CRA has said that subsection 39(2) applies if the capital loss arises solely from foreign currency fluctuations (CRA document no. 2009-0327061C6, October 9, 2009), but many commentators have suggested that subsection 39(2) applies more broadly.

Bill C-48 resolves this issue. New subsection 39(2) does not apply to any capital gain or capital loss to which subsection 39(1) applies: foreign exchange gains or losses in respect of asset dispositions—including dispositions of foreign currency—will be determined exclusively under subsection 39(1) (subject to the $200 de minimis amount for individuals other than trusts, which is continued with some changes in new subsection 39(1.1)). Therefore, subsection 39(2) will apply to debtors upon the repayment of debt and similar obligations that are denominated in foreign currency. Creditors will compute their foreign exchange gains or losses derived from the disposition of those debts and similar obligations under subsection 39(1).

This clarification of the application of subsection 39(1) may give rise to odd results in the case of transactions with foreign affiliates. For example, suppose that a Canadian corporation (the creditor) sustains a foreign exchange loss on the disposition to one of its foreign affiliates (FA 1) of an obligation denominated in foreign currency and owed by another foreign affiliate (FA 2). The creditor holds the obligation on account of capital, and the transfer occurs at fair market value. In this case, there is no capital loss: paragraph 40(2)(e.1) applies to deem the loss to be nil (because the loss is sustained on the disposition of an obligation between related parties and the obligation is still payable after the transfer by the debtor to the new creditor). Paragraph 53(1)(f.11) adds the amount of the foreign exchange capital loss to the adjusted cost base (ACB)of the obligation to FA 1. Because FA 1 is not liable to income tax in Canada, this increase in the ACB is irrelevant (except for the purposes of determining the FAPI and surplus of FA 1). Thus, even though the loss is real, it is still eliminated from the standpoint of the Canadian tax base. Note that this problem would not arise if the transaction had occurred between two related Canadian corporations, because the increase in the ACB would still be within the Canadian tax system.

Another consequence of the amendments to subsection 39(2) is that they close off the tax-planning opportunities introduced by *McMillan-Bloedel* (99 DTC 5454 (FCA)) relating to the redemption of preferred shares denominated in foreign currency. (See Bretsen and Kerr, "Tax Planning for Foreign Currency," in the 2009 Conference Report, 35:1-47.)

Amélie Guimont
PricewaterhouseCoopers LLP, Quebec City
amelie.guimont@ca.pwc.com

Limitation de pertes en capital découlant de la fluctuation de monnaies étrangères

Le nouveau paragraphe 39(2), tel que proposé dans le projet de loi C-48 (première lecture, 21 novembre 2012), permet d'éliminer une incertitude de longue date quant à savoir si certains gains ou pertes sur change étranger sont constatés aux fins de l'impôt en vertu du paragraphe 39(1) ou du paragraphe 39(2). Les nouvelles dispositions peuvent entraîner l'application des règles de limitation des pertes qui, dans certaines situations touchant des sociétés étrangères affiliées, engendrerait la non-reconnaissance aux fins fiscales canadiennes d'une perte économique réelle.

La version actuelle du paragraphe 39(2) s'applique lorsqu'un contribuable tire un gain ou subit une perte en raison de la fluctuation de monnaies étrangères, alors que le paragraphe 39(1) s'applique lorsqu'un contribuable dispose d'un bien. Ces deux dispositions semblent se chevaucher lorsqu'un gain ou une perte en capital résulte de la disposition d'un bien et que la totalité ou une partie de ce gain ou de cette perte en capital découle de la fluctuation d'une monnaie étrangère par rapport à la monnaie canadienne. Doit-on déterminer le gain ou la perte en capital en vertu du paragraphe 39(1) ou du paragraphe 39(2) ?

Cette question importe peu s'il y a un gain. Toutefois, s'il y a une perte, l'application du paragraphe 39(2) pourrait constituer un avantage pour les contribuables : on pourrait soutenir que les règles de limitation des pertes de l'article 40 ne s'appliquent pas étant donné que la perte serait réputée être une perte en capital « résultant de la disposition de la monnaie d'un pays étranger » plutôt que de la disposition du bien lui-même. L'ARC est d'avis que le paragraphe 39(2) s'applique lorsque la perte en capital provient uniquement de la fluctuation d'une monnaie étrangère (voir l'interprétation technique 2009-0327061C6, 9 octobre 2009, par exemple), mais plusieurs commentateurs ont suggéré que le paragraphe 39(2) pourrait s'appliquer de façon plus large.

Le projet de loi C-48 règle cette question. Le nouveau paragraphe 39(2) exclut de son champ d'application tout gain ou perte en capital auquel s'appliquerait le paragraphe 39(1) : les gains et les pertes sur change étranger relatifs à des dispositions d'actifs, y compris les dispositions de monnaie étrangère, seront désormais déterminés exclusivement selon le paragraphe 39(1) (sous réserve du montant minimal de 200 $ pour les particuliers autres que les fiducies, qui est maintenu, mais avec quelques changements, dans le nouveau paragraphe 39(1.1)). Par conséquent, le paragraphe 39(2) s'appliquera aux débiteurs lors du remboursement de dettes et d'obligations semblables libellées en monnaie étrangère. Les créanciers calculeront leur gain ou leur perte sur change étranger résultant de la disposition de ces dettes et obligations semblables en vertu du paragraphe 39(1).

Cette précision de l'application du paragraphe 39(1) peut donner d'étranges résultats dans le cas d'opérations avec des sociétés étrangères affiliées. Par exemple, imaginons qu'une société canadienne (le créancier) subit une perte sur change étranger lors de la cession à une de ses sociétés étrangères affiliées (SEA 1) d'une créance à recevoir d'une autre de ses sociétés étrangères affiliées (SEA 2) et libellée dans une monnaie étrangère. Le créancier détient la créance à titre d'immobilisation et le transfert a lieu à la juste valeur marchande. Dans cette situation, il n'y aurait pas de perte en capital, puisqu'elle serait réputée être nulle en vertu de l'alinéa 40(2)e.1) (la perte découle de la disposition d'une dette entre personnes liées et la dette est toujours payable après le transfert par le débiteur au nouveau créancier). L'alinéa 53(1)f.11) prévoit que cette perte en capital sur change étranger est à ajouter au prix de base rajusté (PBR) pour SEA 1 de la créance acquise. SEA 1 n'étant pas assujettie à l'impôt canadien, cette augmentation du PBR n'a pas d'importance (sauf dans un contexte de détermination du REATB et des comptes de surplus de SEA 1). Par conséquent, même si la perte est bien réelle, elle est tout de même supprimée au regard de l'assiette fiscale canadienne. Il convient de noter que ce problème ne se produirait pas si l'opération avait été effectuée entre deux sociétés canadiennes liées, puisque l'augmentation du PBR serait toujours dans le champ d'application du régime fiscal canadien.

Par ailleurs, les modifications au paragraphe 39(2) ont également pour conséquence de mettre fin aux occasions de planification fiscale introduites par *McMillan-Bloedel* (99 DTC 5454 (CAF) concernant le rachat d'actions privilégiées libellées en monnaie étrangère. (Voir Bretsen et Kerr, « Tax Planning for Foreign Currency », dans 2009 Conference Report, 35:1-47.)

Amélie Guimont
PricewaterhouseCoopers S.R.L./S.E.N.C.R.L., Québec
amelie.guimont@ca.pwc.com

Interest on a Loan Used To Buy Common Shares May Not Be Deductible

Paragraph 20(1)(c) provides for a deduction against income for amounts paid or payable in respect of interest on borrowed money used for the purpose of earning income. Typically, it is taken for granted that interest relating to a purchase of common shares with dividend rights is deductible under this paragraph. However, *Swirsky v. The Queen* (2013 TCC 73; under appeal) has called that presumption into question. In *Swirsky*, though money was borrowed to purchase common shares with dividend rights, the purpose test of paragraph 20(1)(c) was not met, and the interest on the loan was not deductible.

Mr. S owned valuable shares in his family's corporation. Facing financial trouble, he undertook a *Lipson*-like transaction with his wife for creditor-proofing purposes. Mrs. S borrowed money to purchase Mr. S's shares at fair market value. Interest on that loan caused Mrs. S to realize losses, which were attributed back to Mr. S. (The fair market value exception to attribution in subsection 74.5(1) did not apply because the spouses used the subsection 73(1) interspousal rollover.) The deductibility of these losses was at issue. Of particular interest to the court seemed to be the fact that the family corporation did not have a history of paying dividends on its shares (rather, profits of the corporation were distributed by way of bonus to Mr. S) and that neither the Ss' advisers nor Mrs. S herself explicitly and specifically expressed an income-earning purpose for these shares. It is noteworthy that dividends were paid on the shares, albeit years after the exchange between Mr. and Mrs. S.

Given these facts, the court was of the opinion that creditor proofing was the sole purpose for the sale of the shares from one spouse to another. Thus, Mrs. S's borrowing failed the purpose test requirement of paragraph 20(1)(c), and the interest was not deductible. In coming to this conclusion, the court framed its decision using the Supreme Court of Canada's test in *Ludco* (2001 SCC 62): "whether, considering all the circumstances, the taxpayer had a reasonable expectation of income at the time the investment was made." The details of the *Swirsky* decision suggest a more marked skew toward a specific taxpayer's personalized "reasonable expectations" than toward the more generalized objective reasoning usually associated with the belief that borrowing money to purchase common shares with dividend rights has an income-earning purpose. *Swirsky* is a cautionary tale, the lesson being that the same activity can have a different purpose depending on the circumstances of the taxpayer undertaking the activity.

For completeness, in *Swirsky* a deduction under paragraph 20(1)(e.1) was also in dispute and was denied because a similar purpose test is part of that provision. Additionally, the CRA raised subsection 74.5(11) and subsection 245(2) avoidance arguments that were discussed in obiter: the court stated that neither would apply, given the creditor-proofing purpose of the transaction.

Darryl R. Antel
Pitblado Law, Winnipeg
antel@pitblado.com

EU VAT Cases and GST "Supply"

GST applies to a taxable supply, and the amount of GST is based on the amount of consideration for the supply (ETA subsection 165(1)). However, Canadian case law on the meaning of "supply" has been sparse, although the FCA in *Canada v. Costco Wholesale Canada Ltd.* (2012 FCA 160) recently indicated that the term "supply" is broad. Since the GST and the value-added tax (VAT) under the European Union Common Systems Directive (2006/112/EC, November 28, 2006) share common core principles—including the concept of supply—can the jurisprudence on those topics help fill in the gaps?

In the ETA, "supply" is defined to mean the provision of property or service in any manner; "service" means anything other than goods (with other exclusions); and "consideration" includes any amount payable for a supply (including non-monetary consideration). Given the breadth of these definitions, one might be tempted to follow the money—that is, to infer from a transfer of money that there must also be a "supply" for which the transfer is the "consideration." Clearly, however, not all transfers of money involve supplies subject to GST—for example, the return of a deposit. What are the limits to the meaning of "supply"?

A number of European Court of Justice (ECJ) VAT decisions shed light on some potential limits to the meaning of "supply" for GST purposes, at least at a conceptual level (and recognizing that there are statutory differences). For example, the ECJ held in *Mohr* ([1996] EUECJ C-215/94) and *Landboden* ([1997] EUECJ C-384/95) that government payments to farmers who undertook to reduce commodity production were not payments for supplies, notwithstanding that "supply of service" is defined in the directive to mean "any transaction which does not constitute a supply of goods" and includes "the obligation to refrain from an act, or to tolerate an act or situation." The ECJ reasoned that the undertakings were not within the scope of the VAT because they did not give rise to any consumption; the farmers did not provide services to an identifiable consumer or any benefit capable of being regarded as a cost component of the activity of another person in the commercial chain. (Compare this reasoning with the CRA's approach in *Technical Information Bulletin* B-067, "Goods and Services Tax Treatment of Grants and Subsidies," August 24, 1992.)

In *Kretztechnik* ([2005] EUECJ C-465/03), the ECJ held that the issuance of shares by a company was not a supply to the shareholders. Rather, the activity was properly characterized as the company acquiring capital and acknowledging the new shareholders' rights from their investment (the situation may be different with respect to the transfer of existing shares; see *BLP Group plc* ([1995] EUECJ C-4/94). Interestingly, the CRA reached the opposite conclusion in *GST Policy Statement* P-108, "Raising of Capital" (January 26, 1994). One explanation may be that the ETA defines "financial service" to include the "issuance" of a "financial instrument," which in turn is defined to include equity securities (shares). However, if the issuance of shares is not a supply to begin with (on the basis of *Kretztechnik*), then it is not clear that the definition is relevant (at least in respect of the issuance of shares as opposed to insurance policies, for example).

In any event, these decisions illustrate the importance of carefully considering the nature of the activity in order to ascertain the proper characterization. The ECJ's conclusion that the activities at issue, both of which involved transfers of money, did not constitute supplies was not obvious on the basis of the broad wording of the directive provisions. The ECJ based the limits on the scope of "supply" on the nature of the VAT as a tax on consumption and on the character of the particular activity.

B.S. (Simon) Thang
London, England
b.s.thang@lse.ac.uk

Individual Pension Plans: Non-Compliance with the Primary Purpose Test

An individual pension plan (IPP) is a defined benefit registered pension plan (RPP) typically set up for one individual—the owner-manager of a private corporation. Although an IPP can be an effective method of deferring income and providing for retirement, advisers should be aware that many IPPs are not in compliance with the Act. In particular, the use of an IPP to receive funds from the RPP of the owner-manager's previous employer raises a red flag.

Consider the following situation: An individual who has worked for many years for a large employer with a defined benefit RPP wants to retire and transfer the commuted value—an amount equal to the present value of her right to a pension under that plan—to a vehicle in which it can continue to be sheltered from tax.

If she simply transfers the commuted value to her RRSP under subsection 147.3(4), the amount that she can transfer is limited by regulation 8517, and the excess must be brought into income. Thus, for example, if the commuted value is $700,000, it is possible that she will be able to transfer only $500,000 to an RRSP under subsection 147.3(4). In contrast, if she sets up a corporation, establishes an IPP for that corporation, and transfers the commuted value to the IPP, the entire $700,000 can be fully sheltered.

The potential compliance problem arises because regulation 8502(a) provides that the primary purpose of an RPP must be to provide periodic payments to individuals after retirement and until death in respect of their service as employees. This test is easily met in a normal private corporation with business operations and employment duties for the owner-manager. However, in some corporations that are set up for commuted-value transfers to IPPs, no business is being carried on, there is no remuneration, and there is no bona fide employment relationship between the plan sponsor and the member.

In such a situation, the CRA will likely apply section 147.1 to revoke the plan's registered status as of the date of inception of the IPP. Unless the year is statute-barred, the full $700,000 will have to be brought into income, and tax on that amount plus interest will be due. In addition, if the individual has transferred an amount to an RRSP from the revoked plan, the transfer will be ineligible, the amount transferred will be an excess contribution to the extent that RRSP deduction room did not exist, and a further penalty of 1 percent per month will apply.

An appeal from the CRA's decision to revoke an IPP's registered status is made directly to the FCA, which has issued several decisions upholding the CRA's interpretation. (See *1346687 v. Canada* (2007 FCA 262); *Jordan Financial v. Canada* (2007 FCA 263); *Boudreau v. Canada* (2007 FCA 32); *1398874 v. Canada* (2010 FCA 14); *Loba v. Canada* (2004 FCA 342); *Loba v. Canada* (2008 FCA 403); and *Hodge v. Canada* (2009 FCA 210).) One can expect little sympathy from the court. In *Hodge*, for example, the FCA refused to alter the date of revocation to mitigate the burdensome tax consequences of revocation because "[i]f there were no adverse tax consequences on the revocation of the registration of employee pension plans that never complied, there would likely be many more such schemes."

Nabeel Peermohamed
Toronto
nabeel.peermohamed@mail.utoronto.ca

Principal Residence: When Civil Law Muddles Tax Law

The notion of "principal residence" is an important concept in tax law. Under the Act, a taxpayer may be exempt from a capital gain resulting from the disposition of a principal residence. Even though section 54 defines the term "principal residence," Quebec private law complicates its application. Indeed, the right of ownership may be dismembered into usufruct, use, servitude, and emphyteusis under articles 1119 et seq. of the Civil Code of Québec (CCQ). Let us assume that one of these dismemberments applies to a property "ordinarily inhabited" within the meaning of "principal residence" in section 54. Suppose that a widow with a usufruct lives in the principal residence, but the bare (or legal) ownership belongs to the children. The value appreciates, and a disposition (deemed by death or an actual sale) occurs. Can each of the two parties claim an exemption for the capital gain?

For federal income tax purposes, the answer is normally yes. This conclusion is based on a reading of clause 248(3)(a)(i)(A) of the Act, which stipulates that "the usufruct, right of use or habitation, or substitution, as the case may be, is deemed to be at that time a trust," and of paragraph (c.1) of the definition of "principal residence" in subsection 54, which states that a trust may designate a property as its principal residence.

Federal income tax rules may give a different answer in the special case of usufructs created before 1991. Usufructs were deemed trusts under paragraph 248(3)(a) beginning in 1991; therefore, how does one characterize usufructs created prior to the amendments? (Under the former rules, an immovable could not be transferred to a trust.) In the absence of a deemed trust, one must refer to the applicable definitions. Under the CCQ, the usufructuary does not own the property, but possesses a real right of enjoyment (similar but not equivalent to the common-law concept of beneficial ownership). Under the definition of "principal residence," the individual must be the owner. This contradiction raises the question of how a pre-1991 usufruct can qualify as a principal residence.

The CRA interprets the pre-amendment rules under paragraph 248(3)(a) as follows: the property is not transferred to a trust, but the usufructuary is considered the de facto owner of the immovable. Therefore, the usufructuary is the only person entitled to claim the principal residence exemption when the property is sold (CRA document no. 2009-031075117, May 27, 2009). But how is the value broken down between the usufruct and the bare ownership? More specifically, does section 69 apply when the two individuals who hold rights are related within the meaning of the Act, but only one of those rights appears to qualify for the exemption? As far as can be ascertained, these questions remain unanswered.

The answer to the dismemberment question regarding the principal residence exemption is less clear for Quebec provincial income tax purposes. Revenu Québec's view is that the usufructuary may claim the principal residence exemption only "where this application does not result in any unreasonable tax consequence" (*Interpretation Letter* 10-009700-001, April 19, 2011) (my translation). A request has been filed with Revenu Québec asking for a technical interpretation of the circumstances in which such an application would not result in any unreasonable tax consequences.

Marjorie Bergeron
De Chantal D'Amour Fortier S.E.N.C.R.L./LLP
Longueuil, QC
mbergeron@dcdaf.qc.ca

Résidence principale : Lorsque le droit civil brouille la fiscalité

La notion de « résidence principale » est un concept important en matière de fiscalité. La Loi de l'impôt sur le revenu (« LIR ») permet à un contribuable, qui dispose d'une résidence principale, de bénéficier d'une exonération sur le gain en capital découlant de la disposition. Bien que la L.I.R définisse le terme « résidence principale » à son article 54, le droit privé québécois complexifie son application.

En effet, aux articles 1119 et ss du Code civil du Québec (« CcQ »), le droit de propriété peut être démembré en usufruit, en usage, en servitude et en emphytéose. Prenons pour hypothèse que l'un de ces démembrements s'applique à une propriété « normalement habitée » au sens de la définition de « résidence principale » à l'article 54. À titre d'exemple, une résidence principale où l'usufruit appartient à une veuve mais la nue-propriété appartient à ses enfants et qu'il y a disposition (présumée par le décès ou réelle par une vente), et ce, avec plus-value de la propriété. L'auteur de la disposition soit la veuve ou les enfants, selon le cas, pourra-t-il exonérer son gain en capital sur la plus-value accordée à l'un de ces démembrements ?

Aux fins fiscales fédérales, nous pouvons conclure généralement que oui. Plus précisément, cette conclusion vient du cumul de l'alinéa 248(3)a) où il est stipulé qu'« un usufruit est réputé être une fiducie — […] — et les biens sujets à l'usufruit sont réputés avoir été transférés à la fiducie — […] — et être détenus en fiducie et non autrement ». et de l'alinéa (c.1) de la définition de « résidence principale » à l'article 54 où il est indiqué qu'une fiducie peut être admise à désigner une résidence principale.

Puisque ledit alinéa 248(3)a) présume qu'un usufruit est une fiducie que depuis 1991, comment qualifier un usufruit créé avant ces changements à la LIR ? Les anciennes règles ne prévoyaient pas le transfert de l'immeuble dans une fiducie. En l'absence de ladite fiducie présumée, il faut donc revenir aux définitions applicables. En vertu du CcQ, l'usufruitier n'est pas propriétaire du bien, mais il possède un droit réel de jouissance (similaire mais pas équivalent au concept de « *benficial ownership* » en *common law*). En vertu de la définition de « résidence principale », le particulier doit être propriétaire. Cette contradiction crée un problème à savoir comment un usufruit pré-1991 peut se qualifier au titre de résidence principale.

Pour sa part, l'ARC interprète les anciennes règles contenues à l'alinéa 248(3)a) (avant-modifications) de la façon suivante : il n'y aurait pas de transfert de l'immeuble en faveur d'une fiducie, mais l'usufruitier serait considéré comme « le propriétaire de fait » du bien immeuble. L'usufruitier est donc la seule personne en mesure de réclamer l'exonération pour résidence principale lors de la vente du bien (interprétation technique : 2009-031075117, 27 mai 2009). Mais qu'en est-il de la ventilation de la valeur entre l'usufruit et la nue-propriété ? Plus précisément, l'article 69 pourrait-il trouver application dans un cas où les deux détenteurs de droit sont des personnes liées au sens des lois fiscales, mais qu'un seul des droits semblerait qualifiable pour l'exonération ? À notre connaissance, ces questions ne sont pas répondues à ce jour.

La réponse à la question du démembrement et de l'exonération de la « résidence principale » est moins claire aux fins fiscales québécoises. Revenu Québec est d'avis que l'usufruitier ne peut pas bénéficier de l'exonération pour résidence principale sauf si « aucune conséquence fiscale déraisonnable ne découle de cette application. » (*Lettre d'interprétation* 10-009700-001, 19 avril 2011). Une demande d'interprétation technique a donc été logée à Revenu Québec pour connaitre les situations où l'expression « si aucune conséquence fiscale déraisonnable ne découle de cette application » pourrait s'appliquer.

Dans l'intervalle, nous avons une fois de plus une preuve irréfutable que le droit civil québécois n'a pas fini de brouiller les concepts fiscaux.

Marjorie Bergeron
De Chantal D'Amour Fortier S.E.N.C.R.L./LLP
Longueuil, QC
mbergeron@dcdaf.qc.ca

Synthetic Dispositions: Get Cash Now, Pay Tax Later

The 2013 budget addresses concerns about transactions that use financial engineering to disentangle economic substance from legal form, effectively making the timing of a disposition of property for tax purposes an election. Normally, the purpose of such a transaction is to obtain the cash for property while deferring the tax on a gain—for example, in an equity monetization (EM). However, nothing in the proposals limits their application to equity holdings or even to capital property, and the budget notes that the transaction's purpose could be to more fully recognize a loss by avoiding stop-loss rules rather than to defer tax on a gain.

An EM in its plain vanilla form may be as simple as a loan secured by a pledge of shares, without further recourse against the borrower. The taxpayer retains the title to the shares, the voting rights, and the right to any dividends declared and paid. Upon maturity (typically, five years or longer), the taxpayer may forfeit the pledged shares (likely, if they are worth less than the outstanding loan balance) or settle the loan in cash and secure the return of the pledged shares (likely, if they are worth more than the outstanding loan balance). Further refinements of this simple arrangement using options and other financial derivatives can also eliminate the upside potential of holding the shares in return for increased cash.

The government's problem is that there are a wide variety of potential deal structures, some of which leave the equity owner with more risk or return than others. When the government legislated against a previous tax-avoidance strategy involving derivatives known as weak currency loans, it chose a specific quantitative threshold ("exceeds by more than two percentage points": subsection 20.3(1)). This time, the government has chosen a more conceptual approach: the budget proposes to create a deemed disposition at the time the taxpayer enters into a synthetic disposition arrangement, which is defined to be all types of transactions that "have the effect of . . . eliminating all or substantially all of the taxpayer's risk of loss and opportunity for gain or profit in respect of the property for a period of more than one year" (subject to certain exclusions). Thus, the loan-based EM discussed above would not be caught unless the refinement eliminating the upside potential was also added.

In the United States, similar issues have been addressed for many years in the interplay between EMs and both the "constructive sale" provisions and the meaning of the "sale or exchange" of property. Accordingly, the US market response may provide some guidance on how to structure transactions to stay outside the proposed Canadian legislation as well as the general legal definition of "disposition." The following amendments to EM deals may be instructive:

- the taxpayer retains the benefit of price appreciation of up to 10 percent, and accepts the risk of price decreases of up to 10 percent over the length of the contract (perhaps five years);
- the pledged shares are not to be lent to the party on the other side of the transaction (typically a bank) or, for 60 days, to any other party;
- the taxpayer retains voting and dividend rights; and
- at the maturity of the contract, the taxpayer has the option of making a cash settlement rather than delivering the shares, and of delivering other shares rather than the specific shares originally pledged.

Robert Panasiuk
Toronto
rwpanasiuk@sympatico.ca

Unexpected Application of Part XII.2 Tax to a Canadian Personal Trust

An inter vivos trust resident in Canada may initially have only Canadian beneficiaries, but over time the beneficiaries' residences may change. For example, an individual designated as a beneficiary of a trust may study in the United States and then decide to remain there, severing his or her residential ties with Canada. In such a case, part XII.2 tax may apply to the trust, which is a resident of Canada, since one of its beneficiaries has become a non-resident of Canada under the Act.

Part XII.2 tax is imposed on a trust in order to ensure that certain types of trust income allocated to a non-resident beneficiary bear an appropriate level of tax—that is, tax at rates comparable to those applicable under part I to income that is received directly (without interposing a trust). In the absence of part XII.2, the rates applicable under part XIII would apply.

Where applicable, part XII.2 tax applies at the rate of 36 percent on the income from a business operated in Canada earned by a trust, on the income from real property located in Canada earned by the trust, and on the taxable capital gains from the disposition of taxable Canadian property owned by the trust. Interest and dividend income are not included in the definition of "designated income" in current subsection 210.2(2) or in proposed subsection 210(1) and thus are not subject to part XII.2. Part XII.2 tax must be paid by the trust within 90 days from the end of its fiscal year, and it applies to the three types of trust income mentioned above, not just to the amounts allocated to the non-resident beneficiaries. However, beneficiaries who reside in Canada are generally entitled to a refund of the part XII.2 tax paid by the trust on the portion of income attributed to them. Cash flow problems can arise because part XII.2 tax must be paid by the trust many months before the beneficiary's tax return is filed and the refund is received.

Planning opportunities to deal with the emigration of a beneficiary and the resulting application of part XII.2 tax to a trust appear to be quite limited. In some non-arm's-length situations, the non-resident might agree to be removed as a beneficiary. Alternatively, the non-resident could avoid receiving any income or capital from the trust for any given fiscal year in the hope that he or she would not be classed as a beneficiary and thus would not trigger the application of the tax to the trust for that year. The basis of this argument is that the Act does not define the term "beneficiary" for the purposes of part XII.2. Although the non-resident would be "beneficially interested" (as defined in subsection 248(25)) in the trust and thus would meet the definition of "beneficiary" in subsection 108(1), the preamble to that subsection limits the application of the definition to subdivision k (sections 104 to 108). However, in obiter dicta in *Propep Inc.* (2009 FCA 274), the FCA extended the application of the definition of "beneficially interested" beyond those specific sections (in that decision, to subparagraph 256(1.2)(f)(ii)). Thus, at present it is unclear whether avoiding distributions from the trust to non-residents of Canada during a taxation year will be sufficient to eliminate the application of part XII.2 tax to the trust.

Audrey Gibeault
Lavery de Billy S.R.L., Montreal
agibeault@lavery.ca

Are Payments to Research Assistants Tax-Free?

A common tax-planning strategy employed by universities in the last several years has been to treat payments to students holding research assistantships as tax-exempt scholarship income rather than as taxable research grants or employment income. However, this strategy has not been directly tested in court, and the CRA's opinion is ambiguous. The CRA's current views are described in a folio (the successor to interpretation bulletins, information circulars, and other documents) released for public consultation on March 28, 2013 (*Income Tax Folio* S1-F2-C3, "Scholarships, Research Grants and Other Education Assistance"). Consultations are to last for three months.

Unlike employment income and research grants, scholarship income may be fully exempt from personal income tax pursuant to subsection 56(3), provided that it is considered to be received in connection with the recipient's enrolment in an educational program in respect of which an education tax credit can be claimed under subsection 118.6(2). Generally, if the student is enrolled on a full-time basis at a university or college in a program that either leads to a diploma or degree or does not consist primarily of research, the exemption will be available.

The CRA's view is that an award involving a research component should be classified as follows:

1) if the primary purpose of the award is to further the education and training of the recipient, the award will be considered a fellowship (scholarship) (paragraph 3.31);
2) if the primary purpose of the award is to enable the recipient to carry out research for its own sake, the award will be considered a research grant (paragraph 3.32); and
3) if the research is conducted in the context of a traditional employment relationship as determined by the usual factors, the award will be employment income (paragraph 3.29).

This guidance seems to provide universities with some flexibility to classify research assistantships in programs with a thesis requirement (especially PhD programs, but also some master's programs) as scholarships, since the research can be viewed as integral to the completion of the educational program.

The CRA's statements seem relatively clear, if open to interpretation. However, paragraph 3.72 (restating *Interpretation Bulletin* IT-75R4, paragraph 30) suggests that when the funds for a research assistantship are paid out of a research grant—presumably received by the supervising faculty member from a source such as NSERC or SSHRC (as opposed to general university monies)—the payment should be classified as either a research grant or employment income to the student. This implies that such payments cannot be classified as scholarships, and hence should not be eligible for the corresponding exemption from tax. Finally, in commenting on the tax treatment of amounts paid to exceptional international students in their capacity as research assistants under a program offered by a university, the CRA did not refer to the source of the funds involved, but nevertheless indicated that the amounts could potentially qualify as either scholarships or research grants (2011-0427891E5). It is hoped that the final version of the folio will provide some clarity concerning this issue.

The case law is similarly unclear. *The Queen v. Amyot* (76 DTC 6217 (FCTD)) indicates that the purpose of the payment is determinative. *DiMaria v. The Queen* (2008 TCC 114) stands for the proposition that an amount need not be awarded on the basis of academic achievement in order to be classified as a scholarship; nevertheless, it leaves open the possibility that some selection process or criteria may be necessary, notwithstanding that the payer is free to establish such criteria. In *Okonski v. The Queen* (2008 TCC 142), decided under the informal procedure, payments were found to be scholarships, notwithstanding that an unlimited number were available. In summary, it is not clear whether payments can be treated as scholarships if they are provided to all or most students in an academic program, as might occur in PhD programs.

For reference purposes, the following links provide examples of policies adopted by a variety of Canadian universities regarding payments for research assistantships.

- University of British Columbia (www.grad.ubc.ca/current-students/managing-your-program/graduate-research-assistant-gra)
- University of Waterloo (www.research.uwaterloo.ca/finance/documents/GRSvsGRA_000.pdf)
- University of Windsor (www.uwindsor.ca/graduate/system/files/Research%20Assistant%20Guidelines%20November%202012.pdf)

Mark Dumalski
Deloitte LLP, Ottawa
mdumalski@deloitte.ca

Dimitri Sarabalos
Tim Hortons Inc., Oakville
sarabalos_dimitri@timhortons.com

Potential authors are encouraged to send ideas or original submissions to the editor of *Canadian Tax Focus*, Alan Macnaughton (amacnaug@uwaterloo.ca), or to one of the contributing editors listed below. Content must not have been published or submitted elsewhere. Authors should ensure that their firms' applicable review policies and requirements for articles bearing the firm's name have been met before submitting material to *Canadian Tax Focus*.

For each issue, contributing editors from Young Practitioners chapters across Canada suggest topics and assist authors in developing ideas for publication. For the May 2013 issue, we thank the following contributing editors:

Halifax:
- Sean Glover (sglover@coxandpalmer.com)
- Dawn Haley (dawn.m.haley@ca.pwc.com)

Montreal:
- Marie-Hélène Tremblay (mhtremblay@ravinskyryan.com)

Quebec City:
- Amélie Guimont (amelie.guimont@ca.pwc.com)

Ottawa:
- Mark Dumalski (mdumalski@deloitte.ca)
- Amanda Hachey (ahachey@deloitte.ca)

Toronto:
- Timothy Fitzsimmons (timothy.fitzsimmons@dentons.com)
- Brent Pidborochynski (bpidborochynski@thor.ca)

Winnipeg:
- Darryl R. Antel (antel@pitblado.com)

Edmonton:
- Tim Kirby (tkirby@felesky.com)

Calgary:
- Lisa Handfield (lisahandfield@yahoo.com)
- Bernice Wong (bwong@mccarthy.ca)

Vancouver:
- Trevor Goetz (trevor.goetz@ca.gt.com)
- Laura Jeffery (ljeffery@kpmg.ca)

ISSN 1925-6817 (Online). Published quarterly.