TAX FOR THE Owner-Manager

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The Scary New World of Specified Corporate Income

The federal budget tabled on March 22, 2016 introduced a new concept called "specified corporate income" (SCI). If the new concept is implemented as proposed, it will curtail the use of the small business deduction (SBD) by a fairly wide group of CCPCs. SCI, as defined, will be excluded from the SBD definition in subsection 125(1).

This important change in CCPC taxation is set out in the proposed amendments to subsection 125(7). The amendments will restrict the availability of the SBD in respect of income earned from certain intercorporate transactions if the corporations have common or non-arm's-length shareholdings, and even if the corporations are neither associated nor related. The draft legislation defines SCI as the active business income (ABI) of the (payee) corporation where, at any time in the year, the payee corporation (or one of its shareholders) or a person who does not deal at arm's length with the payee corporation (or one of its shareholders) holds a direct or indirect interest in the private (payer) corporation.

Therefore, if the payer corporation or one of its shareholders is non-arm's-length with the payee corporation or one of its shareholders, any intercorporate fee received by the payee corporation is excluded from its preferential low SBD corporate tax rate and is subject to the higher ABI corporate tax rate.

The annual corporate tax differential between SBD and non-SBD ABI ranges from approximately 8 percent to 16 percent, depending on the CCPC's province of residence. There are two main exceptions to the SCI rules. The first exception, found in proposed subsection 125(3.2), is that the payer corporation may assign a portion of its SBD to the payee corporation if certain conditions in the provision are met. In an associated corporate group, this concept is similar to the existing concept of allocating the SBD. However, the SCI rules now expand this allocation concept to potentially related or unrelated corporate groups.

The second exception applies if all or substantially all of the corporation's ABI for the year is derived from the provision of services or property to certain persons and partnerships with which the corporation deals at arm's length. The CRA's administrative position is that "all or substantially all" in other provisions of the Act means at least 90 percent. Presumably, the CRA will take a similar administrative position with respect to the proposed subsection. Note that related persons are deemed not to be dealing at arm's length; however, unrelated persons may also be considered not to be at arm's length as a matter of fact. The determination of arm's-length status now becomes a critical part of the year-end corporate tax filings for tax preparers in ascertaining whether any portion of a CCPC's income includes SCI. For preparers who are not experienced in this area of tax law and jurisprudence, an incorrect determination may prove costly to the client and intimidating to the preparer.

Another intimidating part of the proposed definition of SCI is that it does not appear to exclude the case in which the common or non-arm's-length shareholding is non-voting or below some minimum percentage or value. Further, ABI is a "net income" concept. The tax preparer will now have to match expenses related to the SCI gross income to determine how much active business (net) income is taxed at the low and high SBD rates, respectively. There are no clear rules that show how to do this. As the tax community becomes familiar with the proposals, other issues will be identified. We anticipate that there will be ongoing commentary on the proposals and that this response may lead to some tweaking of the proposals on the part of the Department of Finance.

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In This Issue

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Fictitious Business Losses and Subsection 163(2) Penalties: "This Isn't Horseshoes"

Until recently, the TCC had unanimously upheld subsection 163(2) penalties assessed for fictitious business losses claimed in the tax returns of naïve individuals who entrusted their reporting to fraudsters. The fraudulent schemes operate to generate large refunds paid erroneously by the minister, a portion of which is paid to a preparer who goes rogue after assessment by the CRA. However, in a recent trilogy of cases—*Anderson v. The Queen* (2016 TCC 93), *Morrison v. The Queen* (2016 TCC 99), and *Sam v. The Queen* (2016 TCC 98)—Rowe J allowed the three appeals from the assessment of subsection 163(2) penalties with respect to fictitious business losses. The trilogy is a reminder to the CRA to carefully consider all of the circumstances before assessing a subsection 163(2) penalty. As Rowe J noted in *Anderson*, tax practitioners "must be wary of applying our special knowledge to a situation and to use that as a yardstick by which to judge the conduct of ordinary people who have little or no understanding of the federal income tax system."

The FCA held in *Strachan v. Canada* (2015 FCA 60) that when one is assessing subsection 163(2) penalties, knowledge of a false statement can be attributed to a taxpayer's wilful blindness. In determining wilful blindness, one must consider the education and experience of the taxpayer. Further, according to *Bhatti v. The Queen* (2013 TCC 143) and *Torres v. The Queen* (2013 TCC 380), circumstances that indicate the need for an inquiry prior to filing include (1) the magnitude of the advantage or omission; (2) how blatant or detectable the error is; (3) a lack of acknowledgment by the tax preparer in the return itself; (4) unusual requests by the tax preparer; (5) the tax preparer being previously unknown to the taxpayer; (6) incomprehensible explanations by the tax preparer; and (7) whether others engaged the tax preparer or warned against doing so, or whether the taxpayer himself or herself expressed concerns about telling others. The final requirement for wilful blindness is that the taxpayer has made no inquiry of the tax preparer, a third party, or the minister in order to understand the return.

How did the taxpayers in *Anderson*, *Morrison*, and *Sam* avoid a finding of wilful blindness for the fictitious losses claimed in their returns? Each case was decided on its particular facts; however, the court found that none of the taxpayers were sophisticated in matters of tax, accounting, or business, and all of the taxpayers had previously required assistance to prepare their tax returns. The taxpayers either relied on recommendations from trusted friends who demonstrated that they had previously used the rogue tax preparer without any queries from the minister (*Anderson* and *Morrison*) or were referred to the tax preparer by their existing accounting firm (*Sam*). Most importantly, in all three cases the statement of agent activities, filed with the taxpayer's return or T1 adjustment request reporting fictitious revenues and expenses, was found to have been inserted by the tax preparer after the taxpayer had signed the return or the adjustment request.

In *Wynter v. The Queen* (2016 TCC 103), Rowe J took the opportunity to criticize the CRA for facilitating these scams by not having an early warning system that would put taxpayers on notice before a formal assessment was issued. The gross negligence penalty was upheld in that decision, largely because the taxpayer submitted the return herself. Therefore, there were no duplicitous insertions and the taxpayer had more of an opportunity to review and consider the statements made.

The minister has been criticized for being overly aggressive and applying an oversimplified legal test when assessing subsection 163(2) penalties. For example, in *Fourney v. The Queen* (2011 TCC 520) and in *Mason v. The Queen* (2014 TCC 297; aff'd. on other grounds, 2016 FCA 15), the court held that the "ought to have known" and the "should have known" tests applied by the minister to assess subsection 163(2) (and ETA section 285) penalties are wrong at law. A "high degree of negligence" is required (*Venne v. The Queen*, [1984] CTC 223 (FCTD)), and the magnitude of a misrepresentation or omission is not, by itself, sufficient to justify the imposition of a subsection 163(2) penalty (*Murugesu v. The Queen*, 2013 TCC 21). The recent decisions by Rowe J emphasize the importance of considering the full factual context and they signal the court's concern about the severity of the gross negligence penalty. The effect of the fraudulent schemes, including the resulting assessment of subsection 163(2) penalties, was described as cruel and capable of causing "extreme damage and even destroy[ing] careers, lives, marriages and families" (*Wynter*, at paragraph 43). At a minimum, the minister owes it to taxpayers to carefully consider the surrounding context and to apply the correct legal test when determining whether to assess a subsection 163(2) penalty. For the minister to discharge her onus under subsection 163(3), being close is not enough. As Rowe J remarked in *Sam*, "this isn't horseshoes."

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McGillivray Restaurant Ltd.: The Meaning of De Facto Control Clarified

In the recent case of *McGillivray Restaurant Ltd. v. Canada* (2016 FCA 99), the issue on appeal was whether in the relevant taxation years McGillivray Ltd. was associated with GRR Holdings and MorCourt Properties, on the basis that an individual, Mr. Howard, who had both de jure and de facto control of GRR and MorCourt, also had de facto control of McGillivray Ltd. within the meaning of subsection 256(5.1).

The facts were relatively simple. Mr. Howard and Mrs. Howard were married to each other. Mr. Howard owned all of

the issued shares of GRR and MorCourt. In 1997, GRR entered into franchise agreements with Keg Restaurants Ltd.

Mr. Howard, having decided that one of the restaurants should be relocated, obtained professional advice in respect of the new location. McGillivray Ltd. was incorporated for the purpose of acquiring and operating the new location. Upon McGillivray's organization, Mrs. Howard was issued 760 voting common shares for $76 and Mr. Howard was issued 240 voting common shares for $24. Mr. Howard was the sole director and the sole officer of McGillivray Ltd. Mr. Howard did not require Mrs. Howard's approval to make decisions on behalf of McGillivray Ltd. There was no written shareholders' agreement. After receiving Keg's required consent, the franchise agreement held by GRR applicable to the new location was assigned to McGillivray Ltd. Mr. Howard had assured Keg (as well as the employees of GRR) that notwithstanding these changes, the business would be run on the same basis as in the past. A similar assurance had been given to Mrs. Howard.

In the TCC's decision (2014 TCC 357), Boyle J had determined that there were two competing interpretations of subsection 256(5.1) (the provision addressing the meaning of de facto control). The first, as described by the FCA, was set out in *Silicon Graphics Ltd. v. Canada* (2002 FCA 260) and provided a narrow interpretation

> under which a person would only be considered to have control in fact if that person had the clear right and ability either to effect significant change in the board of directors or the powers of the board of directors or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors.

The second interpretation, as described by the FCA, was based on the decisions of the FCA in *Mimetix Pharmaceuticals Inc. v. Canada* (2003 FCA 106) and *Plomberie J.C. Langlois inc. v. Canada* (2006 FCA 113); it employed a broader test that required looking beyond the ability to affect the composition or powers of the board, and considering "broad manners of influence" in determining who had effective control of a corporation.

The TCC, having decided that *Mimetix* and *Langlois* were binding, applied the broader test and held that Mr. Howard could not have had any more effective factual control over the management and operation of McGillivray Ltd. and its business.

Ryer JA, speaking for a unanimous court, held that the correct test for determining the issue of de facto control was the narrow test set out in paragraph 67 of the decision of Sexton JA in *Silicon Graphics*:

> It is therefore my view that in order for there to be a finding of *de facto* control, a person or group of persons must have the clear right and ability to effect a significant change in the board of directors or the powers of the board of directors or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors.

In reaching this decision, Ryer JA stated that the test in *Silicon Graphics* had been affirmed in *9044 2807 Québec Inc. v. Canada* (2004 FCA 23), and he concluded that that case had not altered the test for de facto control enunciated in *Silicon Graphics*. He further stated that although *Mimetix* and *Langlois* appeared to have employed the broader test identified by Boyle J, the narrower test set out in *Silicon Graphics* had not been directly challenged in either of those decisions. Ryer JA held that those decisions should not be followed to the extent that either of them could be taken as having prescribed a test for de facto control that was inconsistent with the *Silicon Graphics* test. He also held that the decision in *Lyrtech RD Inc. v. Canada* (2014 FCA 267) should not be followed to the extent that it could be taken as having repudiated the *Silicon Graphics* test.

The FCA in *McGillivray* rejected any assertion that the test for de facto control should be based on "operational control." The court further held that the difference between de facto and de jure control related to the breadth of factors that can be considered in determining whether a person or a group of persons has effective control by means of an ability to elect the board of directors of a corporation. In the case of de facto control, a broader range of factors (such as a non-unanimous shareholders' agreement) can be considered. The FCA stated that although the list of such factors is open-ended,

> a factor that does not include a legally enforceable right and ability to effect a change to the board of directors or its powers, or to exercise influence over the shareholder or shareholders who have that right and ability, ought not to be considered as having the potential to establish *de facto* control.

Ryer JA stated that the TCC had found that Mr. and Mrs. Howard had reached an unwritten agreement under which the identity and composition of the board of directors of McGillivray Ltd. would be under the control of Mr. Howard. The FCA held that as long as the agreement was not repudiated by Mrs. Howard, it was influence of the type contemplated by subsection 256(5.1) as interpreted in *Silicon Graphics*. Consequently, because Mr. Howard was found to have de facto control of McGillivray Ltd., the appeal was dismissed.

McGillivray is a welcome decision for tax practitioners because it has clarified the very confusing jurisprudence on the meaning of "de facto control." This clarification has significantly narrowed the ambit of de facto control and has left practitioners with the much simpler and more easily applied test set out in *Silicon Graphics*. It remains to be seen whether the Department of Finance will see fit to amend the provision.

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Admissibility of an Accountant's Statements in Court

An out-of-court statement is generally inadmissible as evidence in court to prove the truth of the statement's contents: this is the general rule against hearsay. There are a number of exceptions to this rule, including an admission made by the opposing party. An admission is admissible as evidence of its contents. When the opposing party's agent makes such a statement, it is also admissible as evidence of the truth of its contents. The recent decision in *R v. Spears* (2016 NSPC 20) stands for the proposition that a taxpayer's accountant's statement to the CRA can be admitted as evidence of the truth of its contents. This is an important case for business owners who rely on their accountants to deal with the CRA on behalf of the business.

Spears is a procedural decision that was rendered in a Nova Scotia criminal proceeding against the taxpayer under ETA paragraph 327(1)(c) for wilful or attempted evasion of GST compliance, payment, or remittance. Details of the offence were not included in the judgment; however, it appears that the corporate defendant, a framing company, had a significant unpaid GST/HST balance. The defendant submitted to the CRA form RC59 ("Business Consent") designating an accountant (who was not an employee of the defendant) as the defendant's "authorized representative." The accountant allegedly made certain statements to the CRA that the CRA wanted to use as evidence of the truth of their contents in the criminal proceedings. The taxpayer objected.

The central issue was whether the accountant was acting as agent for the defendant when she made the particular statements. The minister argued that she was; the defendant argued that she was not, because she was an independent contractor.

The court noted that there is no bright line precluding an independent contractor from being given agency powers by the party who has engaged the contractor's services. Although the accountant did not enjoy the broadest range of agency powers (such as the power to contract on behalf of the taxpayer or to assume liability for its debts), this was not determinative of whether she acted as agent in making the particular statements to the CRA. Similarly, the lack of express authorization to make the statements to the CRA did not imply that an agency authorization did not exist. The court cited authority that noted that it would be rare to find such express authority for these types of statements.

The court ultimately concluded that the accountant was acting as the agent of the defendant in making the statements, and that the statements were admissible as evidence for the truth of their contents in the criminal proceeding. Supporting factors that the court cited included the fact that the accountant was heavily involved with the CRA on the defendant's behalf: inter alia, she signed and filed GST/HST returns and routinely spoke with CRA officials when they called about the defendant (even after the defendant had ceased active operations).

This decision suggests that when an accountant or other professional adviser (including a lawyer) is dealing with tax authorities regarding a taxpayer's affairs, a statement made by the professional may bind the taxpayer and may be used against that taxpayer as evidence of the statement's contents. The court acknowledged that this analysis is fact-driven, which suggests that a professional retained by the taxpayer will not always be considered an agent of the taxpayer. However, owner-managed businesses tend to have arrangements with outside accountants and other professionals similar to the arrangement between the defendant and the accountant in this case—that is, the accountant is responsible for filing returns and dealing with the CRA on the business's behalf. Accordingly, we expect that statements made by accountants for owner-managed businesses will typically be admissible as evidence of their contents. Lawyers who make similar statements should be even more careful, because lawyers are generally viewed as authorized agents for their clients.

The finding of an agency relationship here is probably correct on the facts. The accountant was the exclusive person dealing with the CRA on behalf of the taxpayer (and signing off on returns), and a conclusion of implied agency relationship seems appropriate.

In our view, however, the mere fact that an accountant or other professional is dealing with the CRA on behalf of a taxpayer (even if he or she is signing the returns) does not always imply that the statements made by the accountant should be admissible for the truth of their contents. The extent to which the accountant truly has knowledge of the taxpayer's business operations and the actual content of the statements themselves should be key factors when the court conducts its "fact-driven" analysis.

The important point is that businesses must ensure that they have competent and knowledgeable professionals handling tax matters on their behalf. When business owners and managers leave their tax matters exclusively up to their hired professionals, they ought to be aware that those professionals' statements can be used as evidence against them in court proceedings.

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Lumpy Creditor-Protection Dividends and Subsection 55(2)

When one is determining whether an ordinary dividend (that is, a dividend that is not a deemed dividend under subsection 84(3)) will be recharacterized under subsection 55(2), one of

the conditions in proposed paragraph 55(2.1)(b) is the so-called purpose test. This test will be satisfied if one of the purposes of the dividend is to

1) effect a significant reduction in the capital gain that would be realized on a disposition of *any* share of the dividend payer immediately before the occurrence of the dividend,
2) effect a significant reduction in the FMV of any share of the dividend payer, or
3) effect a significant increase in the cost of the property of the dividend recipient.

As a consequence of the proposed amendments to paragraph 55(3)(a), the purpose for the payment of a "lumpy" creditor-protection dividend has become a matter of critical importance in determining whether creditor-protection strategies will be tax-effective. For present purposes, a lumpy creditor-protection dividend can be conceptualized as a dividend paid outside the normal course by a subsidiary corporation to a parent corporation, with the parent then loaning the proceeds of the dividend back to the subsidiary on a secured basis.

At the Canadian Tax Foundation's 2015 CRA Round Table (see the January 2016 issue of *Tax for the Owner-Manager* for a succinct summary), the CRA opined that these types of dividends would be subject to the application of subsection 55(2). This position was affirmed in a recent technical interpretation (2015-0617731E5, December 21, 2015). The CRA's rationale for applying subsection 55(2) to recipients of creditor-protection dividends is that the dividends effectively result in the conversion of untaxed appreciation in the subsidiary's assets into high-ACB debt that can be sold without any capital gain.

From an administrative standpoint, the CRA's position is understandable. It is arguable that the purpose and the result of a creditor-protection dividend are intertwined to such a degree that they cannot be analyzed separately. That is, the result of the dividend (the reduction in the FMV of the subsidiary corporation's shares) must necessarily follow if the creditor-protection purpose is to be effected. Further, a less restrictive interpretation of the purpose test could embolden taxpayers to circumvent subsection 55(2): many taxpayers would be quick to identify a creditor-protection purpose motivating the payment of a significant dividend.

Notwithstanding the CRA's concerns, it is questionable whether its views on the application of subsection 55(2) to creditor-protection dividends are correct. It is well established that the purpose test is a subjective test and not an objective, results-based test (see *Canada v. Placer Dome Inc.*, 1996 CanLII 4094 (FCA)). In other words, the relevant determination is whether the taxpayer's subjective intention was to effect one of the purposes outlined in proposed paragraph 55(2.1)(b). The fact that the payment of a creditor-protection dividend will almost certainly *result* in the satisfaction of one or all of the criteria in proposed paragraph 55(2.1)(b) should not matter if the recipient can prove that none of its subjective purposes for receiving the dividend is one of the criteria in proposed paragraph 55(2.1)(b).

The subjective purpose of a creditor-proofing dividend was considered in *CPL Holdings Ltd v. The Queen* (95 DTC 5253 (FCTD)), the reasoning in which was approved of in *Placer Dome*. In *CPL Holdings*, the parent corporation received a taxable dividend from a wholly owned subsidiary in an amount equal to the accrued capital gain on the shares of the subsidiary (unsurprisingly, the dividend exceeded safe income on hand). The appellant's position was that the sole purpose for the payment and receipt of the dividend was creditor protection. The minister reassessed CPL Holdings on the basis that subsection 55(2) applied to the dividend because one of the purposes for its payment was to reduce the accrued capital gain. On the basis of the evidentiary record, the court held that the sole purpose of the dividend was creditor protection and that the reduction of the accrued capital gain was not a purpose. Consequently, subsection 55(2) did not apply.

Although the court in *CPL Holdings* did not have to consider the new criteria in proposed paragraph 55(2.1)(b), it is the court's reasoning that is instructive. The analysis of the appellant's purpose focused solely on the testimony of the witnesses and their credibility, without regard for the practical effect of the payment of the dividend. Absent a decision of the FCA to the contrary, a future court should generally be expected to adopt the same reasoning. *CPL Holdings* therefore remains good authority for the proposition that a dividend should not satisfy any of the criteria in proposed paragraph 55(2.1)(b) if the dividend recipient can show convincing evidence that the need to protect against creditors was the sole subjective purpose for the payment and receipt of the dividend.

Nevertheless, a taxpayer that relies on *CPL Holdings* risks confrontation with the CRA. Ideally, implementing a policy of paying normal-course dividends (and having a history of paying such dividends) would be a preferable strategy for achieving creditor protection. The CRA's comments at the 2015 Round Table suggest that these dividends should not be recharacterized. In the alternative, if the parties are quite confident that no unrelated persons will be involved in the series of transactions that includes the dividends, it may be advantageous to employ a "roll-and-redeem" strategy that relies on paragraph 55(3)(a). However, if reliance on paragraph 55(3)(a) is inadvisable and business realities necessitate more proactive creditor protection, potential recipients of a lumpy creditor-protection dividend are strongly advised to (1) confirm that no purpose for the payment of the dividend is described in proposed paragraph 55(2.1)(b); (2) ensure that the rationale for the payment of the dividend is well evidenced; and (3) be prepared to defend their filing position.

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FCA Sends Spouses' Plan To Split Capital Gain Back to TCC for GAAR Analysis

In *Canada c. Gervais* (2016 CAF 1), the FCA instructed the TCC to undertake a GAAR analysis of the taxpayers' (Mr. and Mrs. G's) interspousal capital-gains-splitting strategy, which had been put in place just before the sale of the family business corporation. Mr. and Mrs. G's strategy (sometimes referred to as a "half-loaf plan") involved a sequential sale and gifting of two blocks of a single class of shares from Mr. G to Mrs. G with the objective of averaging Mrs. G's ACB in the two blocks of shares. The strategy essentially shifted a portion of the capital gain on the third-party sale to Mrs. G. Because Mrs. G was able to fully offset her portion of the capital gain using her capital gains exemption, the strategy reduced the total amount of tax paid on the arm's-length sale.

The FCA rejected the TCC's decision (2014 TCC 119) that Mrs. G's gain on the block of shares that she had purchased from her husband should be characterized as being on income account and that the ACB-averaging rule should therefore not apply. Instead, the FCA held that this gain (and the gain on the disposition of the block of shares that Mr. G had gifted to her) should be characterized as being on capital account, and consequently the ACB-averaging rule applied to both blocks of shares. Thus, absent the application of GAAR to the series of transactions, the half-loaf plan worked.

I have simplified the facts of the case for the purposes of this article. Essentially, Mr. G was a shareholder of Opco. He accepted an offer to sell his Opco shares to an unrelated third party for $2 million. This sale was scheduled to occur on October 7, 2002. Mr. G's ACB in the Opco shares was nominal.

Mr. G sold half of his Opco shares to Mrs. G at their fair market value of $1 million ("the purchased shares") on September 26, 2002. Mr. G elected out of the spousal rollover under subsection 73(1). As a result, Mr. G reported a $1 million capital gain on his income tax return, and Mrs. G's ACB in this block of shares was $1 million. The attribution rules did not apply to this block of shares because Mr. G elected out of the spousal rollover and Mrs. G paid FMV consideration to Mr. G.

On September 30, 2002, Mr. G gifted the remaining $1 million worth of his Opco shares to Mrs. G ("the gifted shares"). The spousal rollover provision applied. As a result, Mrs. G's ACB in this second block of shares was nominal, and the attribution rules would apply to a future capital gain on the disposition of those shares.

On October 7, 2002, Mrs. G sold all of her Opco shares to the third party for $2 million. In computing her capital gain on the disposition, Mrs. G applied the ACB-averaging rule under subsection 47(1) to her two blocks of Opco shares (the purchased shares and the gifted shares) so that the ACB of each of the blocks of shares was $500,000 and the capital gain on each of the blocks of shares was $500,000.

Mr. G reported a capital gain of $500,000 that was attributed to him by Mrs. G for the third-party sale of the gifted shares; thus, he reported a total capital gain related to the Opco shares of $1.5 million. Mrs. G reported a capital gain of $500,000 on the sale of the purchased shares, which was completely offset by her capital gains exemption. The taxpayers' plan essentially shifted $500,000 of Mr. G's capital gain to Mrs. G, allowing that portion to be sheltered by Mrs. G's capital gains exemption.

The CRA challenged the taxpayers' filing positions, stating that the ACB-averaging rules could not apply because the gain on Mrs. G's disposition of the purchased shares to the third party should be taxed as income, not as a capital gain. Alternatively, the CRA argued that GAAR applied to add her $500,000 capital gain to Mr. G's capital gain.

If the ACB-averaging rules did not apply, Mr. G would have to pay tax on the entire $2 million capital gain, because the gifted shares would have had nominal ACB, and the capital gain on Mrs. G's sale of the gifted shares that was attributable to Mr. G would therefore have been $1 million. Mrs. G's cost of the purchased shares would be $1 million (the amount that Mrs. G paid for those shares), and Mrs. G would thus have no gain on the purchased shares. The success of the tax plan was dependent on the application of the ACB-averaging rules to move $500,000 of Mrs. G's basis in the purchased shares (which was not subject to the attribution rules) over to the gifted shares. This move would reduce the capital gain that was attributable to Mr. G and increase the capital gain left in Mrs. G's hands.

In general, when an individual (other than a trust) transfers capital property to the individual's spouse, subsection 73(1) provides for a rollover of the property at its ACB, unless the taxpayer elects not to have the subsection apply.

Generally, when an individual loans or transfers property to his or her spouse, subsections 74.1(1) and 74.2(1) attribute any income, gains, or losses from the property (or substituted property) back to the transferor. The attribution rules do not apply when the transferor spouse receives FMV consideration for the transferred property and the transferor spouse elects not to have the rollover provision in subsection 73(1) apply to the transfer, as per subsection 74.5(1).

Subsection 47(1) is a cost-averaging provision that applies when one is determining the ACB of property in circumstances where a taxpayer has acquired identical properties at different times. Generally, if at a particular time a taxpayer who owns property acquires property that is identical to the previously acquired property, subsection 47(1) deems certain events to have occurred. In particular, the taxpayer is deemed to have disposed of the previously acquired identical property immediately before that particular time for proceeds equal to its ACB, and the taxpayer is deemed to have acquired all of the identical property (including the new identical property) for

proceeds equal to the average cost basis of all of the identical properties.

In its decision, the TCC said that the gain on the disposition of the purchased shares should be characterized as business income, since Mrs. G acquired them with the intention to resell them quickly. In particular, this was an adventure in the nature of trade. The TCC recognized that the expectation of profit is a criterion that is typically used to conclude that an adventure was in the nature of trade, and that no profit could be realized on the sale of the purchased shares. However, the TCC found that Mrs. G had nonetheless benefited financially from an increased cash flow.

The TCC concluded that the disposition of the gifted shares by Mrs. G gave rise to a capital gain. The court noted that it is generally accepted that a mere resale, and nothing more, of property received as a gift or inherited, even if it is done shortly after the property was acquired, is a sale that results in a capital gain.

The TCC said that subsection 47(1) only permits ACB averaging for capital property, and it concluded that because both blocks of shares were characterized differently, the ACB-averaging provision in subsection 47(1) could not apply to the purchased shares and gifted shares held by Mrs. G. The TCC also concluded that since Mr. G had not obtained any tax benefit (because the ACB-averaging rules did not apply and because Mrs. G's entire gain was attributed to Mr. G), there was no need to perform a GAAR analysis of the transaction.

On appeal, the FCA found that the TCC had erred in characterizing the gain on the disposition of the purchased shares as business income. The FCA said that it is well established that for a venture to be a commercial venture, the taxpayer must have a reasonable expectation of profit. In the FCA's view, Mrs. G did not have any expectation of profit, since she purchased the shares with the obligation to sell them a few days later at the same price. The FCA said that the notion of financial benefit, which had been introduced by the TCC to justify its finding that Mrs. G benefited from the transaction, is not established in case law and cannot be used to justify the conclusion that Mrs. G's sale of the purchased shares was on account of income.

According to the FCA, the TCC also erred in distinguishing the situation in this case from that in *Irrigation Industries Ltd. v. MNR* (1962 CanLII 55 (SCC)), which established a strong presumption that the acquisition of shares of a business gives rise to the acquisition of a capital asset. The FCA concluded that in the present case the purchased shares were held as capital property, since the facts were not sufficient to reverse this presumption.

Although the FCA did not agree with the entire reasoning of the TCC regarding the gifted shares, it did agree with the conclusion that those shares were held as capital property.

Because both the purchased shares and the gifted shares were capital property, the FCA decided that the ACB-averaging mechanism of subsection 47(1) applied to these shares. However, the FCA concluded that a GAAR analysis was needed, and it sent the case back to the TCC with specific instructions to consider whether GAAR should apply to this case.

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Income Allocated by a Family Trust to Beneficiaries

Paragraph 104(6)(b) provides a deduction to a family trust when an amount that would otherwise be included in the trust's income became "payable in the year" to a beneficiary. Subsection 104(13) then taxes the income to a Canadian-resident beneficiary, and paragraph 212(1)(c) generally subjects the amount to Canadian withholding tax if the beneficiary is a non-resident.

Subsection 104(24) provides that for the purposes of subsection 104(6), an amount is deemed not to have become payable unless it was paid in the year or the beneficiary was entitled to enforce payment of it in the year. In this article, I consider circumstances in which the amounts were not paid in the year.

Subsection 104(18) provides some relief from the aforementioned legally enforceable right of a beneficiary when all or any part of the income of a trust has not become payable in a year because it has vested in an individual who has not attained age 21 by the trust's year-end and the reason for vesting is otherwise than as a consequence of the exercise of, or the failure to exercise, any discretionary power. For the purposes of subsection 104(6), such income is deemed to have been payable to the minor in the year, provided that the minor's right to the income is not subject to any future condition other than that the minor survive to age 40 or younger.

Note that the income in question must still have vested in the minor. It will then ultimately be distributed, tax-free, as capital. Where non-discretionary trusts are concerned, whether or not the income is payable should not generally be controversial; the trust indenture should provide either that the income is payable or that it is not.

However, there could be issues even in the case of non-discretionary trusts. A problem might arise if the trust has earned an amount that constitutes income for income tax purposes but that does not qualify as income under trust law. Two common examples are depreciation recapture and deemed dividends on share redemptions.

Drafters of trust deeds often address this problem by defining income for the purposes of a particular trust as income for tax purposes. If this definition has not been included and is desirable, consideration should be given to applying for a variation of the trust.

Potential problems with trust income not being considered to have been payable are more likely to arise in connection with discretionary trusts. In this regard, there are at least two court cases that tell us what *not* to do.

In *Cole Trusts* (81 DTC 8 (TRB)), the trust deed gave the trustees the discretion to pay income or capital to the beneficiary before the beneficiary turned 21. The T3 returns for the years in question indicated that all of the trust income was payable to the beneficiary. The income was not actually paid until some time later. Promissory notes had not been prepared, formal written notice of the obligation had not been given, and financial statements did not disclose the obligation. When the CRA contended that the income was not payable in the particular years, the trustees executed a statutory declaration to the effect that the decision to have the income vest in the beneficiary was made during the applicable year. The court held that the actions of the trustees did not amount to payment, making the income payable or causing the income to vest in the beneficiary. The income was therefore taxable to the trust.

In *Langer Family Trust* (92 DTC 1055 (TCC)), the trust kept no records, did not reconcile its income, and maintained no bank accounts. Trust distributions, ostensibly for the benefit of the trust's beneficiaries, were paid into the father's personal bank account. The father claimed that he spent the money for the benefit of the children. The court did not give the trust a tax deduction.

In light of all of the above, I suggest that the following practices be implemented by discretionary family trusts to help ensure that income is taxed to the beneficiaries at their marginal rates rather than to the trust, which generally is taxed at the highest personal rate:

- The trustees should prepare minutes, within the particular trust year, evidencing their decision that the trust income is intended to be payable to the beneficiaries.
- The beneficiaries (or their guardians, if they are minors) should be made aware, in writing, of the aforementioned decision.
- Promissory notes should be prepared within the year to give the beneficiaries a legally enforceable right.
- The amounts should be paid as soon as possible after the trust's year-end.

Practitioners may say that the suggestions above are impracticable because, in most cases, the precise amount of the trust's income for a particular year will not be determinable until after the end of the year. To deal with this common problem, consider reflecting an estimated amount in the pre-year-end documentation (the estimate should be subject to a price adjustment clause). In this regard, some comfort can be derived from *Lutheran Life Insurance Society* (91 DTC 5553 (FCTD)). Although the case dealt with the efficacy of dividends recorded by journal entry after the fiscal year-end and thus is not directly on point, the following comment made by the court appears to be relevant: "[T]he timing of the decisions concerning the . . . dividends, after year end but before the accounts were closed seems to me indicative of no more than prudence."

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Life Insurance: Why Would Your Owner-Manager Client Want It?

The traditional perception of life insurance is that it is a financial product for managing risk and providing liquidity at death for paying capital gains taxes or equalizing an estate. But what if your business-owner client is so prosperous that she is effectively self-insured? Your client may not think that she needs life insurance, but she may still have an insurable need and may want to use corporate-owned life insurance as a tax-advantaged way of both accumulating passive wealth inside a company and transferring that wealth to surviving family members.

This article discusses how corporate-owned life insurance can be used to transfer corporate wealth to a business owner's family members after she dies. It also discusses how the new policyholder taxation rules that will come into effect in 2017 (applicable to policies issued after 2016) will affect corporate-owned life insurance.

Transferring Corporate Wealth

Many business owners take advantage of the low corporate tax rates on active business income by saving money in their corporations if they don't need it for personal purposes. They achieve a tax deferral, but eventually these assets will come out of the corporation and be taxed at either capital gains tax rates or dividend tax rates, depending on the taxpayer's post mortem planning. But this result is not inevitable if the shareholder is insurable and if there is an insurance need—protecting the estate, for example. In many cases, life insurance can be used in the client's planning so that some or all of the insurance death benefit can be paid out from the CCPC as a tax-free capital dividend.

Life Insurance and the Capital Dividend Account

Paragraph (d) of the definition of "capital dividend account" (CDA) in subsection 89(1) includes in its calculation an amount equal to the life insurance proceeds (the death benefit) received by a corporation, less the policyholder's ACB in the policy. The policy's ACB is generally the sum of the cumulative premiums paid less the cumulative net cost of pure

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insurance (NCPI). NCPI is defined in regulation 308; despite its name, it is not actually used in product pricing. Often, the effect of the NCPI is to grind the ACB down to nil by the time the life insured reaches her life expectancy, at which time the entire death benefit is paid to the corporation as beneficiary and then distributed to shareholders as a tax-free capital dividend, to the extent of the corporation's CDA balance.

The rules affecting the calculation of NCPI will change for life insurance policies issued after 2016. This change will affect a policy's ACB and, therefore, the credit to a CCPC's CDA. Generally, the CDA credit may be less than it is under the existing rules.

In the case of whole life policies, the impact will be minimal: the ACB will generally go to nil up to five years later than it does under the existing rules. For universal life, however, the negative impact on the ACB and the CDA will be significant, particularly with respect to policies issued for persons older than 55. (Life insurance policies issued before the end of 2016 will be grandfathered.)

Example

Assume that your business-owner client is a 60-year-old male with a holding company that has a sizable investment portfolio. He and his spouse, who is also aged 60 and is a shareholder, can easily identify a portion of their corporate-owned portfolio that they intend to pass on to their children after their deaths. They are non-smokers, and each of them is considered a standard risk to an insurer's underwriters. They decide to reposition $750,000 of passive investments held in their holding company into a life insurance policy over a 15-year period. They want a policy with cash value, which can be used as a source of income. To accomplish this, the client's holding company purchases a joint last-to-die participating whole life insurance policy on the client's and the spouse's lives, with a $50,000 annual premium that will be paid for 15 years.

The accompanying table compares the estate values of this arrangement at ages 85 and 95 if the corporation had invested the same premium dollars in a conservative portfolio growing at 5 percent per year (40 percent interest, 40 percent dividends, and 20 percent capital gains). The corporate tax rate on passive income is 51 percent, the personal tax rate on non-eligible dividends at death is 44 percent, and the tax rate on regular income in the year of death is 52 percent. As for post mortem planning, on the insurance side the table assumes a subsection 164(6) loss carryback with sufficient non-insurance assets paid out to the graduated rate estate so that the stop-loss rules do not apply. On the non-insurance side, the table shows both a hybrid pipeline (to address the accumulated RDTOH and CDA balances) and a loss carryback.

The comparison shown in the table illustrates that, in addition to the immediate enhancement to the client's estate, permanent life insurance can help to generate a larger inheritance for surviving family members compared with investments by keeping both policy growth and the corporate distribution after death better protected from tax erosion. The table also shows that even with the policyholder taxation changes affecting policies issued after 2016, corporate-owned permanent life insurance policies will continue to be an effective means of enhancing a business owner's estate.

Net Estate Value Comparison

	Corporate-owned participating whole life insurance		Corporate-owned conservative portfolio at 5%	
Age	Policy issued before 2017	Policy issued after 2016*	Hybrid pipeline	Loss carryback
85	$2,295,673	$2,287,153	$1,047,509	$912,883
95	$3,023,113	$3,023,113	$1,457,687	$1,323,270

* Differences in the net estate values are attributable to the changes in the calculation of the NCPI and the resulting ACB of the policy and credit to the CCPC's CDA. The example illustrated in this table is hypothetical and is not based on Canada Life, Great-West Life, or London Life products that will be available after 2016. Those products may be of significantly different design, and thus may have a bigger change in the CDA credit than shown here.

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