TAX FOR THE Owner-Manager

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CRA Confirms Partner Time Not Part of Professional's WIP Cost

In a recent letter to the APFF (TI 2017-0709101E5), the CRA clarified its position on how professionals can determine the cost and FMV of their year-end work in progress (WIP) for the purposes of calculating their taxable income. This guidance is intended to help "designated professionals" (lawyers, accountants, dentists, doctors, veterinarians, and chiropractors) who can no longer elect to exclude the value of their WIP from income due to the elimination of billed-basis accounting in the 2017 federal budget. (Following its response to the APFF, the CRA made similar comments on calculating WIP in a letter to CPA Canada dated May 1, 2018.)

The CRA confirmed that designated professionals should determine the cost of their WIP in accordance with the guidance in archived *Interpretation Bulletin* IT-473R ("Inventory Valuation," December 21, 1998). Although the CRA also provided welcome guidance to confirm that partner time and fixed or indirect overhead costs do not have to be included in WIP, it did not address certain other issues, including what constitutes variable versus fixed overhead. Further, the CRA has tightened its position on contingency fee arrangements to recognize that WIP associated with these arrangements may have FMV in certain limited circumstances.

Although the CRA issued guidance on calculating the cost of WIP in *CRA Views* 5-8507 (September 19, 1989), many professionals elected to use billed-basis accounting and, as a result, were not required to determine the cost of WIP. Now that these professionals can no longer elect to exclude WIP from income, the tax community has been asking the CRA to clarify whether they can rely on the previous guidance. To help professionals make this transition, the CRA was also encouraged to address certain issues that remained unclear in this previous guidance, including how overhead should be calculated and allocated, and which overhead is variable and which is fixed. Although not all of the concerns were addressed, the CRA did say that designated professionals have some flexibility in developing a costing method.

Generally, under the current tax rules, a professional or a professional corporation must include the value of WIP at the end of the year in its income for tax purposes to account for partly finished services for which a client has not yet been billed. Under subsection 10(1) and paragraph 10(5)(a), WIP of a professional business is generally considered to be inventory and must be valued at the end of the year at the lower of its cost to the taxpayer and its FMV. The FMV of WIP at a professional business's year-end is the amount that can reasonably be expected to become receivable after the end of the year in respect of the WIP, under paragraph 10(4)(a).

Prior to the changes in the 2017 federal budget, designated professionals could effectively defer tax by electing under section 34 not to include the value of their year-end WIP in their income for the year (that is, they could elect to use billed-basis accounting). Expenses associated with their WIP could be expensed without the matching inclusion of the revenue. The 2017 federal budget eliminated this election for taxation years beginning after March 21, 2017: designated professionals must now include WIP at the end of the year in their business income for that year.

The budget also allowed transitional relief under subsection 10(4.1) to phase in the WIP inclusion over five years. For the first taxation year that begins on or after March 22, 2017, only 20 percent of the lesser of the cost and the FMV of the WIP must be taken into account when one is determining the value of a designated professional's inventory. The amount of WIP to be included in income increases to 40 percent in the second taxation year, 60 percent in the third taxation year, 80 percent in the fourth taxation year, and 100 percent in the fifth taxation year.

Because the cost of WIP is not defined in the Act, the CRA provided guidance in archived IT-473R. In paragraph 12, the CRA said that "cost" means "the laid-down cost of materials plus the cost of direct labour applied to the product and the applicable share of overhead expense properly chargeable to production." The CRA noted that it would accept either direct costing (which allocates variable overhead to inventory) or absorption costing (which allocates both variable and fixed overheads to inventory), but the method used should give the

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most accurate picture of the taxpayer's income. The CRA said that it will not accept prime cost, a method in which no overhead is allocated. Further, in *CRA Views* 5-8507 the CRA said that a taxpayer was not required to include fixed or indirect overhead costs in WIP such as rental, secretarial, and general office expenses, or to impute the cost of the partner's or proprietor's time.

The CRA noted in its response to the APFF that when a taxpayer determines the cost of acquisition of WIP or its FMV, the SCC's decision in *Canderel* (1998 CanLII 846 (SCC)) must be taken into account. In *Canderel*, the SCC determined that the taxpayer's goal under "determination of profit" is to obtain an accurate picture of its profit for the given year. Therefore, the SCC said, the taxpayer is free to adopt any method that is consistent with the Act, with established case law principles ("rules of law"), and with well-accepted business principles (including, but not limited to, GAAP). Should the CRA disagree with the chosen method, on reassessment the CRA must show either that the figure provided does not represent an accurate picture, or that another method of computation would provide a more accurate picture.

Previously, the CRA had issued guidance on its website in 2017 confirming that no amount of a professional's WIP under a contingency fee arrangement would normally be recognized at the end of a taxation year. The CRA also indicated that professionals can continue to deduct expenses incurred for the purpose of earning income under a contingency fee arrangement in the taxation year in which they were incurred. Under the terms of a contingency fee arrangement, designated professionals are not typically able to bill for their services until the right to collect an amount, based on a future event, is established.

Both the APFF and the CBA-CPA Joint Committee on Taxation voiced concerns about the elimination of the section 34 WIP election in 2017. In its response to the APFF, the CRA confirmed that the valuation of WIP is a question of mixed fact and law. For designated professionals, WIP must generally be valued at the end of the year at (1) the cost at which the taxpayer acquired the property or (2) its FMV at the end of the year, whichever is lower, or in a prescribed manner. In addition, a designated professional's determination of the cost of acquisition of WIP or its FMV must follow the decision in *Canderel*. The CRA's view is that although taxpayers have some flexibility in choosing the method for valuing WIP, they must be able to demonstrate that the method chosen provides an accurate picture of their income for the year.

The CRA also said in its response to the APFF that its position on determining cost remains consistent with that set out in IT-473R—namely, that taxpayers can use either direct costing or absorption costing. This means that variable overhead must be included in WIP regardless of the method chosen. However, the CRA noted that if the direct costing method is chosen, designated professionals do not need to include fixed overhead costs, such as the costs associated with renting office space, in the cost of WIP.

The CRA further stated that the cost of labour of designated professionals, including employee benefits, should be included in the cost of WIP. However, if a partner or sole proprietor contributes to the WIP, the amount of that contribution should not be included in the cost of the work.

The CRA said that the FMV of a service business's WIP should generally be based on the hourly rate billed to the client. This is consistent with its previous comments in TI 2008-0294011E5 (January 5, 2009).

The CRA also noted that if a designated professional provides services under a contingency fee agreement, the FMV of the WIP at the end of the taxation year will be nil if the amount of the fee is not ascertainable until after year-end. However, if a designated professional is able to establish an amount that can reasonably be expected to be received after the end of the taxation year for contingency fee work, the projected amount is the WIP's FMV.

Although the CRA's response to the APFF provides helpful comments on some outstanding issues, other questions remain unanswered. As hoped, the CRA has confirmed that partner/sole proprietor time should not be included in WIP cost. Also, many professionals will welcome the CRA's clarification of the acceptable approaches to the determination of cost, and its position that WIP does not need to include fixed overhead costs such as rent.

However, the CRA did not comment on whether indirect overhead costs, such as general office expenses, should be included in WIP cost. Can professionals still rely on the CRA's 1989 position, set out in *CRA Views* 5-8507, that such costs need not be included in WIP?

Further, the CRA did not comment on how professionals should compute or allocate overhead, or on what constitutes fixed or variable overhead. Most professionals are likely to choose the direct method of allocation (which includes only variable overhead), since this method will presumably result in the lowest WIP cost and income inclusion. However, it is unclear what types of expenses a typical professional services firm would include in variable overhead. Until the CRA provides specific examples, these questions remain open.

The CRA also did not say whether the cost of labour should be based on a professional employee's paid hours, hours worked, or hours billed. Arguably, employee salary costs for unbilled time is a variable overhead cost that must be included in the cost of WIP, given that the employee's services are available for billable work. However, it is not clear whether paid hours will form part of the cost of WIP even when that amount is higher than the cost of billed hours. Until the CRA provides further guidance, this issue also remains open to interpretation.

In addition, the CRA's new caveat on the FMV of WIP under contingency fee arrangements appears to create further

uncertainty. Specifically, the CRA does not provide any details about when professionals with contingency fee arrangements may be able to establish the amounts that they expect to receive after the end of the taxation year.

Although it is not yet clear whether the CRA plans to release additional guidance to address these remaining questions, its response to the APFF confirms that designated professionals have flexibility in developing a costing method, provided that the method chosen is well reasoned and presents a true picture of profit supported by appropriate documentation.

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Taxable Windup: A Practical Approach to Capital Dividends

In the context of a taxable windup, the effective utilization of a corporation's capital dividend account (CDA) is an important element in planning for the distribution of property to shareholders. When one relies on subsection 88(2), however, the filing requirements necessary to make a valid capital dividend election can be challenging from both a timing perspective and a CDA calculation perspective. For this reason, practitioners often rely on alternatives to subsection 88(2) to achieve similar results—for example, late-filing the capital dividend election and paying the late-filing penalty, or actually disposing of the corporation's property and declaring separate dividends before the windup. At the 2017 APFF Conference (CRA document no. 2017-0709021C6, October 6, 2017), the CRA acknowledged the existence of such difficulties in a taxable windup and suggested that some practical relief from the formal requirements in filing the capital dividend election might be available.

To understand the practical difficulties that can arise, consider the following points:

- When a Canadian corporation is wound up and property is distributed to shareholders in a situation where subsection 88(1) does not apply, the shareholders are deemed to have received a dividend under subsection 84(2) to the extent that the FMV of the funds and property distributed exceeds the PUC of the shares. For the purposes of calculating the CDA in connection with a non-subsection 88(1) windup, subsection 88(2) deems (1) the taxation year of the corporation to have ended immediately before the distribution to shareholders and (2) the corporation to have disposed of its property at FMV immediately before the deemed year-end.
- If the corporation is deemed to have paid a dividend under subsection 84(2), then subparagraph 88(2)(b)(i) deems the corporation to have paid a separate dividend up to its CDA balance immediately before the windup. This rule effectively allows the winding-up deemed dividend to be received tax-free by the shareholders to the extent of the corporation's CDA immediately prior to the windup. Subject to late filing, in order for the portion of the winding-up dividend to be a capital dividend, an election under subsection 83(2) must be made on the earlier of the date that the dividend becomes payable and the date that any portion of the dividend is paid.
- Pursuant to subsection 83(2), an election to pay a capital dividend must be made in the prescribed manner and form (form T2054, "Election for a Capital Dividend Under Subsection 83(2)"). A certified copy of the directors' resolution (or other authorization by persons legally entitled to administer the affairs of the corporation) declaring the capital dividend, and a schedule showing the computation of the CDA balance immediately before the election was made, must accompany form T2054 when it is filed. The amount of the capital dividend must be specified in the authorizing resolution.
- If the amount of the capital dividend exceeds the corporation's CDA, then the corporation will be subject to part III tax equal to 60 percent of the excess amount plus interest until the tax is paid. The recipient shareholder is still treated as having received a tax-free capital dividend.
- It is possible to make a late-filed capital dividend election, provided that the election is made along with the payment of a late-filing penalty.
- Because the consequences of declaring an excessive capital dividend are punitive, if there is doubt about the balance of the corporation's CDA at the time that a dividend is to be paid, practitioners must often choose between (1) late-filing the election and paying the penalty after the uncertainty is resolved; (2) making a conservative CDA calculation and paying a capital dividend that is less than the actual CDA balance; or (3), in the context of a taxable windup, disposing of the capital property and paying separate capital and taxable dividends before the windup to resolve the uncertainty.

As mentioned above, at the 2017 APFF Conference, the CRA was asked about a capital dividend election in the context of a taxable windup to which subsection 88(2) applied (that is, not a parent-subsidiary windup under subsection 88(1)). The windup situation described at the conference involved a corporation that owned capital assets with fluctuating values (portfolio investments) at the time of the windup. The fluctuating values made it impossible to determine, in advance, the capital gain resulting from the deemed disposition of the assets upon the distribution to the shareholders in the course

of the windup. As a result of that value fluctuation, the capital dividend election could not be made within the prescribed time limit because the FMV of the corporate assets would not be known until after the windup and the payment of the winding-up dividend. The question was whether any administrative relief was available in that situation or whether alternative measures to address the issue were under consideration.

The CRA provided some practical and welcome comments in response. It said that although a corporation remains responsible for calculating its CDA balance as accurately as possible in light of all the facts known at the time that the election is to be filed, special circumstances may make the calculation excessively difficult.

In the circumstances described, the CRA said that when the balance of the CDA, as established by the CRA, differs from the balance calculated by the corporation at the time that the election is filed, the CRA will adjust the amount of the capital dividend as well as form T2054 to reflect the subsequently established CDA balance. To facilitate the processing of this treatment, the CRA said that the directors' resolution should make it clear that the capital dividend portion of the winding-up dividend, for which form T2054 is being prepared, constitutes a winding-up dividend to which subsection 88(2) applies.

The CRA said that the directors' resolution need not specifically reference the amount of the capital dividend in those circumstances, which is contrary to what is normally expected. It also said that even though a capital dividend election would be invalid if it was not made in respect of the total amount of the declared dividend, the CRA would make an exception if the winding-up dividend exceeded the corporation's CDA.

These comments are of interest to those who may be faced with a taxable windup situation. First, practitioners who will deal with the CDA balance on a taxable windup using alternative means may want to reconsider relying on subsection 88(2). In the specific context of a windup where subsection 88(2) will apply and there is uncertainty about the CDA balance, the CRA's comments seem to provide for the following process:

1) The authorizing resolution, which must be signed in advance of any liquidation, can be drafted in a formulaic manner such that a portion of the deemed winding-up dividend is declared a capital dividend to the extent of the corporation's CDA as determined immediately before the windup.
2) A specified amount, based on the best information available, can then be entered on form T2054.
3) If there are some discrepancies due to value fluctuation, the CRA should be expected to adjust form T2054 accordingly.

This process is beneficial because it allows the capital dividend election to be filed on time, thereby avoiding late-filing penalties, and it also provides some comfort that an excessive capital dividend is not being paid.

Depending on the quantum of the capital dividend, a modified approach may be to declare the formulaic capital dividend, but then late-file the CDA election when the uncertainty regarding the CDA balance is resolved. This approach offers additional certainty that no excessive capital dividend was paid, and the taxpayer will not have to rely on the CRA to adjust form T2054. Because the late-filing penalties can be relatively minor, this modified approach may be a useful alternative if the factual context is appropriate. Of course, under either method, any commercial issues relating to the dissolution's timing should be considered.

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Facts, Not Assumptions: Penalty Relief for Taxpayers?

A recent TCC decision offers hope for taxpayers facing penalties based on auditors' assumptions rather than facts. In *Semenov* (2018 TCC 58), Sommerfeldt J held that the imposition of penalties requires evidence of taxpayer misconduct, not just assumptions sufficient to reopen a statute-barred tax year.

The facts in *Semenov* are not uncommon. Funds were deposited into an individual shareholder's personal bank account, and the CRA assumed that the money represented unreported income to the corporate taxpayer. The TCC considered the consistency and reliability of the evidence of the taxpayer and the CRA, and found that both fell short of their evidentiary burden.

The court found that the taxpayer had made misrepresentations, personally and as an officer of his corporation, that justified the CRA's assessment beyond the normal reassessment period, but that he had demonstrated the non-taxable source of some of the amounts in issue. The balance of the amounts in issue "likely" represented unreported corporate income, and "likely" represented taxable shareholder benefits.

The court found that the CRA audit had its own problems. The audit was started by one auditor but finished by another. Some of the transition information was not entered into evidence, despite requests from the taxpayers' counsel. Part of the analysis was based on a "copy and paste" analysis of another taxpayer unrelated to either of the taxpayers under audit. While the court observed that it was "likely" that in using the copy-and-paste approach, the relevant information and references for the taxpayers was preserved, "there is no certainty that such was the case." However, the auditor's most critical error was her reliance on "deeming" rules. In particular, the CRA "deemed" the individual taxpayer to have withdrawn funds from the corporate taxpayer without reporting that

income. In other words, the CRA was relying on an assumption about what happened, not on the facts.

The court was clear that while such a deeming approach may be sufficient to support a reassessment in respect of which the minister has the benefit of relying on assumptions, it is not sufficient to support a finding that a taxpayer received income that it failed to report, so as to be liable for a penalty, given that the minister cannot rely on assumptions to support a penalty.

The CRA applied a similar deeming approach in imposing penalties on the corporate taxpayer. The individual's only source of income was the corporation, "so, when monies goes [sic] into his account, that is, like, so it has to be from somewhere, so we are deeming it from the corporations. That's why we are also applying penalty [sic] onto the corporation" (at paragraph 89).

The CRA also did not do any third-party analysis in respect of the corporation's income. It did not review invoices issued by the corporation to its customers, nor did it ask customers about their payments.

The CRA failed to demonstrate the facts necessary to support its penalty assessments. I am aware of many cases, often involving alleged shareholder benefits or unreported income, in which the CRA has assessed statute-barred years on the basis of assumptions about a taxpayer's conduct. It is costly and time-consuming to rebut such assumptions, which are often based on a lack of understanding of how the taxpayer's business works. Assumptions of fact, however, can be rebutted. Often the CRA assesses penalties based on the same assumptions but without ascertaining the facts. The *Semenov* decision may be helpful in reminding the CRA that it must demonstrate facts, not just assumptions, to support penalties. The decision will assist other taxpayers that face similar penalty assessments based on the CRA's assumptions. But how long will it take for the decision in this case to alter the approach of front-line auditors?

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GAAR: The Search for Object, Spirit, and Purpose

The TCC's decision in *Oxford Properties Group Inc. v. The Queen* (2016 TCC 204) left open some questions about how specific anti-avoidance provisions would interact with GAAR and how the object, spirit, and purpose of the provisions should be interpreted in light of subsequent legislative amendments. The FCA largely overturned the TCC's decision (2018 FCA 30) after analyzing the rollover provisions, bump provisions, and related specific anti-avoidance provisions. The FCA's decision not only offers a practical and effective approach to searching for the object, spirit, and purpose of the provisions, but it also sheds light on the effect of subsequent amendments in a GAAR analysis.

The series of transactions in question involved rolling over appreciated real estate properties into a multi-tiered partnership structure and bumping up the ACB of the partnership interests through vertical amalgamations and dissolutions of partnerships. The prepackaged partnership interests with accrued gains derived from the underlying real estate properties were then sold to arm's-length tax-exempt entities after the three-year holding period referenced in subsection 69(11) had passed, without triggering tax on recapture and deferred capital gains in the property held by the partnerships. The minister applied GAAR to the transactions, stating that the taxpayer had abused subsections 97(2), 88(1), 98(3), and 100(1), and denied the effect of the bumps. The TCC concluded that GAAR was not applicable to the series of transactions because there had been no abuse.

The disposition of a partnership interest with an accrued gain will result in a capital gain, 50 percent of which is taxable; a disposition of a depreciable property with an accrued gain may trigger recapture of previously claimed CCA, 100 percent of which is includible in income. Thus, according to Noël CJ, by "packaging" a depreciable property into a non-depreciable partnership interest, a taxpayer can convert a latent recapture into a capital gain when the partnership interest is sold. The purchaser will then be responsible for the latent recapture when the underlying depreciable property is ultimately disposed of. If the purchaser is a tax-exempt entity, however, the recapture will never be taxed. Therefore, subsection 100(1) was introduced to prevent potential revenue loss by making the disposing partners liable for tax on 100 percent of any portion of the gain resulting from the sale of their partnership interest that can be attributable to depreciable capital property held by the partnership.

Noël CJ also ruled that because the transferor's deemed proceeds become the transferee's deemed cost, it is clear that Parliament wanted the tax deferred by the rollover provisions to be paid when the transferee disposed of the underlying properties. As a result, it was logical to conclude that the object, spirit, and purpose of subsections 97(2) and 97(4) was to track the tax attributes of depreciable property in order to ensure that deferred recapture and gains would be taxed upon the eventual disposition of the properties. The treatment under subsection 100(1), which taxes the latent recapture when partnership interests are sold to tax-exempt entities, is also consistent with the object, spirit, and purpose of the rollover provisions. Thus, on the premise that the object, spirit, and purpose of subsections 97(2), 97(4), and 100(1) was to tax deferred gains and recapture in subsequent sales, it followed that the series of transactions in question abused those provisions.

Noël CJ suggested that the TCC's approach leaned toward a more literal interpretation of the law and that the court

might have concluded differently if it had asked whether the fact that deferred gains and recapture would never be taxed would have frustrated the object, spirit, and purpose of subsection 97(2). Moreover, he clarified that the bump provisions under paragraphs 88(1)(c) and (d) and subsection 98(3) generally preserve the tax cost in the shares or units of the subsidiary or a lower-tier partnership when that cost is higher than the tax cost of the properties held by the subsidiary or a lower-tier partnership upon a vertical amalgamation or a partnership windup, with similar restrictions on depreciable properties. For instance, subparagraph 88(1)(c)(iii) prohibits the parent from bumping the cost of "ineligible property," which includes depreciable property. The UCC of a depreciable property cannot be bumped up because the latent recapture is taxed as income at a 100 percent inclusion rate, whereas a capital gain is taxed at a 50 percent inclusion rate. By using a multi-tier partnership structure combined with the bump provisions, Oxford was able to circumvent the rules that prohibited the bump of the cost base of depreciable property and achieve a bump-up of the ACB of the second-tier partnership interests, which essentially derived the majority of their value from underlying depreciable properties.

Noël CJ's approach to the abuse analysis under GAAR offers a logical and clear path to follow in searching for the object, spirit, and purpose of the provisions, and it demonstrates how a "unified textual, contextual and purposive approach" should be applied in a GAAR case. Moreover, Noël CJ reversed the TCC's conclusion that if a specific anti-avoidance rule did not apply, then GAAR could not apply. His finding that the specific anti-avoidance provision in subsection 100(1) was abused in a GAAR analysis is consistent with *Lipson* (2009 SCC 1), *Descarries* (2014 TCC 75), and *Desmarais* (2006 TCC 44). After all, even if the transactions, viewed in isolation, would not offend any specific anti-avoidance provision, preference must be given to the overall result in light of the purpose of the provisions when one is evaluating GAAR.

In addition, it is interesting to note Noël CJ's analysis of the role of new subparagraph 88(1)(d)(ii.1) in determining the object, spirit, and purpose of the bump provisions as they existed before the amendment. By relying on the literal wording of the old provisions, the TCC concluded that the amendment was not a clarification of the old provisions, but rather a new policy adopted by Parliament. In contrast, Noël CJ stressed the importance of determining the underlying rationale before assessing whether the amendment clarifies or alters a pre-existing policy. The old bump provisions already drew a distinction between depreciable and non-depreciable properties; given the different tax treatments afforded to each type of property, it was evident that the amendment sought to clarify this existing policy rather than to operate as a new law. It is clear that one must first determine the object, spirit, and purpose of the old provisions before placing any significance on the impact of a subsequent amendment on the proper interpretation of those provisions.

Interestingly, the FCA's recent decision in *Univar* (2017 FCA 207) also considered the relevance of a subsequent amendment in a GAAR analysis. *Univar* clarified that subsequent amendments would not necessarily reinforce or confirm the result of an abuse test. According to *Univar*, subsequent amendments introduced many years after the transactions under review were implemented did not sufficiently demonstrate that the transactions frustrated the object, spirit, and purpose of the provisions before enactment of the amendments. In *Oxford*, Noël CJ followed the FCA's approach in *Univar*: only after concluding that the previous bump provisions were abused did he consider the effect of the subsequent amendments.

Nonetheless, subsequent amendments, especially those explicitly used to close loopholes, seem to have played some part in guiding the courts in the search for the object, spirit, and purpose of the provisions. In this regard, Noël CJ had consistent opinions in *Oxford* and *Water's Edge* (2002 FCA 291). In both cases, he said that the prospective amendments were indications that the transactions in question frustrated the object, spirit, and purpose of the relevant provisions, since the amendments were introduced immediately by Parliament in response to the loopholes exploited by the taxpayers. In *Oxford*, he said that the effect of the legislative amendment is that "GAAR will no longer have to be resorted to in order to prevent the result achieved in this case." Arguably, one of the factors that distinguished *Univar* from *Oxford* and *Water's Edge* was the timeline of the subsequent amendments, given that the amendment in *Univar* was not an immediate response to the alleged exploitation.

An application for leave to appeal to the SCC has been filed. If the SCC grants leave, it is to be hoped that its decision will shed more light on the extent to which subsequent amendments may be considered in interpreting statutory provisions relevant to a GAAR analysis.

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Corporate Attribution: Refreeze May Cause Unsolvable Corporate Attribution Problem

Subsection 74.4(2) provides for an attribution of income when an individual transfers or loans property to a corporation and certain conditions are met. One condition is that the loan or transfer be for the purpose of reducing the individual's income for the benefit of a person who is a "designated person" (defined in subsection 74.5(5)) vis-à-vis the individual. Typically,

this corporate attribution rule is a factor considered in any typical estate freeze involving an individual, a private corporation, a spouse, and minor children. Although the corporate attribution rule is generally well understood in typical cases, we have recently looked at a situation where the wording of the rules, if taken literally, leads to an illogical result. The problem arises because the amount subject to attribution is calculated by reference to the "outstanding amount" of the transferred property (or loan) involved in the estate freeze (see paragraph 74.4(2)(d) and the definition in subsection 74.4(3)). That amount is defined as the FMV of the property at the time of the transfer to the freeze corporation, less certain allowed consideration (subsection 74.4(3)). Any excess amount is the basis for the calculation of the attributed amount. The key is the requirement that the attributed amount be based on the value of the property *at the time of the transfer to the corporation*.

Example

In the following example, assume that sometime after a typical estate freeze, the value of the freeze shares declines due to market circumstances. A refreeze is implemented and a new class of shares is substituted for the original freeze shares. The new shares are worth less than the original freeze shares. How will the corporate attribution rules work in that event?

Mr. X is a Canadian resident and is not a US citizen, US resident, or US green-card holder. He transfers his common shares of Opco, worth $15 million, to Holdco pursuant to section 85 ("the first transfer"). As consideration, he receives from Holdco $15 million of class A preferred shares. A family trust with beneficiaries who are designated persons vis-à-vis Mr. X subscribes for the common shares of Holdco. Holdco is not and never will be a small business corporation. One of the main purposes of the transaction is to reduce the income of Mr. X and benefit the designated persons ("the purpose test"). The trust does not qualify as a subsection 74.4(4) trust, so Mr. X cannot avoid attribution under that section. Due solely to the economic downturn, the FMV of Opco declines to $3 million. Mr. X then exchanges his $15 million of class A preferred shares of Holdco for $3 million of class B preferred shares of Holdco pursuant to section 86 ("the second transfer"). All of the other facts are the same as they were for the first transfer, except that the purpose test is not met for the second transfer; therefore, in respect of the second transfer, subsection 74.4(2) should not apply.

The class B preferred shares are subsequently redeemed for $3 million cash.

Analysis

"Outstanding amount" is defined in paragraph 74.4(3)(a) as "the fair market value of [the property transferred to the corporation] at the time of the transfer." In the example given above, the initial outstanding amount is the original $15 million of common shares; it does not include the subsequent $3 million refreeze amount of the class B preferred shares because the purpose test is not met for the second transfer.

Upon the section 86 exchange of the class A preferred shares for the class B preferred shares, the outstanding amount is not reduced from the initial $15 million, since the class B preferred share consideration, which is excluded consideration, does not reduce the outstanding amount because of subparagraph 74.4(3)(a)(ii). As that provision is worded, the outstanding amount is reduced—but only from $15 million to $12 million—upon the redemption of the class B preferred shares, because the cash consideration received by Mr. X does not represent excluded consideration.

This phantom outstanding amount of $12 million will be subject to corporate attribution at the prescribed rate applicable for the relevant periods in the particular taxation year of Mr. X. Corporate attribution will exist forever for Mr. X. It cannot be cured: no further dividends can be paid on the class B preferred shares because they have been fully redeemed.

This seems to be an unintended consequence of the legislation that follows from a literal reading of the applicable provisions. In our view, it might be addressed in one of two ways:

1) The definition of "outstanding amount" could be amended to reduce the outstanding amount by the amount of any downward change in FMV (in the example, $12 million) of the property transferred to the corporation. A simultaneous amendment to the definition of "excluded consideration" would also be required.
2) The CRA could say that it considers subsection 74.4(2) to no longer apply when the property that was originally transferred to the individual (here, the class A shares) ceases to exist and any property substituted for that property (here, the class B shares) is no longer caught by the purpose test.

To our knowledge, no articles or papers have been written and no case has been decided on the impact of a refreeze transaction on the "outstanding amount" subject to the corporate attribution rules. We hope that Finance and/or the CRA will clarify the application of the corporate attribution rules in circumstances such as those described in the example. Pending such clarification, practitioners should proceed with caution when considering a refreeze prompted by a decline in value of Opco and its related Holdco.

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Discretionary Trusts and Associated Corporations

Are beneficiaries of a discretionary trust, whose potential share of income and capital does not exceed 24.99 percent of the trust property, deemed to hold 24.99 percent or 100 percent of the shares held by the trust for the purposes of the association rules (section 256)? The TCC answered this question in *Moules Industriels (C.H.F.G.) Inc. v. The Queen* (2018 TCC 85).

The ultimate issue in the case was whether three corporations were associated for the purposes of sharing the small business deduction business limit (section 125). It appears that the trust deed in question was drafted to avoid the association rules. By limiting each beneficiary's potential interest to 24.99 percent of the income and capital, the settlor was likely seeking to prevent the 25 percent crossholding required to associate the corporations (paragraphs 256(1)(c), (d), and (e)).

The transparency rules in paragraph 256(1.2)(f) attribute to each beneficiary the shares that it holds in a corporation in proportion to the FMV of its interest in the trust (subparagraph 256(1.2)(f)(iii)). This presumption does not apply, however, if the beneficiary's interest "depends on the exercise by any person of, or the failure by any person to exercise, any discretionary power" (subparagraph 256(1.2)(f)(ii)). In that case, each beneficiary whose interest depends on such a discretionary power is deemed to own all of the shares "owned, or deemed by this subsection to be owned, at any time by a trust" (subparagraph 256(1.2)(f)(ii)).

In *Moules Industriels*, counsel for the Crown relied on the CRA's longstanding position set out in CRA document no. 2003-0052261E5 (January 6, 2004): because the trust deed made the beneficiaries' interest subject to the exercise of the trustees' discretionary power to attribute between 0 percent and 24.99 percent of income and capital to each of them, it met the condition in subparagraph 256(1.2)(f)(ii). Thus, each beneficiary would be deemed to own all of the shares owned by the trust itself, and not 24.99 percent.

Taxpayer's counsel pointed out that none of the beneficiaries of the trust could ever receive 25 percent or more of the shares and argued that the beneficiaries' shares were similar to a fixed share of 24.99 percent, which would not cause the corporations to be associated (subparagraph 256(1.2)(f)(iii)). Counsel argued that the trust deed in question appeared to be consistent with the underlying tax policy that triggered the association rules when a 25 percent crossholding exists, which was not possible in this case.

Counsel also referred the court to Quebec civil law in interpreting the relevant provisions of the Act. According to article 1261 of the Civil Code of Québec, a trust constitutes patrimony by appropriation in which none of the settlor, trustee, or beneficiary has any real interest. A Quebec civil-law trust cannot formally own an interest in its property. How, then, can it "own" the shares of a private corporation as required by subparagraph 256(1.2)(f)(ii) if that is impossible under civil law? By its very nature, a civil-law trust property is not "owned" by a trust but is appropriated to a particular purpose; thus, the taxpayer's counsel argued that the appropriation of the trust's property, which imposes a 24.99 percent limit, must instead be considered when one is interpreting the tax provisions. This 24.99 percent limitation should be an integral part of the appropriation of the trust patrimony, according to the trust deed in *Moules Industriels*.

Lamarre ACJ rejected each of the taxpayer's arguments and opted for a literal interpretation of the law. To accept the position of the taxpayer would have amounted to "accepting an interpretation that requires the insertion of extra wording when there is another interpretation which does not require any additional wording."

The court also noted that the lawmakers had expressly provided that shareholders, partners, or beneficiaries are deemed to own shares held, respectively, by a corporation (paragraph 256(1.2)(d)), a partnership (paragraph 256(1.2)(e)), or a trust other than a discretionary trust (subparagraph 256(1.2)(f)(iii)) in proportion to the FMV of their interests in the entity. In contrast, the law does not make such a proportional calculation in cases where the interest of the beneficiaries depends on the exercise of discretionary power. An analysis of the June 1988 *Explanatory Notes to Legislation Relating to Income Tax* confirms this conclusion.

Lamarre ACJ refused to use Quebec civil trust law to interpret the corresponding tax provisions. Recognizing that a trust cannot "own" the shares for the purposes of the Act would assign "a completely different meaning" to paragraph 256(1.2)(f) from the meaning intended by Parliament and could render inapplicable the provisions of the Act relating to the rollover of trust property to beneficiaries (sections 107 et seq.). She found that Parliament had dissociated itself from civil law in taxation matters and presumed that a trust is an individual for the purposes of the Act (subsection 104(2)), and a trust is therefore a person capable of owning shares for tax purposes. In light of the June 1988 explanatory notes, it appears that Parliament intended that subparagraph 256(1.2)(f)(ii) cover all of the shares held by a trust.

Citing *Jean Coutu Group (PJC) Inc. v. Canada (Attorney General)* (2016 SCC 55), Lamarre ACJ said that it was desirable from a tax policy perspective that the federal tax system produce similar results for taxpayers subject to common law and for those subject to Quebec civil law. The court concluded its reasons by stating that subparagraph 256(1.2)(f)(ii) constituted "a deeming provision," which (as the SCC said in *Verrette*, 1978 CanLII 208) creates a legal fiction that differs from reality.

By dismissing the taxpayer's appeal, the TCC confirmed that each of the beneficiaries of the trust is deemed to own,

for the purposes of section 256, all of the shares held by the trust.

Although the decision in *Moules Industriels* is consistent with the letter of the Act, in my view it produces a result that defies logic. How does one explain to a beneficiary that he or she will have to suffer the tax consequences associated with owning 100 percent of the shares held by the trust when the trust deed attributes a potential interest in only 24.99 percent? It is understandable that broadening the scope of certain tax provisions makes it possible to counter situations that Parliament deems inappropriate. In this case, however, the fairness of such a measure must be questioned. A legislative amendment is required.

On the other hand, the reasons for the decision, sound in the circumstances, confirm that taxpayers can interpret the Act according to its clear terms and that despite the disparities between common law and civil law among Canadian provinces, the Act should apply in the same manner across Canada.

This judgment illustrates once more the importance of careful trust planning. The transparency rules in subsection 256(1.2) must be thoroughly considered. Setting the portion of shares of the beneficiaries of a trust at less than 25 percent and not making the portion subject to the trustees' discretionary power is a potential solution to such a problem, albeit at the cost of having less flexibility and of creating an annual income inclusion for the beneficiary. Conversely, the taxpayer who wants more flexibility could cause the trust to hold a maximum of 24.99 percent of the shares of a corporation while conferring total discretionary power on the trustees. Even if the presumption in subparagraph 256(1.2)(f)(ii) applies in this case, the 25 percent threshold will never be crossed. An alternative solution will have to be found for the remaining 75.01 percent of shares, making planning more complex.

Finally, element (e) of the "specified shareholder" definition in subsection 248(1) is worded almost identically to subparagraph 256(1.2)(f)(ii), which was analyzed in this case. The beneficiary of a trust may qualify as a "specified shareholder" of a corporation because of, among other things, the discretionary power of the trustees that results in the potential application of the attribution rule in subsection 74.4(2) (if the other conditions of that subsection are met). This specific attribution rule applies in particular to trusts created in the context of an estate freeze. The drafting of such trust deeds should obviously take into account the decision in *Moules Industriels*.

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De Facto Control at the FCA: The End of the McGillivray Saga

In *Aeronautic Development Corporation v. Canada* (2018 FCA 67), the FCA dismissed the taxpayer's appeal of the TCC's decision (2017 TCC 39) in which it found de facto control under subsection 256(5.1) after the decision in *McGillivray Restaurant Ltd. v. Canada* (2016 FCA 99).

The issue in dispute was whether the appellant (ADC) was entitled to refundable R & D credits at the rate of 35 percent for its expenditures in respect of its 2009, 2010, and 2011 taxation years. The minister had argued that ADC was not a CCPC in the relevant taxation years because it was "controlled, directly or indirectly in any manner whatever" by a non-resident of Canada within the meaning of subsection 256(5.1).

The facts were relatively straightforward. ADC was incorporated in Nova Scotia in April 2009. Its sole shareholder was Seawind Corp. (SC), a US corporation controlled by Mr. Silva, an American engineer who was involved in the development of an amphibious aircraft known as the *Seawind*. Subsequently, ADC entered into a development agreement with SC to provide SC with the services necessary to complete the prototyping and certification of *Seawind*. After the execution of the development agreement on August 17, 2009, ADC issued additional common shares, and from that date forward a majority of its common shares were held directly or indirectly by residents of Canada.

The TCC upheld the minister's contention that ADC was not a CCPC in the relevant taxation years because it was controlled in fact by non-residents. The TCC considered the FCA's holding in *McGillivray*, which had limited a finding of de facto control to situations where a person or group of persons has "the clear right and ability either 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."

The FCA also stated in *McGillivray* that in determining whether there was de facto control, only factors that "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 . . . shareholders who have that right and ability" should be considered. However, the TCC in *Aeronautic Development*, relying on the proposition that Parliament does not speak in vain, held that for a court to find control in fact, "the evidence must show that the controller has the ability to affect the economic interest of the voting shareholders in a manner that allows the controller to impose his or her will on them." The TCC then went on to perform what seems to be the sort of operational analysis specifically prohibited by the holding in *McGillivray*.

On appeal in *Aeronautic Development*, the FCA agreed with ADC that the TCC had erred in applying the concept of de facto control as set out in subsection 256(5.1) because it had examined

a broad range of operational control factors rather than asking only whether there was some legally enforceable arrangement that gave rise to de facto control. Notwithstanding this error, however, the FCA found no reason to interfere with the TCC's decision: the development agreement was held to be a legally enforceable agreement capable of establishing de facto control in and of itself. (The FCA stated that ADC had conceded on this issue.)

The FCA then turned to the question whether the exception in subsection 256(5.1), which concerns certain commercial agreements entered into between arm's-length parties, could save ADC from the finding that it was not a CCPC in the relevant taxation years. The exception, in general terms, provides that if an agreement is of the sort that falls within the ambit of subsection 256(5.1) and the agreement is arm's-length, then its existence cannot be the basis of a finding of de facto control.

The FCA reviewed the TCC's finding that in the relevant period ADC and SC were not dealing at arm's length. The FCA found that the TCC had made no reviewable error for the period after 2009 with respect to the question whether the development agreement was arm's-length. Specifically, the FCA held that the TCC had correctly relied on, among other things, the fact that ADC was nearly totally economically dependent on SC and that Mr. Silva had the ability to force the two companies to disregard the agreement's terms (as he had done when certain markup payments were not made to ADC) to conclude that the parties were not dealing at arm's length.

Therefore, because the development agreement was capable in and of itself of establishing de facto control and it was not one that fit within the exceptions applicable to arm's-length commercial agreements, the FCA found that the TCC had properly held that ADC was not a CCPC in the relevant taxation years. Accordingly, the appeal was dismissed.

This case probably represents the final decision under subsection 256(5.1) prior to the introduction of subsection 256(5.11). Subsection 256(5.11) was intended to overturn the decision in *McGillivray* and restore an earlier understanding of the de facto control test that includes a consideration of operational control and economic influence.

Thus, the indeterminate operational test applied by the TCC in *Aeronautical Development* will be much closer to the analysis performed from now on than the FCA's relatively more straightforward analysis in *McGillivray*.

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Restrictive Covenants and Withholding Tax

A wide range of transactions may fall under the umbrella of restrictive covenants. According to a CRA ruling (2017-0701291I7, August 16, 2017), such transactions may even include lump-sum payments for exclusive distribution rights. In this article, I review the CRA's ruling on withholding tax on payments made for exclusive distribution rights that do not concern computer software. (Computer software distribution rights may have different tax implications.)

In the ruling, Canco, a Canadian-resident corporation, paid NRco, an arm's-length non-resident corporation, an upfront lump-sum payment for the exclusive right to distribute NRco's product in Canada under a trademark owned by NRco. The CRA opined that the lump-sum payment was not a royalty because it did not depend on Canco's profit or on the degree to which Canco exercised its exclusive distributorship rights. The CRA also confirmed that the lump-sum payment would not likely be caught by subparagraph 212(1)(d)(i): Canco was granted only the right to distribute, promote, and advertise the products, not the right to use the trademark for manufacturing purposes, which indicates that there was no extensive use of the intellectual property. The CRA reached this conclusion on the basis of *Farmparts Distributing* (80 DTC 6157 (FCA)) and *Grand Toys* (90 DTC 1059 (TCC)); in those cases, the courts ruled that it was open to the minister to allocate a portion of the payments to the use of the trademark.

Interestingly, the CRA also pointed out that to the extent that neither subparagraph 212(1)(d)(i) nor (iv) applies to the upfront payment, paragraph 212(1)(i) is broad enough to apply to the payment on the basis that the payment is an amount that, if NRco had been a resident in Canada throughout the taxation year in which the amount was received, would be required by subsection 56.4(2) to be included in computing NRco's income for the taxation year. Subsection 56.4(2) requires a taxpayer to include in its income an amount received in respect of a restrictive covenant. The CRA took the position that the broad definition of "restrictive covenant" would apply to NRco's undertaking under the distribution agreement. In the end, the CRA stated that the upfront payment would be exempt from Canadian withholding tax under article VII of a typical OECD-style treaty because it was business profits of NRco that was not earned through a permanent establishment in Canada.

The CRA's position on the applicability of the restrictive covenant provisions may come as a surprise to some practitioners. Granted, the definition of "restrictive covenant" under section 56.4 is very broad; unfortunately, the CRA's ruling did not say exactly why section 56.4 would apply to the transaction in question. Perhaps the CRA believes that the lump-sum payment would fall under the definition of a "restrictive covenant" because the exclusive distribution agreement would function as a waiver of an advantage or a right by NRco within the "restrictive covenant" definition in subsection 56.4(1). Specifically, NRco would essentially be waiving the advantage or the right to use a different distributor that might offer a better deal. That is, NRco would have received the lump-sum payment

under the exclusive distribution right as compensation for not approaching other Canadian distributors. However, one might still ask whether the CRA's interpretation is overly broad, because section 56.4 was introduced to override *Fortino* (1999 CanLII 9258 (FCA)) and *Manrell* (2003 FCA 128). In those two cases, the FCA held that payments received by a taxpayer for entering into a non-competition agreement were not income from a source and thus were not taxable. Arguably, the restrictive covenant rules were not meant to target payments under an exclusive distribution agreement.

Nonetheless, this ruling is welcome news to taxpayers that make similar payments to non-resident recipients in jurisdictions with which Canada has a tax treaty. Payments under an exclusive distribution agreement will likely be exempt from Canadian withholding tax under the tax treaty due to the exemption for business profits earned without a permanent establishment in Canada.

Note that in the ruling, NRco also granted Canco the right to use the trademark for the commercialization of the product in Canada, without any payment from Canco based on sales. In effect, the CRA did not indicate that it would allocate some portion of the upfront payment to the right to use the trademark.

On this premise, it would be advisable for taxpayers to negotiate a distribution agreement at the outset or unbundle an existing distribution and royalty agreement such that, if the circumstances allow, none or a minimal portion of the payments can be attributed to the use of the trademark. This would maximize the amount allocated to the exclusive distribution and minimize or eliminate the Canadian withholding tax. It is interesting to speculate, however, how the CRA would rule if the parties to the agreement were not acting at arm's length.

The picture is not so rosy for non-resident taxpayers that receive similar payments but reside in a jurisdiction that does not have a tax treaty with Canada. In the absence of a treaty, a taxpayer cannot rely on the business profits exemption for withholding tax. The CRA's broad application of the restrictive covenant rules appears to expose those taxpayers to the withholding tax.

However, it is worth noting that in the ruling the intangible asset (the right to distribute the product) was to be transferred back to NRco upon the termination of the exclusive distribution agreement. This might allow NRco to argue that it did not dispose of or alienate any property. That said, the definition of "property" is also very broad and encompasses a right of any kind whatever, even a right that covers only a finite period. Moreover, Canco paid for something with the lump-sum payment—but what? Clearly, Canco paid for a property right of some sort, so perhaps one could argue that NRco disposed of a property. Because the property would not be a taxable Canadian property for NRco, any payments or proceeds that NRco received on the disposition of the property should not be subject to Canadian withholding tax, with or without a tax treaty.

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Claiming ITCs When Starting Up or Winding Down a Business

The ability to claim input tax credits (ITCs) is a cornerstone of the GST/HST system in Canada and is necessary in order for taxpayers to avoid the cascading of tax (tax on tax). However, the claiming of ITCs is limited by the extent to which supplies were acquired or imported "for consumption, use or supply in the course of commercial activities of the person" (ETA subsection 169(1)). For a business that is starting up or winding down, this test can be a source of uncertainty about entitlement to ITCs when one is not carrying on a business that makes taxable or zero-rated supplies (that is, before the first sale or after the last sale).

The FCA's decision in *ONEnergy Inc. v. The Queen* (2018 FCA 54) provides a useful review of the applicable rules in ETA subsection 141.1(3) in a winding-down situation, and is a welcome clarification on the state of the law that may be of assistance when dealing with CRA auditors. The primary issue between the parties was whether the taxpayer was entitled to ITCs with respect to litigation expenses incurred in an action against its former executives during the 2011-2013 period when ONEnergy was no longer making taxable supplies.

Facts

By way of background, ONEnergy ceased carrying on business in November 2009, two months after having sold off its wireless spectrum and CRTC broadcast licence upon the windup of the company. In July 2011, ONEnergy filed a lawsuit against its former executives: it alleged that they had breached their fiduciary duty to the corporation and had unjustly enriched themselves by paying excessive compensation to holders of share options and a share appreciation rights plan equal to 25 percent of the proceeds of ONEnergy's sale of its wireless spectrum and broadcast licence.

ONEnergy was of the view that ETA paragraph 141.1(3)(a) operated to deem any activities in connection with the termination of commercial activity (including litigation against the directors with respect to the proceeds of the wireless spectrum and broadcast licence) to have been done in the course of commercial activity. The CRA was of the view that subsection 141.1(3) was inapplicable to the litigation expenses because the litigation was not sufficiently "in connection with" the spectrum sale, which had occurred nearly two years earlier. Accordingly, the CRA reassessed ONEnergy, which appealed to the TCC (2016 TCC 230).

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TCC Proceedings and Decision

Because the issue was primarily legal rather than factual, ONEnergy and the Crown brought a rule 58 motion to the TCC seeking a determination whether ETA paragraph 141.1(3)(a) applied to the litigation expenses. In an agreed statement of facts, the parties set out the chronology of the dispute between ONEnergy and its directors.

The TCC considered the positions of the parties and determined that an "alternate view of the issue could therefore be a distinction between an activity in connection with the winding up of a business carried on by the corporate taxpayer versus an activity in connection with the wind down of the corporation itself." In the TCC's view, subsection 141.1(3) would apply only if the litigation expenses were in connection with the winding up of a business (that is, the spectrum sale).

The TCC undertook a textual, contextual, and purposive analysis of paragraph 141.1(3)(a) and concluded that the litigation expenses lacked the requisite connection to the termination of commercial activity. On a textual analysis, the TCC viewed the expenses as separate from the termination of the business and "as close to what I would consider a 'personal expense' in a corporate context as I can imagine." In the process, the TCC noted that litigation expenses to collect accounts receivable "clearly are part of the termination of the business." On a contextual and purposive analysis, the TCC found that (1) the fact that the directors had used the funds arising from the spectrum sale and (2) the timing of the origin of the share options and share appreciation rights also failed to create the requisite connection.

FCA Proceedings and Decision

The FCA held that the TCC had made a palpable and overriding error in finding that the amounts paid for legal services were "personal" in nature and that there was no connection between the litigation and the proceeds of the spectrum sale. The FCA preferred to view the litigation as being about "a claim for overpaid remuneration" against the former executives and therefore as connected to the business of the employer. The litigation was also "inextricably linked to the sale of the Spectrum and License" because there was a direct connection between the source of the funds (the spectrum sale) and the litigation.

The FCA then reviewed its decision in *General Motors of Canada Ltd. v. Canada* (2009 FCA 114), which dealt with a similar issue—namely, whether General Motors (GMCL) was entitled to ITCs for fees paid to investment managers who managed funds held in the pension plans established by GMCL. In that case, although the services of the investment managers were not directly related to GMCL's commercial activities, they were "a necessary adjunct of its infrastructure to making taxable sales" and they were "paid for in the consumption or use in the course of the commercial activities of GMCL."

The FCA also considered ETA subsection 141.01(2) (which had not been considered by the TCC) and identified a potential technical conflict between ETA subsection 141.01(2) and ETA subsection 141.1(3). According to the FCA, this conflict ought to be resolved in favour of the application of ETA subsection 141.1(3) because it is the more specific provision. Accordingly, although ETA subsection 141.01(2) applies generally, if a registrant acquires a property or service in circumstances where subsection 141.1(3) applies, that registrant "will not lose the entitlement to claim an input tax credit solely because that person is not making any taxable supplies at the time that such property or service is acquired."

Finally, the FCA demonstrated that the TCC's example of litigation expenses incurred to collect accounts receivable was functionally similar to the present claim for overpaid remuneration from the former executives, and that it led to the same legal conclusion and ITC entitlement. In this respect, the FCA noted that the overpaid remuneration was in respect of services rendered by the former executives while ONEnergy was still making taxable supplies, and that accordingly there was a connection between the litigation expenses to recover the overpaid remuneration and the termination of commercial activity.

Comments

The FCA's decision in *ONEnergy* is an important victory for taxpayers and contributes to keeping the GST/HST efficient by ensuring that there is no inappropriate cascading of tax. As the CRA's actions demonstrate, however, registrants should pay close attention to their business activities during their startup and wind-down periods, since the CRA will review expenses incurred during these periods to confirm registrants' ITC entitlement. If a registrant expects to incur significant expenses during these periods, it is important to consult with a tax lawyer to determine how best to minimize the potential audit risk on the basis of the decision in *ONEnergy* and other applicable case law.

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