

The Small Business Deduction and the AAI Grind: Is It a Real Problem?

The federal government's introduction of the "passive income business limit reduction" rules in 2018 has been the topic of much discussion in the tax and financial communities. The rules say that when a CCPC, together with any corporations associated with it, earns more than \$50,000 of adjusted aggregate investment income (AAII), access to the small business deduction (SBD) will be reduced. When the AAI for the group reaches a threshold of \$150,000 for the year, the SBD is eliminated for the CCPC. These rules have caused accountants, tax advisers, investment advisers, and other financial experts to review their tried-and-true planning strategies and come up with new recommendations to limit the rules' application so that corporations can continue to take advantage of the SBD.

Currently, a CCPC that has access to the SBD is taxed at 9 percent rather than 15 percent on the first \$500,000 of active business income (ABI) that it earns. This represents a tax-deferral benefit of up to \$30,000 federally ($\$500,000 \times [15\% - 9\%] = \$30,000$). In addition, the benefit of the SBD can vary from province to province. In Ontario, for example, income taxed at the small business rate is subject to tax at 3.2 percent rather than 11.5 percent, representing a tax-deferral benefit of up to \$41,500 ($\$500,000 \times [11.5\% - 3.2\%] = \$41,500$). In aggregate, the current maximum tax-deferral benefit arising from claiming the SBD is \$71,500 per year in Ontario.

Interestingly, the Ontario and New Brunswick governments did not mirror the federal government in adopting the passive income business limit reduction rules. As a result, in

both of those provinces the impact of the rules is significantly reduced. In Ontario, for example, a CCPC that earns ABI of \$500,000 and has AAI of \$150,000 can still obtain a tax-deferral benefit at the provincial level of up to \$41,500 for the year.

It is important for taxpayers to understand why the SBD is beneficial. Although the SBD results in a lower current rate of tax on ABI, this does not represent an overall tax saving, but rather a deferral of tax. When the funds are eventually withdrawn from the corporation as dividends in future years, personal taxes, in addition to the corporate taxes previously paid, will apply. Corporate and personal taxes paid are said to be integrated, and the integrated taxes are approximately the same whether or not the SBD is claimed. This result arises because only income taxed in a corporation at the general corporate rate is added to the general rate income pool (GRIP), and only dividends paid from GRIP can be designated as eligible dividends. Eligible dividends are subject to tax in an individual's hands at a lower rate than non-eligible dividends. Table 1 sets out the corporate and individual integrated taxes payable in respect of ABI earned in Ontario.

Table 1

	SBD is claimed	SBD is not claimed
Income earned by CCPC	\$500,000	\$500,000
Corporate tax rate	12.2%	26.5%
Corporate tax	(\$ 61,000)	(\$132,500)
Net income after tax	\$439,000	\$367,500
Dividends received	\$439,000	\$367,500
Personal tax rate (assume top marginal rate)	47.74%	39.34%
Personal tax	(\$209,579)	(\$144,575)
Net cash retained personally	\$229,421	\$222,925

Table 1 shows that the amount of net cash retained by the individual shareholder after the funds are extracted from the corporation is similar whether or not the SBD is claimed. If the SBD is claimed, however, the corporate-level tax paid is significantly lower, resulting in a deferral advantage if the funds are retained or reinvested by the corporation. In such a case, it might seem that an SBD grind attributable to AAI is to be avoided. However, this may not be so, especially in Ontario and New Brunswick. In those provinces, the integrated taxes for ABI subject to the passive income business limit reduction rules actually represent an overall tax saving, because future dividends paid by the CCPC can be paid as eligible dividends. Table 2 illustrates this point using Ontario tax rates.

When the funds are eventually paid out to the individual shareholder, the net cash retained by the shareholder in Ontario or New Brunswick is greater if the passive income business limit reduction rules are applied, which is an unexpected

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Table 2

	SBD is claimed	SBD grind is applied
Income earned by CCPC	\$500,000	\$500,000
Corporate tax rate	12.2%	18.2%
Corporate tax	(\$ 61,000)	(\$ 91,000)
Net income after tax	\$439,000	\$409,000
Dividends received	\$439,000	\$409,000
Personal tax rate (assume top marginal rate).....	47.74%	39.34%
Personal tax	(\$209,579)	(\$160,901)
Net cash retained personally	\$229,421	\$248,099

result. Generally, even in other provinces, the difference between the integrated taxes paid is minimal. A shift in investment strategies or the extraction of funds from the corporation to avoid the application of the passive income business limit reduction rules may not be advisable. Paying larger salaries or dividends to remove excess funds from the CCPC can result in significant taxes at the personal level, which can exceed the tax-deferral benefit that arises from claiming the SBD. Significant changes in investment strategies may also affect the growth of the individual's portfolio and the ability to achieve future retirement and investment objectives.

Many corporate taxpayers benefit from the SBD, and it can help to alleviate the current tax burden for a CCPC. However, when one looks at the bigger picture, there is no need to fear the SBD grind if the corporation earns AAI; in certain cases, it can even result in an advantage.

Jeanne Cheng
MNP LLP
Markham, ON
Jeanne.Cheng@mnp.ca

Capital Gains Exemption Planning, Trusts, and the 24-Month Holding Period Rule

Note to readers: This article was modified on August 11, 2021 to change the facts in example 2.

Capital gains exemption planning involves a number of technical issues, especially when shares of a qualified small business corporation (QSBC) are owned by a family trust. In particular, planners should pay careful attention to the requirements of the 24-month holding period in the subsection 110.6(1) QSBC definition. The following four examples illustrate some of the issues to be considered.

Example 1

Mr. X incorporated Opco in 2015. On February 23, 2019, he settled a family trust for the benefit of himself and other fam-

ily members, all of whom are related to him. On January 31, 2021, Mr. X sold all of his Opco shares to the trust; the shares became the trust's only asset. On June 30, 2021, the trust sold the shares to a third party. Assume that, apart from the 24-month holding period, the shares of Opco meet all of the requirements of the QSBC shares definition. Do the shares meet the 24-month test when they are sold to the third party?

Because the family trust held the shares from January 31, 2021 to June 30, 2021, a period of 5 months, the trust, as the shareholder, did not meet the 24-month holding period condition on its own. To meet that condition, the trust, as the shareholder, must satisfy the conditions in subparagraphs 110.6(14)(c)(i) and (ii):

(c) a personal trust shall be deemed

(i) to be related to a person or partnership for any period throughout which the person or partnership was a beneficiary of the trust, and

(ii) in respect of shares of the capital stock of a corporation, to be related to the person from whom it acquired those shares where, at the time the trust disposed of the shares, all of the beneficiaries (other than registered charities) of the trust were related to that person or would have been so related if that person were living at that time.

It is important to note that although the two subparagraphs quoted above are linked by "and," they are actually two separate rules; therefore, "and" should be read as "or." Subject to certain conditions, subparagraph (i) deems a personal trust to be related to any given beneficiary, while subparagraph (ii) deems a personal trust to be related to the person from whom it acquired the shares. There is no requirement to satisfy both conditions: either will suffice. (See the technical notes to paragraph 110.6(14)(c), 1988 and 1991.)

In this example, the trust has been in existence since February 23, 2019, and Mr. X was a beneficiary from that date to the date that the trust sold the shares; the conditions of subparagraph (i) are met, and the trust is deemed to be related to Mr. X for the period from February 23, 2019 to June 30, 2021. This period exceeds 24 months. Therefore, on the date of sale the shares were owned by the actual vendor (the trust) or by someone related to the vendor (Mr. X), and the 24-month holding period requirement is met.

Example 2

In this example, assume that the facts are the same as those in example 1, except that the trust was settled on January 31, 2021, and the beneficiaries of the trust are Mr. X's two children, but not Mr. X. Mr. X transferred his shares to the family trust on that day. As in example 1, if there is a sale to a third party on June 30, 2021, the trust, as the shareholder, will not meet the 24-month rule on its own. Therefore, we must examine paragraph 110.6(14)(c) to determine whether either of the deeming rules applies.

As noted above, subparagraph (i) provides that a personal trust is deemed to be related to any person that is a beneficiary of the trust during the period throughout which the person is a beneficiary. In this example, the trust was settled on January 31, 2021. Therefore, the period referred to in subparagraph (i) begins on January 31, 2021, since no person can be a beneficiary of the trust before its existence. Subparagraph (i) thus deems the trust to be related to Mr. X's two children only for the period from January 31, 2021 to June 30, 2021. Although Mr. X's children are related to Mr. X at all times, including before January 31, 2021, the subparagraph (i) deeming rule applies to beneficiaries only and does not extend to persons to whom beneficiaries are related. Because the trust was not related to Mr. X before January 31, 2021, the shares have not been held by the vendor, or by someone related to the vendor, for the 24-month period prior to the sale, and the deeming provision in subparagraph (i) does not assist.

In this situation, we must look to the deeming rule in subparagraph (ii), which says that a trust is deemed to be related to a person from whom it acquired the shares, provided that all beneficiaries are related to the individual at the time that the shares are sold to the third party. Because the trust acquired the shares from Mr. X and there are no non-related beneficiaries in this example, subparagraph (ii) deems the trust to be related to Mr. X. The 24-month test is met, since the shares are owned by the vendor (the trust) or by Mr. X (deemed by subparagraph (ii) to be related to the trust) for the prescribed 24-month period.

Note that Mr. X cannot be a beneficiary of the trust in this example because a person is not related to himself or herself for the purposes of paragraph 110.6(14)(c).

Example 3

Another common situation is one in which the beneficiaries of a trust include another trust ("the second trust"). In such a case, subparagraph (i) deems the second trust to be related to the trust during the period that the second trust is a beneficiary of the trust.

For subparagraph (ii) to apply,

- 1) the person from whom the trust acquired the shares must be related to all beneficiaries of the trust at the time that the trust disposes of the shares, as discussed above;
- 2) therefore, in addition to being related to all beneficiaries, the person from whom the trust acquired the shares must also be a beneficiary of the second trust, and thus deemed to be related to the second trust pursuant to subparagraph (i) at the time that the trust disposes of the shares.

Example 4

It is also common for a trust to have a corporation as a beneficiary. In that case, subparagraph (i) deems the corporate

beneficiary to be related to the trust during the period that the corporation was a beneficiary of the trust. For subparagraph (ii) to apply,

- 1) the person from whom the trust acquired the shares must be related to all beneficiaries of the trust at the time that the trust disposes of the shares, as discussed above;
- 2) therefore, in addition to being related to all beneficiaries, the person from whom the trust acquired the shares must also be related to the corporate beneficiary at the time that the trust disposes of the shares.
- 3) It should be noted that trusts often own shares of a corporate beneficiary. If the person does not have direct control of a corporate beneficiary, an analysis should be done to determine whether the person from whom the trust acquired the shares controlled the corporate beneficiary in some other manner and thus is related pursuant to paragraph 251(2)(b).

The four examples set out above reinforce the point that any planning with respect to the capital gains exemption is fraught with complexities and requires a careful analysis of all relevant provisions. If a trust has not been in existence for 24 months, it is important to ensure that subparagraph (ii) is complied with and that all beneficiaries of the trust are related to the person selling the shares, which means that no aunts, uncles, or cousins can be beneficiaries. Further, care should be taken if in-laws are included as beneficiaries; if there is a divorce, for example, an in-law may no longer be related to the original owner of the shares at the time of the third-party sale. However, if the trust has been in existence for more than 24 months, it can have beneficiaries who are not related to the transferor and still meet the conditions in subparagraph (i).

David Carolin

Kakkar CPA Professional Corporation, Toronto
davidc@kakkar.com

Manu Kakkar

Kakkar CPA Professional Corporation, Montreal
manu@kakkar.com

Stan Shadrin

CPA Solutions LLP, Toronto
sshadrin@cpasolutions.ca

Paid-Up Capital Shifts: Some Practical Examples

The definition of "paid-up capital" (PUC) in subsection 89(1) provides that the PUC of a particular share of a class of shares is determined by calculating the average PUC per share of all of the shares of that class. Accordingly, when shares of the same class are issued for different prices, individual share-

holders may have PUC per share that is different from the amount paid by them as consideration for the issuance of their shares. Because the amount of PUC per share can affect the tax consequences upon a redemption or reduction in the PUC of the shares, the operation of the PUC averaging rule can raise both concerns and planning opportunities for affected shareholders. The following examples illustrate this point.

Assume that a corporation (Opco) issues one class A share to its sole shareholder, Mr. A, for \$100. Over time, Opco's value grows, and Ms. B is invited to invest as a second shareholder with the same rights and participation as Mr. A. Opco issues Ms. B one new class A share for \$400, its FMV. Following this investment, the PUC of all of the outstanding class A shares is increased to \$500. Each of the two outstanding shares now has PUC of \$250. Ms. B is concerned because the PUC of her share is less than her actual cost. Mr. A is the beneficiary of the averaging rule because the PUC of his share is now \$250 rather than his cost of \$100.

This result can be avoided if Opco amends its share structure to allow for its class A common shares to be issuable in series (subject to the applicable corporate-law requirements). Opco can then issue Ms. B a share of a series different from that held by Mr. A. The PUC averaging will be avoided because subsection 248(6) treats each series as a separate class. Note that the parties should still enter into a unanimous shareholders' agreement (USA) in order to avoid commercial issues in the future. Another possibility is to simply issue a different class of voting common shares (class B common) to Ms. B, and to rely on the provisions of a USA to ensure equal voting and participation rights.

Now assume instead that Ms. B invests initially in a class A share. When she realizes the effect of this investment on the PUC of her share, she wants to correct the situation. Provided that Mr. A agrees, Opco can undertake a PUC shift under section 86, in which Mr. A and Ms. B exchange their initial shares of the same class for shares of a new and different class (or series); at the same time, they reset the PUC of their new shares to the corrected amounts. In CRA document no. 9613115 (May 8, 1996), the CRA states that it does not consider a PUC shift in such circumstances to be abusive.

It is possible that despite the PUC averaging and the tax issues that arise therefrom, the parties will still want to have shares of the same class (with no separate series). The PUC averaging here does not, of itself, cause an adverse tax result. In *1245989 Alberta Ltd. v. Canada (Attorney General)* (2018 FCA 114), the court ruled that a transaction involving PUC averaging is abusive only when the offending PUC is used to extract value from the corporation. However, there may be circumstances in which the CRA will regard as abusive the subsequent reduction or redemption of the increased PUC by the benefiting shareholder: *Agence du revenu du Québec c. Custeau* (2020 QCCA 1496). (See Éric Hamelin, "Quebec Court of Appeal

Considers 'Series of Transactions' in GAAR Appeal," *Tax for the Owner-Manager*, April 2021.)

In this context, a possible defence to a CRA challenge of a future PUC extraction as abusive is to assert that the PUC shift and future PUC extraction are not part of a series, as illustrated by the QCCA's decision in *Custeau*. It is in this context that one must examine a tax attribute and its tax benefit in conjunction with the notion of series, or vis-à-vis the underlying intention of the investor at the time of her investment. Specifically, the existence of a business reason to invest in the same class of shares—for example, when the sole intention is to protect the capital investment—could potentially support the position that a future extraction of PUC by a shareholder who benefited from a PUC shift is not part of the same series as the initial share subscription that caused the PUC shift. In such a situation, it is prudent for the involved parties to document (1) the commercial reason for the issuance of shares of the same class and (2) why the investment was made in shares of the same class. Of course, having a longer time between the PUC shift and the PUC extraction will also help to weaken the notion of a series and any accompanying GAAR risk.

Kenneth Keung
Moodys Tax Law LLP, Calgary
kkeung@moodystax.com

Balaji (Bal) Katlai
BDO Canada, Toronto

A Comedy of Errors: Delayed Cancellation of GST/HST Registration Under the ETA

It is a widely recognized point of tax law that taxpayers are not entitled to rely on the erroneous advice of government officials as a defence to non-compliance (see *Deschamps v. The Queen*, 2014 TCC 181, among others). It is less clear, however, what happens when incorrect advice is received from multiple government agencies. Such was the case in *Fazal v. The Queen* (2020 TCC 137), which dealt with the question whether a taxpayer remained a "registrant" for the purposes of section 240 of the ETA years after she believed that she had successfully closed her existing GST/HST registrations. The TCC found that the appellant was a "registrant in name only" and condemned the "dubious" associations made by the CRA and other government agencies who were "oblivious to . . . reality."

Facts

In February 2009, the appellant, Nazma Fazal, registered a sole proprietorship in British Columbia ("Varx Technology"), which was to manufacture building panels. She also registered for the GST/HST. In September 2009, the appellant decided to

close Varx Technology and move the business to a new incorporated entity, Varx Technology Incorporated (“Varx Inc.”). To begin this process, the appellant communicated with BC Registry Services, which told her that her sole proprietorship would be closed and that from the transition date onward the appellant would properly do business as Varx Inc. Moreover, Varx Inc. obtained its own separate GST/HST registration.

In 2011, after moving to Ontario, the appellant decided to discontinue and deregister Varx Inc. In 2014, the CRA finally approved her request, and the appellant believed that all registrations had been cancelled.

Then the hammer dropped. In November 2018, the appellant received a “pending cancellation notice” informing her that the GST/HST registration for Varx Technology—which she believed had been dealt with in 2009—had only now been cancelled, effective December 31, 2017. The CRA also issued a notice of assessment against the appellant for uncollected and unremitted GST/HST under Varx Technology’s registration for the reporting periods from January 2011 to December 2016. The CRA’s position was that the secretarial services now performed by the appellant for her husband were in respect of her Varx Technology registration, which required the appellant to collect and remit GST/HST on her supplies of those services. Within days of the assessment, the appellant received another letter from BC Registry Services, which enclosed a certificate of dissolution for Varx Technology retroactive to December 31, 2009.

The appellant objected to the CRA’s assessment, taking the position that the CRA could not assess her through her sole proprietorship because it had been dissolved in 2009. The objection was denied.

TCC Appeal

On appeal, the issue was whether the appellant was a “registrant” for the purposes of ETA section 240. If she was, she would be considered a voluntary registrant under subsection 240(3) and would be required to collect and remit GST/HST on her supplies of secretarial services. If she was not a registrant for at least some of the years within the relevant period, the court determined that she would have qualified as a small supplier for the purposes of ETA section 148 and would not have been required to collect and remit GST/HST.

The key questions were twofold:

- 1) How could the CRA argue that a sole proprietorship dissolved as of December 31, 2009 continued to hold a legitimate GST/HST registration number until its official cancellation effective December 31, 2017?
- 2) Was it acceptable to associate the appellant’s secretarial services with Varx Technology’s original business of manufacturing building panels?

The court first found that although it was reasonable for the appellant, as a layperson, to have relied on the representations

from BC Registry Services as to the status of Varx Technology’s GST/HST registration, ultimately this reliance was not a defence for any non-compliance. The court then went out of its way to condemn the “comedy of errors” that had led to the case, saying that there was a “lack of diligence” on the part of the CRA and BC Registry Services that created an “unending bureaucratic delay,” which caused the appellant to remain on the CRA’s list as, “technically speaking,” a registrant.

The court found that the appellant was a registrant “in name only,” not in law. According to the court, the definition of “registrant” requires the CRA to turn its mind to the nature of the registrant’s commercial activity; it cited the recognition of a “person separate” from their initial registration for small-supplier status under ETA subsection 129(3) based on the “nature of activities [they are] engaged in.” From the court’s perspective, there was a clean break between the appellant’s activities in the context of Varx Technologies and her recent secretarial work. The court concluded that the appellant, having clearly abandoned the manufacturing business and taken steps to dissolve her previous ventures, could not be found to be a registrant within the meaning of the law.

Ultimately, the court allowed the appeal in part without costs, finding, among other things, that the appellant was a small supplier for at least two of the years in the relevant period.

Commentary

Fazal v. The Queen is a difficult case to evaluate. While one can sympathize with the plight of the appellant, who went through a multi-year ordeal because of her “reasonable” assumptions made on the basis of inaccurate information and general bureaucratic paralysis, it is not easy to square the court’s decision with the actual wording of the registration provisions. In going out of its way to (rightly) condemn the CRA’s behaviour, the court may have read the law in a way that is inconsistent with the ETA.

Section 242 sets out the process by which either the minister or a registrant can initiate the cancellation of a registration. Nowhere, however, does it contemplate that the registration becomes invalid or is cancelled if a sole-proprietor registrant shuts their business. Subsection 242(2) merely states that the minister is to cancel the registration if the person has “filed with the Minister in prescribed manner a request, in prescribed form containing prescribed information.” *GST/HST Memorandum 2.7* (“Cancellation of Registration”), which was not referred to in the decision, appears to contain the forms and information “prescribed” by the minister in respect of section 242. Unless this process is undertaken, there seems to be no way for a person to cease being a registrant.

It is not clear from the facts when the appellant formally initiated the cancellation process. Subsection 242(2) suggests that the cancellation is effective after the last day of the fiscal year of the person once the appropriate forms have been filed. Through delays on the part of the appellant, BC Registry

Services, or the CRA, the cancellation of Varx Technology's registration was made effective only on December 31, 2017. On the plainest reading of the law, it seems that this means that the appellant was lawfully a registrant until that point. The court itself appeared to turn its mind to the issue when it found that it could not "imagine legislators enacting a statute with such a coercive purpose in mind."

Perhaps the issue before the court should have been framed in terms of when the registration cancellation process was initiated and completed under the ETA, with the appellant's position being that she had met the terms of subsection 242(2) in 2009. In those circumstances, the decision may have offered a clearer explanation for the court's ultimate result.

Stuart Clark and Robert G. Kreklewetz

Millar Kreklewetz LLP, Toronto

sgc@taxandtradelaw.com

rgk@taxandtradelaw.com

DiCaita v. The Queen: When Are Repairs and Maintenance Expenses Currently Deductible?

Although *DiCaita v. The Queen* (2021 TCC 5) was heard under the informal procedure and thus has no precedential value, it illustrates the law regarding two fundamental issues that arise under the Act—namely, whether a taxpayer has a source of income and whether an expense is on income or capital account. In this article, we deal only with those issues, which were relevant to one of the two properties that were the subject of the appeal.

The appellant owned one unit in a condominium complex in Vancouver. The unit was always a rental property of the appellant, and it always enjoyed a high occupancy rate. In April 2010, the board that managed the complex undertook a major remediation to deal with multiple issues that involved only the complex's exterior common elements and did not affect any of the units' interiors.

During the remediation work, the complex became an active construction site, which was very disruptive for the occupants of the complex. The appellant's tenant was unhappy with the disruption and asked for a significant rent reduction, which the appellant refused to grant. As a result, the tenant vacated the unit in November 2010. The appellant attempted to rent the unit out but was unable to do so because of the remediation project.

During the period when the appellant was unable to rent the unit, he decided to undertake needed repairs to address problems caused by wear and tear and to replace some fixtures and appliances that had reached the end of their useful lives. In January 2012, he hired a contractor to make the necessary repairs—among other things, replacing some bathroom

fixtures, kitchen cabinetry, countertops, appliances, flooring, and baseboards. Those repairs were completed in May 2012.

The work cost about \$24,000, which the appellant estimated to be 5 percent of the unit's FMV. No construction permits were required, and the existing items were replaced with items of similar quality and value. The repairs were not intended to have a material effect on the value of the unit.

The building's exterior remediation work fell behind schedule and affected the appellant's ability to rent out his unit even after the interior repairs were completed. The unit remained vacant until November 2012. It was rented out in December 2012 for \$2,200 per month, an increase of \$700 per month, which was in line with rents charged for comparable units.

The appellant deducted \$22,483 for repairs and maintenance in his 2012 taxation year. The minister disallowed the expenses on the basis that the unit was not available to be rented out, and therefore the appellant did not have a source of income. Alternatively, the minister claimed that the expenses were capital expenditures and thus not deductible under paragraph 18(1)(b).

The TCC first addressed the source-of-income issue. Relying on *Stewart v. Canada* (2002 SCC 46), Masse DJ said that

[a] property does not need to be generating income at every stage of operation in order to be considered a source of income. What is required . . . is the predominant intention to make a profit in accordance with objective standards of businesslike behaviour. That has been clearly established. The fact that the unit was vacant from January through to November of 2012 means only that it was not earning income during that time—it does not mean that it was not a source of income.

He noted that the unit had been continuously rented out for the years prior to the repairs and was rented out after the exterior remediation and interior repairs were completed.

In the absence of legislation or binding case law otherwise, the TCC held that a property did not have to be generating income at every stage of operation in order to be considered a source of income; the unit did not lose its character as a source of income while the repairs were being conducted simply because it was vacant or not available to be rented for an interval of time. The court thus concluded that the unit was a source of income before, during, and after the renovations.

Next, the court addressed the question whether the impugned expenses were capital expenditures or current operating expenses. Relying on *Rainbow Pipe Line Co. Ltd. v. Canada* (2002 FCA 259), the court said that whether a particular outlay should be capitalized or treated as a current expense is a determination that must be made in accordance with GAAP and is not dealt with by any specific provision of the Act. (We note that the FCA phrased this point somewhat differently at paragraph 12 of its reasons: "On the basis of the expert evidence, Mogan T.C.J. found that well-accepted business principles, including GAAP, ran against the appellant and, in particular, that there is much stronger support in GAAP in the circum-

stances of this case for capitalizing the replacement cost than expensing it.” The important point is that the determination does not depend on GAAP. Rather, well-accepted business principles, including GAAP, are determinative.)

The TCC cited *Minister of National Revenue v. Algoma Central Railway* (1968 CanLII 774 (SCC)) for the proposition that “[t]he classic definition of a capital expenditure is one incurred for procuring ‘the advantage of an enduring benefit,’ and includes ‘preserving an asset,’ but not an expense that creates no identifiable asset.” The court also referred to *Hare v. The Queen* (2011 TCC 294) and *Hare v. Canada* (2013 FCA 80) for guidance. Masse DJ quoted the court in *Cousineau v. The Queen* (2013 TCC 375) for its “thorough analysis” of the multiple considerations that go into determining this question of fact.

The TCC then considered six factors to be weighed in determining whether an expenditure was current or capital in nature:

- 1) betterment and enduring benefit,
- 2) typical repairs,
- 3) timing of the repairs,
- 4) vacancy of the property during repairs,
- 5) cost of repairs relative to the value of the property, and
- 6) increase in rent following the repairs.

The court stated that the overarching test was the purpose and nature of the expenditure. It held that although the repairs were of enduring benefit, they were not significant enough “to bring into existence a different capital asset than what was there before”; they merely updated what was already in existence. In reaching this conclusion, the court referred to the cost of the repairs relative to the value of the unit, the lack of a need for building permits, the absence of building code issues, and the fact that the materials and items purchased were “like for like” replacements of existing materials.

Masse DJ found that the repairs were typical of current expenses. With respect to the timing of the repairs, he rejected the minister’s assertion that the lumping together of multiple repairs must have resulted in the creation of a new asset, and he held instead that the “the timing of the repairs was somewhat serendipitous in that the hiatus in tenancies provided [the appellant] with an opportunity to effect the needed repairs all at once.” In the court’s view, therefore, the timing of the repairs was merely fortuitous and not a significant factor in the case.

The court also rejected the minister’s argument that the fact that the unit needed to be vacant so that the repairs could be made resulted in the repair expenses being capital in nature. The court held that the unit’s vacancy during the repairs did not mean that it had to be vacant: “Although it is true that the unit was vacant between tenancies, it does not follow that it had to be vacant in order to effect the repairs. It was simply easier to effect the repairs if the unit was vacant.” The court

also found that the cost of the repairs was small in relation to the value of the unit, which supported a finding that the expenses were current.

Finally, the court found that “[t]he increase in rent is just as likely attributable to the exterior remediation [as] it is to the interior repairs,” and held that the rent increase was not a significant factor in the determination. Accordingly, the TCC held that the repairs were current in nature.

DiCaita serves as a welcome reminder of the often complex analysis that goes into distinguishing a current expense from a capital expense. It is also a reminder that the question whether a property or a business is a source of income involves complex issues of intention and manifestations of objectively businesslike behaviour; mechanistic points of timing of receipts of income are a poor basis for determining whether at a particular time there is a source of income.

Philip Friedlan and Adam Friedlan
Friedlan Law
Richmond Hill, ON
philip.friedlan@friedlanlaw.com
adam.friedlan@friedlanlaw.com

TCC Takes Expansive View of Subsection 256(2.1)

In *Nicole L. Tiessen Interior Design Ltd. v. The Queen* (2021 TCC 29, under appeal), the TCC applied subsection 256(2.1) to deem 8 appellant corporations to be associated (along with 22 other corporations) and to share a business limit for the purposes of the small business deduction (SBD). If the decision is upheld, the court’s approach to subsection 256(2.1) could cause unrelated corporations with strong reasons to separate their independent economic interests to be associated when they carry on a common business.

The appellants established a “sidcar” structure to carry on an architectural partnership (referred to herein as “Partnership”). Fifteen corporations (Partnercos) were partners of a partnership. Fifteen other corporations (Servicecos) provided services to a single Partnerco controlled by the same shareholder. The shares of each Partnerco were owned by a single individual (a principal) who also controlled a Serviceco. In all, there were 15 pairs of corporations consisting of a Partnerco and a Serviceco controlled by a single principal. Previously, Partnership’s business was operated through a corporation. From late 2010 to early 2011, a reorganization took place whereby the Partnercos and Servicecos were created and the business of the corporation was transferred to Partnership.

The appellants filed their 2012 and 2013 returns on the basis that (1) the Partnercos shared a single specified partnership business limit to determine each Partnerco’s eligibility for the SBD in respect of its share of Partnership’s active business income, but (2) only the Partnerco and Serviceco

controlled by a principal were associated, and therefore every corporate pair was entitled to its own business limit.

The CRA reassessed the appellants for their 2012 and 2013 taxation years on the basis that all 30 corporations were associated under subsection 256(2.1). The CRA contended that one of the main reasons for the separate existence of the 30 corporations was to reduce the taxes payable.

Subsection 256(2.1) is an anti-avoidance rule that deems two or more corporations to be associated if it may be reasonably considered that one of the main reasons for the separate existence of those corporations in a taxation year is to reduce the taxes payable. The CRA's position was that the reorganization and arrangements between the Partnerco-Serviceco pairs were intended to permit more income to be taxed at the SBD rate, and therefore one of the main reasons for the reorganization was to reduce the taxes payable by multiplying access to the SBD. The appellants asserted that SBD access was not one of the main reasons for the reorganization or the separate existence of the Partnercos and Servicecos. They advanced several other purported reasons (for example, addressing succession issues, the removal of spouses as direct owners of the business, financial and estate planning flexibility, asset protection, and simplification of the operational side of the business).

The TCC stated, correctly, that the appellants' reasons or purpose was to be determined objectively, having regard to all of the facts and circumstances and not merely the appellants' statements. Monaghan J observed, again correctly, that subsection 256(2.1) required the court to identify the reasons for the separate existence of the corporations rather than the reasons for establishing them. However, she then went on to find that the reasons for the reorganization and the separate existence of the 30 corporations were "inextricably linked" and that the reasons for the reorganization would therefore be the reasons for the separate existence of the corporations. The conclusion that the reasons for the reorganization and the reasons for the separate existence of the corporations could be conflated was critical to the outcome of the case, since it formed the premise for the remainder of the TCC's analysis.

The TCC concluded that SBD multiplication was one of the main purposes of the reorganization, finding that the evidence was not consistent with the appellants' subjective statements of purpose. The evidence revealed that the principals' tax adviser was the driving force behind the reorganization and that few of the principals clearly understood why the reorganization took place other than for tax benefits stemming from SBD multiplication. Monaghan J placed particular emphasis on the fact that once the principals' tax adviser "put the illustrative examples in front of the Principals showing the savings from the SBD, it was full steam ahead to implement the corporate partnership as quickly as possible."

The conclusion that the reasons for the establishment of the relevant corporations were inextricably linked with the reasons for the separate existence of those corporations is

questionable. There is little doubt that at the inception of the structure, tax savings were a main reason for the separate existence of a Partnerco and Serviceco from each principal's perspective. Having a Partnerco and Serviceco was the key element to providing an additional SBD to each respective principal. However, subsection 256(2.1) has no application to these corporations, since they were already associated pursuant to subsection 256(1). Perhaps more importantly, the separate existence of other corporate pairs had no impact on the tax liability of a particular corporate pair. If, for example, a principal's interest in Partnership was acquired by the principal directly in an individual capacity, the tax liability of the other 14 principals would not be affected. In other words, the decision of any one principal to implement a paired structure had no bearing on the tax result of any other principal. As a result, it cannot accurately be said that the separate existence of any other Serviceco and Partnerco, from the perspective of any particular principal, reduced taxes otherwise payable.

Notwithstanding these potential errors, the decision in *Tiessen* is a stark reminder that the "one of the main reasons" test places the onus on the taxpayer to provide objective evidence that none of the main reasons for the transaction or arrangement was the reduction of tax. Because the CRA can assume that tax avoidance is one main reason for a transaction, mere denial of that purpose and a bare or implausible assertion of other purposes will not be enough. Taxpayers should carefully document their dominant intentions when purpose-based tests are relevant, and they should dispassionately evaluate whether their stated reasons can withstand scrutiny.

Jon M. Ponath

Felesky Flynn LLP, Saskatoon
jponath@felesky.com

Ashvin R. Singh

Felesky Flynn LLP, Edmonton
asingh@felesky.com

SR & ED: Is Improving Cost Efficiency Relevant?

In *6398316 Canada Inc. v. The Queen* (2021 TCC 17), the issue was whether cost concerns could constitute technological uncertainty for the purposes of the tax credit for scientific research and experimental development (SR & ED). In finding that the construction of a uniquely energy-efficient house at a price comparable to that of a "regular home" was not SR & ED, the court underscored the importance of highlighting the technological aspects of the uncertainty that the SR & ED work seeks to overcome, even if cost efficiency is a critical part of the advancement being sought.

In 2012 and 2013, 6398316 Canada Inc. designed and successfully constructed a house that required no grid-tied fuel for heating and cooling (such as electricity or natural gas) at the

same cost as that of a regular home. The house was designed and built to harness temperature and other fluctuations in the natural environment in order to maintain a constant indoor temperature. The house was completed in late 2013, and the appellant claimed certain construction expenses as SR & ED. The minister denied all of the appellant's expenditures related to the project.

The TCC's Decision

In rendering its decision, the court applied the five-part test for SR & ED set out by Bowman J in *Northwest Hydraulic Consultants Ltd. v. The Queen* (1998 CanLII 553 (TCC)), focusing on whether the project addressed "scientific or technological uncertainty." The appellant argued that the technological uncertainty was whether it could construct a house that did not require a furnace at a price point similar to that of a traditional house; thus, the technological uncertainty as framed by the appellant was the cost.

In concluding that the work did not constitute SR & ED, the court said that "[c]onceptually there is no technological aspect implicit in the notion of an item costing or priced at 'x' rather than 'y' dollars": the formulation of technological uncertainty as solely a matter of cost "misses [the] *Northwest Hydraulic* target," which requires a hypothesis specifically aimed at a technological uncertainty (paragraph 31). The court said that although SR & ED can also give rise to lowered pricing or to cost efficiency, cost efficiency in and of itself cannot constitute technological uncertainty.

In our view, when read in context, Russell J's rejection of the appellant's position in *6398316 Canada Inc.* is not so much a rejection of the proposition that cost or pricing may be relevant in an SR & ED project as it is a refusal to accept that cost concerns, without more, indicate that there is a technological uncertainty to be resolved. This is consistent with the recent decision in *National R&D Inc. v. The Queen* (2020 TCC 47), which involved the development of a computer program to automate certain portions of filing SR & ED claims with the CRA. In that case, Lafleur J affirmed that "economic considerations" imposed some uncertainty and that "[b]usiness constraints and the business context of the taxpayer that is claiming the SR&ED deduction and credit are relevant factors to take into account when considering the criterion of technological uncertainty" (paragraph 44).

Key Messages from the Case

In our view, *6398316 Canada Inc.* has three key messages:

- 1) Taxpayers should be careful to frame the hypothesis and technological uncertainty in a manner that highlights technological rather than economic obstacles. While there is no need to deny that cost may have motivated the SR & ED work or that it was a relevant consideration, as was evident in *6398316 Canada Inc.*,

emphasizing cost can open the way for the court to give short shrift to obstacles present in technologies themselves; and, in many cases, it does an injustice to the technological advancements sought in SR & ED projects.

- 2) Taxpayers should provide a clear description of the project's technological uncertainty and advancement. The CRA, and at times the court, has a tendency to apply the *Northwest Hydraulic* factors to the individual activities undertaken to advance a project. This tendency was on full display in *6398316 Canada Inc.*, where the court's decision focused on the fact that specific activities or materials used in the project were known, rather than on the novelty of the project as a whole (that is, how those activities achieved the technological advancement sought by the project). In doing so, the court undercut its own acknowledgment that SR & ED can utilize and build on existing technologies. A clear articulation of technological uncertainty and advancement at the project level is crucial in moving the analysis away from a dissection of component activities devoid of a larger context.
- 3) The case shows the importance of expert evidence, the absence of which Russell J noted throughout the decision. SR & ED appeals often involve complex scientific or technological issues, and it is essential that taxpayers call expert witnesses who can speak to the validity of the purported advancement. Such evidence is critical to a judge's ability to assess whether the project involves the resolution of a scientific or technological uncertainty.

When businesses undertake the development of new or improved technological processes or procedures, they necessarily take cost into consideration. The inclusion of "experimental development" (often referred to as "shop floor SR & ED") in paragraph (c) of the SR & ED definition illustrates the legislative recognition that SR & ED does not take place in a vacuum. To conclude that cost efficiency is not a relevant factor or that it somehow disqualifies work from being a valid SR & ED project would be inconsistent with the intention of the SR & ED regime, which is to encourage Canadian businesses to undertake research and development in Canada. The legislation is aimed at making Canadian companies internationally competitive in research and innovation. In reviewing SR & ED claims, the CRA and the courts should always be cognizant of the benefits resulting from research and development in Canada, which is crucial to increasing the economic growth of our country.

Jennie Han and Joanne Vandale
Osler Hoskin & Harcourt LLP, Calgary
jhan@osler.com
jvandale@osler.com

A Voluntary Disclosure Gone Wrong

In 4053893 *Canada Inc. v. Canada (National Revenue)* (2021 FC 218), the court dismissed an application by the taxpayer (referred to herein as “405”) for judicial review of the CRA’s denial of relief under the voluntary disclosure program (VDP). The court found that the denial of relief was reasonable given the record in front of the CRA. The record included information given to a CRA agent by 405’s sole shareholder in a telephone conversation.

Mr. H was the sole shareholder of 405. He and 405 had failed to file tax returns for more than 10 years. The CRA sent a number of letters to Mr. H about his unfiled returns. In 2016, the CRA wrote to him again, and a CRA agent also spoke to him. During the telephone call, Mr. H told the agent about 405. He confirmed that 405 was active and that it had unfiled returns. The agent responded by informing Mr. H that both he and 405 were required to file tax returns. The CRA agent made notes about the call, in accordance with the CRA’s usual practice.

About five months after this conversation, 405 purported to make a voluntary disclosure by filing its unfiled returns. Mr. H then filed personal tax returns showing that he had received dividend and employment income from 405.

The CRA denied VDP relief to 405 on the basis that its disclosure was not truly voluntary. The CRA decided that its enforcement actions against Mr. H were “likely to have uncovered the information being disclosed” by 405 (see paragraph 32 of *Information Circular* IC00-1R5, “Voluntary Disclosures Program,” which was applicable at the time). 405 sought judicial review of the CRA’s decision.

In a judicial review application, the court does not review a CRA decision on a standard of correctness. Rather, it merely determines whether the impugned CRA decision was a reasonable one that met the requirements of “justification, transparency and intelligibility” set out in *Canada (Minister of Citizenship and Immigration) v. Vavilov* (2019 SCC 65). If the court finds that the decision was unreasonable, it generally refers the matter back to the CRA for reconsideration. Except in rare cases, the court does not substitute its own decision for the CRA’s.

In response to 405’s first application, the court referred the decision back to the CRA because it had not explained adequately how its enforcement action against Mr. H would have led it to discover 405’s non-compliance (2019 FC 51). The CRA reconsidered the matter and confirmed that it should not have accepted 405’s voluntary disclosure. 405 sought judicial review a second time.

In its second application, 405 argued that the CRA’s enforcement action against Mr. H likely would not have uncovered 405’s delinquency because the actions taken against Mr. H before 2016 had not done so. It also argued that the actions that the CRA said it would take against Mr. H in 2016—the

issuing of arbitrary assessments—would not have uncovered the link to 405 (because Mr. H would not have been forced to report any employment or dividend income from the corporation). Finally, 405 said that the second decision still did not explain how it was likely that the CRA would have uncovered information regarding 405.

The court rejected all of these submissions. It agreed that what was likely to have been discovered had to be considered in light of CRA practice, but it noted that the CRA’s 2016 action included the telephone call to Mr. H that revealed his link to 405 and the company’s failure to file returns. Moreover, the enforcement action in fact prompted Mr. H to file returns that reported income received from 405. The CRA’s second decision referred to both of these key facts, which, in the court’s view, provided a reasonable justification for the refusal to provide VDP relief.

4053893 *Canada Inc.* shows the difficulty facing a taxpayer who wants to apply for judicial review of the CRA’s denial of relief under the VDP. Even if the application for judicial review is accepted, the final result may be a reconsideration that corrects the deficiencies of the CRA’s first attempt. Moreover, the case shows that what a taxpayer says to the CRA, including during a telephone conversation, can and will be used against the taxpayer or related persons for the purposes of enforcing the Act.

John Loukidelis
Loukidelis Professional Corporation
Hamilton, ON
john@jltax.ca

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