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Editor: Thomas E. McDonnell, QC

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Pipeline Transactions and the 21-Year Rule

For the first time, the CRA confirmed in an advance ruling (2018-0765411R3, released February 13, 2019) that shares of a corporation subject to a deemed disposition on a trust's 21st anniversary (paragraph 104(4)(b)) may be subject to pipeline-type planning. Thus, after the deemed disposition, the trust and its beneficiaries were able to extract the corporation's surplus without paying any taxes other than the income tax payable on the capital gain triggered by the effect of the law. Taxing these amounts as a capital gain rather than a dividend represents an immediate disbursement for the trust, but at a lower rate. The difference between these tax rates can reach up to 21.47 percent, depending on the province of residence of the trust and/or its beneficiaries and the nature of a possible dividend.

The CRA had previously issued several advance income tax rulings to the same effect, but always in the context of a deemed disposition following the death of a taxpayer. This was the case for pipelines implemented as a result of a deemed disposition upon the death of an individual because of subsection 70(5) (see, among others, CRA document nos. 2018-0777441R3, 2018; 2016-0629511R3, released March 7, 2018; and 2011-0401861C6, June 2, 2011) or because the death of a beneficiary triggered a deemed disposition of trust property pursuant to paragraph 104(4)(a) (see 2013-0503611R3, released May 16, 2014; 2014-0563081R3, released July 10, 2015; 2014-0548621R3, released September 4, 2015; and 2015-0604851R3, released April 1, 2016). However, the recently issued advance ruling concerns a deemed disposition resulting from the application of the 21-year rule (paragraph 104(4)(b)) while all beneficiaries of the trust are still alive.

The pipeline technique generally involves three tax risks, which, if they materialize, transform the outflow of corporate funds into a deemed dividend (section 84.1 and subsections 84(2) and 245(2)). The Act and the CRA's previous positions clearly explained how to avoid the risks posed by section 84.1 and subsection 84(2). The advance ruling is interesting because of the CRA's conclusions on tax avoidance. In recent years, the CRA has said that it was "concerned about internal transactions to artificially manufacture the cost base" (my translation), such as the increase in the ACB of shares (see TI 2016-0655911C6, October 7, 2016, and 2012-0433261E5, June 18, 2013), and that it was considering applying subsection 245(2). The new ruling illustrates that the CRA accepts that an increase in the ACB resulting from the deemed disposition on the trust's 21st anniversary does not constitute an artificial ACB increase that could qualify as tax avoidance. The CRA's position appears to be consistent with the findings of the TCC, which has held (in *Gwartz*, 2013 TCC 86; *Descarries*, 2014 TCC 75; and *MacDonald*, 2012 TCC 123 [overturned on appeal on other grounds, 2013 FCA 110]) that the distribution of a corporation's surplus as a capital gain rather than a dividend "does not inherently constitute abusive tax avoidance" (*Gwartz*, at paragraph 50).

The facts of the advance ruling are relatively straightforward. An inter vivos trust, deemed resident in Canada (probably of the family type), held several assets—namely, a condominium, shares of three CCPCs, and a cash balance. Some time before its 21st anniversary, the trust distributed all of its assets to its beneficiaries on a tax rollover basis (subsection 107(2)), with the exception of unidentified property and class C preferred shares of a corporation, Opco 1. One of the objectives of the transactions was to protect certain assets through the trust. However, the value and nature of the assets held were not disclosed.

Opco's preferred class C non-voting, non-participating shares, redeemable at a fixed redemption price, carried the right to a preferred non-cumulative monthly dividend. The trust did not hold any other shares of this corporation. Opco 1 owned all the shares of an operating company, Opco 4. One of the beneficiaries of the trust, who also acted as one of its three trustees, controlled Opco 1. The remaining shares of Opco 1 were owned by other trusts and a management corporation.

At the end of the day of its 21st anniversary, the trust disposed of the Opco 1 class C shares at their FMV, as required

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by paragraph 104(4)(b), triggering a capital gain. The trustees did not allocate this gain to the beneficiaries, which meant that the trust itself paid the resulting tax. However, there was no indication of the source of the funds used for this purpose. The deemed disposition increased the ACB of the Opco 1 class C preferred shares to an amount equal to their FMV in the trust.

After these events, the pipeline transaction was implemented. All of the Opco 1 shareholders, including the trust, transferred all of their Opco 1 shares to a newly incorporated corporation, Newco. In accordance with subsection 85(1), all of them chose an agreed-upon amount corresponding to the ACB. Newco issued to each of them shares with legal and tax features (ACB, PUC) identical to Opco 1 shares, except for the class C shares that were issued to the trust. In this case, the PUC was increased to correspond to the ACB now made equal to the shares' redemption value as a result of the deemed disposition referred to above.

Paragraph 84.1(1)(a) did not reduce the PUC for these new class C shares, because no part of the ACB of the Opco 1 shares that were owned by the trust was derived from the use of the capital gains deduction or the pre-1972 tax-free margin by a beneficiary or a person related to one of them.

The trust then held preferred shares of Newco redeemable without any immediate tax consequences, since their ACB, PUC, and redemption price were equal. However, the CRA makes this distribution of surplus subject to the same conditions that apply to frequently authorized post mortem pipelines: (1) there must be a delay between the previous sale of class C preferred shares by the trust to Newco and the beginning of share repurchases; (2) there must be a progressive distribution of the corporation's surpluses; and (3) the corporation, Opco 1, must continue its business. The CRA considers such conditions necessary to ensure that the funds are not distributed "on the winding-up, discontinuance or reorganization" of the business of Opco 1 and Fusionco (which was formed by the merger of Opco 1 and Newco), thereby eliminating the risk that this capital transaction will be transformed into a deemed dividend because of the effect of subsection 84(2).

The advance ruling mentions that Opco 1 and its subsidiary, Opco 4, continued to operate their business and remained separate legal entities for a minimum period of time, which unfortunately was not disclosed. Fusionco continued to operate Opco 1's business.

Subsequently, Fusionco began the progressive redemption of the class C shares held by the trust. There are no tax implications because their cash value is equal to the amount of their PUC and ACB. Without revealing the period over which this phased repurchase will take place, the CRA specifies that Fusionco will pay for it "out of the excess liquidity generated by its operations" (my translation). The trust is allocating the amounts received to its beneficiaries tax-free and in accordance with the provisions of the trust document.

The advance ruling only partially discloses the purpose of the proposed transactions by indicating that they are being carried out "in order to gradually restore the value of these shares . . . while maintaining asset protection within Trust 1" (my translation). The CRA concludes that section 84.1 and subsections 84(2) and 245(2) will not apply in these circumstances.

This openness on the part of the CRA will certainly be appreciated by Canadian taxpayers. However, one can question whether the CRA would maintain the same position in different circumstances. What would happen, for example, if the trustees allocated the deemed capital gain to beneficiaries with tax losses carried forward, or if the beneficiaries' effective tax rate was lower than that of the trust (provided that the trust document allows it; see TI 2016-0634921C6, June 10, 2016)? Does a partial distribution of shares before or after the 21st anniversary date change anything? How important to the CRA is the trust's asset-protection objective identified in the advance ruling? Finally, we should remember that the CRA believes that subsection 84(2) applies in the event of a rapid distribution of cash if the target corporation does not carry on any business or activity and holds highly liquid assets ("cash corporation"; see, among others, TI 2018-0748381C6, May 29, 2018).

Éric Hamelin
Université de Sherbrooke

Section 212.1 Lookthrough Rules Create Issues for Trusts with Non-Resident Beneficiaries

In 2018, lookthrough rules that were added to section 212.1 greatly expanded its scope. Domestic trusts with non-resident beneficiaries must now be mindful of the section's effect when undertaking even routine tax-planning transactions.

Section 212.1 is an anti-avoidance rule aimed at preventing cross-border surplus-stripping transactions. It generally applies when (1) a non-resident person disposes of shares of one Canadian-resident corporation to another Canadian-resident corporation that does not deal at arm's length with the non-resident person and (2) after the disposition the two corporations are connected. Unlike section 84.1, however, section 212.1 looks only at the PUC of the disposed shares. Thus, a taxpayer can be deemed to receive a dividend even if he or she has full ACB in the subject shares.

Finance's introduction of the lookthrough rules was intended to ensure that section 212.1 "cannot be frustrated by transactions involving partnerships or trusts." Coupled with specific examples of targeted transactions, the rules essentially "allocate the assets, liabilities and transactions of a partnership or trust to its members or beneficiaries . . . based on the relative fair market value of their interests." Subsections 212.1(5) through (7) implement that concept.

Unfortunately, it appears that the new lookthrough rules raise the risk of double tax in the context of certain common transactions. One example is post mortem pipeline planning. Such planning is typically considered whenever an individual dies holding shares of a private corporation (Opco); it is undertaken to mitigate the risk of double tax—once upon the deemed disposition on death, and again when corporate surplus is distributed.

Consider a situation in which Ms. A dies holding all the shares of Opco. Those shares have significant FMV but low ACB and PUC. If the shares are not bequeathed to a surviving spouse, Ms. A is deemed to dispose of them for FMV proceeds under subsection 70(5). A capital gain is thus reported on Ms. A's terminal return, and her estate acquires the Opco shares at a bumped ACB equal to the shares' FMV immediately before death. However, the PUC of those shares remains at their historic low.

To avoid double tax, the estate can undertake a post mortem pipeline by transferring its Opco shares to another Canadian-resident corporation (Holdco) in exchange for either a promissory note or shares (with high ACB and PUC). Over time, Opco and Holdco merge, and the corporate assets are distributed either on repayment of the note or as a return of capital. The result is no additional shareholder-level tax. The CRA has issued numerous advance tax rulings sanctioning post mortem pipeline planning.

Complications arise if one or more of the estate's beneficiaries are non-resident. Suppose, for example, that Ms. A divided her estate equally between two heirs, one of whom is a non-resident. If a post mortem pipeline is undertaken with Holdco issuing only a promissory note to the estate as consideration for the Opco shares, the following results appear to occur:

- Paragraph 212.1(6)(b) deems each beneficiary of the estate to directly dispose of one-half of Opco's shares to Holdco, and to directly receive one-half of the non-share consideration (the promissory note) received by the estate from Holdco. This deeming rule applies only for the purposes of certain other provisions within section 212.1, not part I.
- Subsection 212.1(1) applies in respect of the non-resident beneficiary because he or she is deemed to have disposed of the Opco shares to Holdco.
- Paragraph 212.1(1.1)(a) deems Holdco to pay a dividend to the non-resident beneficiary equal to the amount by which one-half of the non-share consideration exceeds one-half of the Opco shares' PUC.
- Subsection 212(2) subjects the deemed dividend to withholding tax.

The result is a deemed dividend, notwithstanding that no corporate surplus has been extracted. Indeed, the non-resident beneficiary may never receive any shares or assets of either Opco or Holdco.

In this situation, it appears that the estate will not realize a capital loss. That is, the dividend deemed to be paid to the non-resident beneficiary does not reduce the estate's proceeds of disposition. Amended paragraph (k) of the "proceeds of disposition" definition in section 54 reduces a partnership's proceeds of disposition to the extent that a dividend is deemed to be paid to one of its partners under section 212.1, but no similar language exists for trusts. It is not clear why such a discrepancy exists, particularly since subsection 212.1(5) partly cures this issue for both stacked trusts and partnerships. The result is double tax on the value of the Opco shares notionally attributed to the non-resident beneficiary.

Materially different consequences appear to occur if the estate only receives shares of Holdco. In such circumstances, no dividend will arise on the initial transfer to Holdco (though subsection 212.1(1.2) appears to be engaged). Instead, paragraph 212.1(1.1)(b) grinds the PUC of the Holdco shares by one-half of the amount by which the increase in PUC of Holdco's shares exceeds the Opco shares' PUC.

On a subsequent repurchase of the Holdco shares, subsection 84(2) or (3) will deem the estate to receive a dividend to the extent that the repurchase price exceeds the shares' PUC (which it can then allocate to the non-resident beneficiary). Critically, however, the estate should also realize a capital loss, since its proceeds of disposition will be reduced by paragraph (j) of that term's definition. The estate can then carry back the capital loss to Ms. A's terminal tax return under subsection 164(6) if the estate is a graduated-rate estate and completes the repurchase within its first taxation year. This step may be particularly beneficial if the corporations have a capital dividend account or a refundable dividend tax on hand balance.

Similar, yet subtly different, considerations apply for life interest trusts (for example, alter ego, spousal, and joint partner trusts). The period within which a capital loss can be realized to offset the terminal capital gain may be extended to three taxation years, but the potential application of the stop-loss rules must be considered further. Planners should also consider the foreign tax consequences for the non-resident beneficiary (having regard to the potential applicability of any double tax treaty).

The effect of the new lookthrough rules extends beyond post mortem pipelines. Planning with inter vivos trusts may trigger the same concerns, and corporate acquisitions by partnerships that undertake standard post-closing simplification mergers may also be caught if one of the partners is a non-resident.

Ultimately, the scope of the new rules may catch many taxpayers, and their advisers, off guard. It is hoped that Finance will take note of these issues and consider legislative amendments, particularly for trusts in the post mortem context. We have communicated the issues discussed in this article to Finance.

Alexander Demner
Thorsteinssons LLP, Vancouver

Kyle B. Lamothe
Thorsteinssons LLP, Toronto

The New Passive Income SBD Grind Rules: When Do We Start? Part 2

In our previous article ("The New Passive Income SBD Grind Rules: When Do We Start?" *Tax for the Owner-Manager*, January 2019), we discussed the application of the new passive income SBD grind rules in paragraph 125(5.1)(b) to three hypothetical associated companies. (See table 1 below.) In this article, we address the provisions of subsections 125(2), subsection 125(3), and paragraph 125(5.1)(b) and how those provisions work together.

Table 1

Company	Tax year-end	First year-end for the application of paragraph 125(5.1)(b)[a]	Tax year when AAII is calculated for the tax filing of the company
A Co	December 31	December 31, 2019	The company's and associated companies' tax year ending in 2018.
B Co	July 31 and October 31[b]	October 31, 2020	The company's and associated companies' tax year ending in 2019.
C Co	March 31	March 31, 2020	The company's and associated companies' tax year ending in 2019.

a Paragraph 125(5.1)(b) is effective for tax years beginning after December 31, 2018.

b Two year-ends occur in B Co's 2018 calendar year as a result of a loss restriction event on August 1, 2018.

Assume that A Co's SBD limit is ground down to $50,000 in December 2019 because of its December 2018 adjusted aggregate investment income (AAII). The AAII of the companies is calculated on the basis of the fiscal year ending in the previous calendar year, and paragraph 125(5.1)(b) is effective for taxation years beginning after December 31, 2018 (subject to the anti-avoidance provision in subsection 125(5.2)). Therefore, A Co will be subject to paragraph 125(5.1)(b) in calendar 2019 and B Co and C Co in calendar 2020.

How do the results above interact with subsections 125(2) and 125(3)? Those two subsections essentially operate together to ensure that associated corporations share one business limit. However, because of the word "notwithstanding" in subsection 125(5.1), the business limit reduction must be calculated before the limit is allocated to the associated companies under subsection 125(3).

This creates an interesting situation in respect of associated corporations' passive income SBD grind rules when one of the corporations in the group has a calendar year-end. As shown in table 1, A Co's passive income SBD grind rules start in calendar 2019, whereas B Co's and C Co's start in calendar 2020. If B Co and C Co were to allocate the SBD between themselves in calendar 2019, they would get the full $500,000 of the shared limit between them, since paragraph 125(5.1)(b) will not apply to them at that time. However, if B Co and C Co were to allocate the full $500,000 to A Co, the associated corporate group would get only $50,000 of the small business limit in calendar 2019.

The rationale for allocating the business limit in a calendar year for which a particular taxation year of an associated corporate group ends is set out in CRA document no. 2004-0091711E5 (September 9, 2005), which cites subsection 249(1) as the statutory authority for specifying the term "calendar year" in line 50 of schedule 23 of form T2.

Setting aside the specified corporate income rules in section 125 and any reasonableness issues in section 67, if A Co pays a management fee to B Co or C Co before its December 31, 2019 year-end (to reduce its active business income and take advantage of this allocation issue under subsection 125(3)), it will be recorded before B Co's and C Co's 2020 year-ends, and this anomaly will disappear, since paragraph 125(5.1)(b) will be effective for all three companies from that point forward.

In essence, this means that perhaps in calendar 2019 B Co and C Co should share the associated group's $500,000 SBD to the exclusion of (or the minimization of the SBD allocation to) A Co. If B Co and C Co cannot use the full limit in calendar 2019, they should consider forgoing the discretionary deductions that would increase the active business income that would be subject to the SBD to take advantage of this one-year deferral (such as CCA deductions, SR & ED deductions, bad debt reserves, and reserves for unearned amounts) and subsequently allocate the remainder, if any, of the SBD to A Co with its $50,000 limit.

Identification of transitional rule issues in the passive income grind context may lead to planning opportunities or traps such as the one discussed. As can be seen, a corporate associated group may inadvertently subject non-calendar year-end companies to the passive income SBD grind rules one year earlier if there is a calendar-year-end company in the group.

Manu Kakkar
Kakkar CPA Professional Corporation, Montreal

Alex Ghani
CPA Solutions LLP, Toronto

Subsection 125(5.2): The SBD Grind and Associated Corporations

The 2018 budget introduced new legislation in subsection 125(5.1) to reduce or grind the SBD if a threshold level of investment income is earned among a group of associated CCPCs. For taxation years commencing after December 31, 2018, the availability of the SBD will begin to be phased out when an associated group of corporations earns adjusted aggregate investment income (AAII) in excess of $50,000 per year.

To combat transactions intended to avoid the SBD grind in paragraph 125(5.1)(b), Finance introduced an anti-avoidance rule in subsection 125(5.2) that contains broad and robust language. The rule applies to related, but unassociated, corporations if

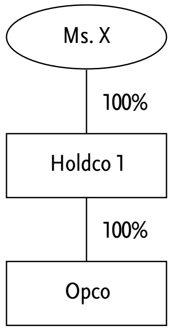
1) one of the corporations lends or transfers property directly, indirectly, or in any manner to the other corporation, and
2) one of the reasons for the loan or transfer is to reduce variable E in paragraph 125(5.1)(b) in respect of the transferor corporation or any corporation with which the transferor corporation is associated.

Variable E is calculated as the aggregate AAII of the transferor corporation and all corporations associated with the transferor corporation in the relevant taxation year. If subsection 125(5.2) applies, then, for the purposes of calculating the SBD grind, the transferor and transferee corporations are deemed to be associated at all times that they are related. The anti-avoidance rule's broad inclusion of transfers by a corporation "directly or indirectly . . . or by any other means whatever" to another corporation and its use of a "one of the reasons" test suggests a wide application of the rule. By wording the rule in this fashion, Finance appears to have eliminated the simplest method of avoiding the SBD grind, which would involve transferring all investment assets to a related but unassociated corporation and relying on the related-party butterfly exception pursuant to paragraph 55(3)(a).

The rule may also apply if the shares of a corporation that carries on a business and claims the SBD are transferred in order to disassociate that corporation from a corporation that holds investment assets. Consider, for example, the situation illustrated in figure 1.

- Opco is a CCPC and a "small business corporation";
- Opco is a wholly owned subsidiary of Holdco 1;
- Holdco 1 has significant investment assets and generates AAII of $150,000 per year;
- Opco does not generate AAII and claims the SBD;
- Ms. X is the sole shareholder of Holdco 1; and
- Ms. X and her spouse, Mr. Y, are both actively involved in the business of Opco.

Figure 1

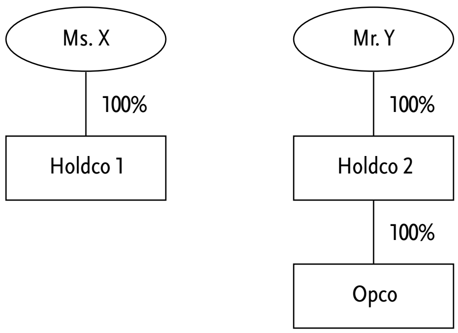


Absent subsection 125(5.2), Ms. X and Mr. Y could presumably avoid the SBD grind without reducing the AAII of their related group of corporations by proceeding as follows:

1) Ms. X and Mr. Y incorporate a new holding corporation, Holdco 2.
2) Ms. X, Mr. Y, Holdco 1, and Holdco 2 undertake a related-party butterfly to transfer the shares of Opco to Holdco 2 on a tax-deferred basis.
3) It should be possible to disassociate Holdco 1 and Holdco 2 as part of this series of transactions while meeting the criteria of paragraph 55(3)(a).

The corporate structure that will be in place following this reorganization is illustrated in figure 2. The result is that the AAII of Opco and its associated group (that is, Opco's variable E of paragraph 125(5.1)(b)) is reduced to nil because Opco is no longer associated with Holdco 1. Opco and Holdco 2 have no investment assets or AAII; but for the application of subsection 125(5.2), future years of Opco would not be subject to the SBD grind.

Figure 2



Although there has been no direct transfer of investment assets by Holdco 1, it is likely that the anti-avoidance rule in subsection 125(5.2) will apply to this series of transactions. Specifically,

1) Holdco 1 transferred property (its shares of Opco) to Holdco 2;
2) Holdco 1 is related to, but unassociated with, Holdco 2; and

3) Opco's (that is, a corporation that was associated with Holdco 1) variable E of paragraph 125(5.1)(b) is reduced.

Although Holdco 1's (the transferor's) variable E is not reduced, paragraph 125(5.2)(c) contemplates that a reduction in the variable E of a corporation (Opco) that was associated with Holdco 1 is also an offending transaction. Thus, for the purposes of calculating the SBD grind, subsection 125(5.2) will likely deem Holdco 1 and Holdco 2 to be associated at all times that they are related. Because Holdco 2 controls Opco, it will be associated with Opco, and Opco will therefore be deemed to be associated with Holdco 1 pursuant to subsection 256(2). As a result, Holdco's AAII of $150,000 presumably will grind Opco's SBD.

It is interesting to note that Opco is associated with Holdco 1 because of the combined operation of subsection 256(2) and the anti-avoidance rule in subsection 125(5.2). The anti-avoidance rule applies to associate Holdco 1 and Holdco 2 (the transferor and transferee corporations), but the SBD grind of importance is in respect of Opco, which is associated with Holdco 1 only by virtue of subsection 256(2). It may therefore be possible to use the election in subparagraph 256(2)(b)(ii) to sever Opco's association with Holdco 1. Before one considers using this election, any transfers from Opco to Holdco 1 prior to the reorganization (such as intercorporate dividends) must also be considered. If one of the reasons for a transfer from Opco to Holdco 1 was to reduce Opco's (or a corporation associated with Opco's) variable E, the anti-avoidance rule in subsection 125(5.2) will deem Opco and Holdco 1 to remain associated. The reasons for a transfer from Opco to Holdco 1 are a question of fact subject to interpretation and the circumstances of the particular transfer.

Jeremy L. Comeau and Darryl R. Antel
Felesky Flynn LLP, Edmonton

Income from Publicly Traded Partnerships: Subject to TOSI?

When the tax on split income (TOSI) rules were expanded on December 13, 2017, the tax community knew that the rules would be difficult to apply because of their broad nature. In addition, the legislation contains several apparently unintended traps, many of which reveal themselves when partnerships are involved.

Assume, for example, that Father owns 0.0000001 percent of a publicly traded limited partnership (Public LP) that earns business income and annually allocates the business income to its limited partners. Father gifts his 19-year-old son $100,000 to invest in Public LP. Son already owns 0.0000001 percent of Public LP. Son has no other income sources; therefore, income from Public LP will otherwise not be subject to tax (because the income earned will likely be less than the basic personal amount), and the attribution rules will not apply. (Business income generally does not attribute, subject to subsection 96(1.8), and Son is not a minor.)

Is the business income that Father and Son earn from Public LP subject to the TOSI rules and thus potentially subject to tax at the highest marginal tax rate? For business income to be subject to the TOSI rules, the following criteria must be met:

1) The individual (other than a trust) who receives the income in question must be a "specified individual."
2) The income in question must be "split income."
3) The income in question must not be an "excluded amount" with respect to the specified individual.

The criteria can be analyzed as follows.

First, each of Father and Son is a specified individual, because each is a non-trust individual who is resident in Canada at the end of the year.

Second, clause (b)(ii)(A) of the definition of "split income" in section 120.4 includes a portion of an amount (other than dividends from non-publicly traded corporations and income from certain shareholder benefit/loan provisions described in paragraph (a) of the definition) "included because of the application of paragraph 96(1)(f) . . . to the extent that the portion . . . can reasonably be considered to be income derived directly or indirectly from one or more related businesses in respect of the individual."

Paragraph (b) of the definition of "related business" in section 120.4 includes a business of a particular partnership (here, Public LP) "if a source individual in respect of the specified individual at any time in the year has an interest—including directly or indirectly—in the particular partnership."

Father and Son are "related persons," and thus each is a "source individual" in respect of the other. As a result, from each of their perspectives, a source individual has an interest in Public LP. Therefore, the business income allocated from the partnership is split income. Absent one of the exclusions in the definition of "excluded amount," the partnership income will be taxable at the highest marginal tax rate to each of Father and Son.

Third, several exclusions in the "excluded amount" definition attempt to ensure that income earned from investments that are generally arm's-length will not be subject to the TOSI rules. The first, in subparagraph (e)(i) of the definition, applies to individuals over the age of 17 if the income "is not derived directly or indirectly from a related business in respect of the individual for the year." As illustrated above, however, the income earned by each of Father and Son from Public LP is income derived from a related business in respect of each of Father and Son. Thus, this exclusion cannot be relied on.

An exclusion in paragraph (g) of the "excluded amount" definition applies when the individual is over the age of 24 in the year, and the amount is a "reasonable return" in respect of the individual. Subparagraphs (b)(ii), (iii), and (v) of the definition of "reasonable return" generally looks at the "property [that the individual] contributed, directly or indirectly, in support of the related business"; the "risks [the individual] assumed in respect of the related business"; and "such other factors as may be relevant" to the investment that generated the income. (Other criteria are noted in this exclusion, but they are not relevant here.)

Does Father's purchase of the Public LP units on the open market satisfy this exclusion? Father has risked capital to make the investment and is earning a return thereon. Whether Father has made a "contribution" in respect of the business is a question of fact. If Father and Son have contributed nothing to Public LP's business, can Father rely on this exclusion, given that his "contribution" to the business (nothing) is measured relative to Son's contribution (also nothing)?

Because Son is only 19 years of age, he cannot rely on the "reasonable return" exclusion, and he will be unable to do so until the year in which he turns 25. In this case, there are two possible exclusions on which Son can rely. The amount realized must represent

1) a reasonable return on arm's-length capital, and/or
2) a safe-harbour capital return (SHCR).

The details of the exclusion for a reasonable return on arm's-length capital are beyond the scope of this article. However, because Father gifted the invested funds to Son, the amount realized in respect of the investment will not constitute a reasonable return on arm's-length capital. Son will have to try to rely on the SHCR exclusion in order to avoid the TOSI rules.

Simply put, an SHCR will essentially permit Son to earn a return on his capital contributed ($100,000) equal to the highest prescribed rate in effect for a quarter in the year. Thus, Son can earn up to 2 percent on the FMV of property contributed by him in support of a related business, at the time it was contributed. However, Son purchased the Public LP units from a third party on the open market; he did not contribute the funds directly to Public LP. Does this purchase constitute "property contributed" by Son "in support of a related business"? Probably not, but this remains to be seen.

The outcome described above appears to be an unintended consequence of the labyrinthine TOSI rules. An adult child, investing gifted funds into a widely held and (in this case) publicly traded investment vehicle, in which no person related to him is actively engaged, or owns a material interest, can potentially be caught by the TOSI rules.

One cannot help but notice that if the funds had been used to purchase public company shares, or if the Public LP units had earned dividend income from public companies (rather than generating business income), the TOSI rules probably would not be applicable. Note, however, that this observation is based on a recent (and perhaps generous) interpretation published by the CRA (2018-0768831C6, October 5, 2018). An alternative reading with respect to the earning of public company dividends through a partnership that constitutes a related business is that such dividends could be subject to TOSI, and that the CRA's interpretation—which automatically excludes from the TOSI rules, in all cases, public company dividends allocated from a partnership—is perhaps questionable.

Justin Abrams
Kraft Berger LLP
Markham, ON

CRA: Supplemental Retirement Plan's Bonus and Vacation Pay Contributions Likely Indicate an SDA

In a technical interpretation (2018-0740741E5, January 11, 2019), the CRA stated that certain components of a taxpayer's two supplemental retirement plans would likely constitute salary deferral arrangements (SDAs). The CRA noted that although it was unable to provide a definitive determination due to insufficient information, the plan's bonus contribution and vacation pay contribution components appeared to be primarily motivated by tax deferral considerations and, as a result, were SDAs. The CRA's comments are helpful in determining whether components of supplemental retirement plans are SDAs and thus taxable to employees in the current year rather than in the year in which the amounts are received.

Assume that an employer (Canco) sponsors a defined contribution registered pension plan (RPP) under which it makes contributions equal to a fixed percentage of each member's pensionable earnings. Canco also matches any voluntary contributions made by the member. In addition, Canco provides an unfunded and unsecured plan for each member of the RPP whose contributions are capped by the RPP limits under the Act ("the supplemental plan"), as well as an unfunded and unsecured plan for the accumulation of a retirement allowance benefit for Individual X, one of its executives ("the retirement allowance plan").

Under the supplemental plan, Canco allocates notional contributions (and interest) to the member's account based on the same contribution rate as the RPP less the actual employer contributions made to the RPP. In addition, a plan member can elect to reduce or forgo future bonus entitlements and accrued vacation pay entitlements for additional allocations (of equal amounts) to the member's account. At the earliest of the member's termination of employment, retirement, or death, the member is entitled to benefits equal to the account balance payable by the employer as a lump sum, or in annual instalments over a period of up to 10 years.

Under the retirement allowance plan, Canco allocates notional contributions each month to Individual X's account at 7 percent of the remuneration received in the previous month (plus interest). The plan also provides for a one-time $125,000 notional contribution to Individual X's account at the start of the plan. At the earlier of the termination of employment and the attainment of age 65, Individual X is entitled to benefits equal to the account balance, either as a lump sum or in annual instalments over a period of up to 10 years.

Although it is not part of the retirement allowance plan, severance pay is also payable to Individual X upon termination of employment or upon retirement in an amount equal to 24 months of base salary, plus an amount in lieu of pension and automobile benefits.

Generally, pension benefits paid to a taxpayer are included in income in the year in which they are received under paragraph 56(1)(a).

An SDA is generally defined in subsection 248(1) as an arrangement that gives a person the right, in a taxation year, to receive an amount in a subsequent taxation year, where one of the main purposes of the right is to postpone tax payable on an amount that is, or is on account or in lieu of, salary or wages for services rendered by the taxpayer in the year or a preceding taxation year.

Under subsections 6(11) and (12), a taxpayer who has a right to receive a deferred amount under an SDA or a right to receive interest or another additional amount that accrued on a deferred amount is deemed to have received the amount in the year in which it was earned. As a result, the taxpayer must include the amount in his or her income from an office or employment under paragraph 6(1)(a), even though the taxpayer receives no cash during the year.

If an employee who renders services to his or her employer includes a deferred amount under an SDA in income under paragraph 6(1)(a) for such services, the employer may deduct that amount in computing its income under paragraph 20(1)(oo).

Subsection 6(14) provides that when an SDA is part of a larger combination plan that provides other benefits, the SDA will be treated as a separate arrangement independent of the parts of the plan that are not an SDA. Accordingly, each of the three notional contribution components of the supplemental plan can be considered separately in determining whether the particular component is an SDA.

In the TI, the CRA stated that the bonus contribution and vacation pay contribution components in these plans would likely constitute an SDA. The CRA noted that although whether a plan constitutes an SDA is a question of fact, these components appeared to be primarily motivated by tax deferral considerations. However, the CRA conceded that the supplemental plan's basic contribution component appeared to be largely consistent with the CRA's position and would not constitute an SDA.

In the TI, the CRA noted that a plan may be considered an SDA if one of its main purposes is to postpone tax on a taxpayer's salary or wages for services rendered in the year or a preceding taxation year. The CRA noted that, as it has stated in the past, it will consider a plan to be an SDA unless the plan has the characteristics of an unregistered or supplementary pension plan, and the amounts paid out from the plan can be considered reasonable superannuation or pension benefits. The CRA considers these benefits to be reasonable when the plan's terms are substantially the same as those of the RPP that applies to the same beneficiaries, and the benefits paid under the plan are the same as the benefits that would have been paid under the RPP but for the defined benefit or money purchase limit. The CRA said that it will also consider the terms of a plan that are not the same as those provided under the RPP or that are greater than those that could be provided under the RPP and any other relevant information to determine whether the benefits are reasonable in order to ensure that a plan is not considered an SDA.

The CRA said that it did not have sufficient information to comment on whether constructive receipt might apply, as outlined in paragraph 10 of *Interpretation Bulletin* IT-502, "Employee Benefit Plans and Employee Trusts." The CRA offered to provide a definitive determination on Canco's plans through an advance income tax ruling, if requested.

Dino Infanti
KPMG Enterprise Tax, Vancouver

Uncertainty Resolved: Milne Estate Reversed

The recent decision of the Divisional Court in *Milne Estate (Re)* (2019 ONSC 579) is welcome news to advisers to owner-managers in Ontario. The court reversed the decision of the Superior Court (2018 ONSC 4174), which had refused to grant probate to wills containing a certain kind of allocation clause used in Ontario as part of planning designed to mitigate exposure to the Estate Administration Tax Act, 1998 (Ontario). (See "Milne Estate: How Should Multiple Wills Be Drafted in Ontario?" *Tax for the Owner-Manager*, January 2019.) The decision of the Divisional Court largely mirrors the decision of Penny J in *Panda Estate (Re)* (2018 ONSC 6734), which dealt with a nearly identical scenario but reached the opposite conclusion.

In *Milne Estate*, the matter at issue related to the admissibility to probate of the primary wills of John Milne and Sheilah Milne, both of whom died on October 2, 2017. Each left a primary will and a secondary will. The clauses used in allocating the assets of the estates granted discretionary authority to the executors of the primary will to allocate assets into the secondary will by exclusion from the primary will. In particular, the clauses included in the primary wills all of the property owned at death by the deceased, except "any other assests for which [the executors] determine a grant of authority by a court of competent jurisdiction is not required for the transfer or realization thereof."

Dunphy J had refused to grant probate to the primary wills on the basis that the wills were a form of trust and lacked the requisite certainty of subject matter required under trust law. He had also determined that the role of a probate court was inquisitorial, and therefore issues of construction (interpretation) could be raised at the probate stage.

The Divisional Court rejected the finding that a will is a form of trust. The court noted that the definition of "will" in section 1(1) of the Succession Law Reform Act (SLRA) does not define it as such. It then reviewed the law of wills to determine that a will may contain a trust, but that it is not a requirement for a valid will. The court acknowledged that SLRA section 2(1), which devolves the property of a deceased individual upon his or her personal representatives, uses the term "trustee." However, the court rejected the conclusion that this meant that a will was therefore a trust. It held that Dunphy J had erred in finding that the wills were a trust and, by implication, in applying trust-law principles when considering the admissibility of the primary wills to probate.

The Divisional Court also held that if SLRA section 2(1) did create a trust, such a trust would be a statutory trust and would not be subject to the requirement to satisfy the three certainties of trust law (including certainty of subject matter).

The court also held, in the alternative, that if the three certainties must be satisfied, the subject matter of the primary wills, being the only certainty in issue, was certain. Citing Eileen E. Gillese, *The Law of Trusts*, 3d ed. (2014), at 43, the Divisional Court held that the property in the primary wills was certain because "there is an objective basis to ascertain it; namely whether a grant of authority by a court of competent jurisdiction is required for transfer or realization of the property." The court concluded that the executors could allocate a deceased's property between the primary and secondary wills on an objective basis.

The court remarked in obiter that Dunphy J had exceeded his authority by considering issues of construction at the probate stage.

Although perhaps not entirely unexpected in light of the decision in *Panda Estate*, the decision is welcome. Advisers can now be confident that clauses similar to the ones used in *Milne Estate* are legally effective and that probate planning previously undertaken using such clauses will continue to be effective.

However, readers should be aware that for multiple wills to be effective, the person drafting the wills must use appropriate language. Careful testators will want to ensure that the person retained for this purpose has the necessary experience in dealing with wills of this type.

Philip Friedlan and Adam Friedlan
Friedlan Law
Richmond Hill, ON

Rectification: It's All About Intention

The availability of the remedy of rectification has been a controversial topic in the last few years, particularly in the context of tax law. In December 2016, the SCC released two landmark decisions: *Fairmont* (2016 SCC 56) and *Jean Coutu Group (PJC)* (2016 SCC 55). The cases dealt with the equitable remedy of rectification when unforeseen tax liabilities arise in the common-law and civil-law context, respectively.

The majority in *Fairmont* held that rectification may be permitted (paragraph 38):

> Where the error is said to result from a mistake common to both or all parties to the agreement, rectification is available upon the court being satisfied that, on a balance of probabilities, there was a prior agreement whose terms are definite and ascertainable; that the agreement was still in effect at the time the instrument was executed; that the instrument fails to accurately record the agreement; and that the instrument, if rectified, would carry out the parties' prior agreement.

The SCC's companion decision to *Fairmont*, *Jean Coutu Group*, addressed the concept of "rectification" as it applies in the Quebec Civil Code (QCC). QCC article 1425 provides that "[t]he common intention of the parties rather than adherence to the literal meaning of the words shall be sought in interpreting a contract."

Unlike the common law, QCC article 1425 requires the judge or interpreter to give the parties' common intention precedence over the wording of the contract (see *Uniprix inc. v. Gestion Gosselin et Bérubé inc.*, 2017 SCC 43, at paragraph 116).

Since *Fairmont* was decided, taxpayers have struggled to obtain rectification when there has been an error in the implementation of a tax plan. The recent decision in *Crean v. Canada (Attorney General)* (2019 BCSC 146) has breathed new life into the use of the equitable remedy of rectification. In *Crean*, the court granted the application for rectification after a sale of shares resulted in an unanticipated tax liability pursuant to subsection 84.1(1).

The petitioners (two brothers, Thomas Crean and Michael Crean; Crean Holdings Ltd.; and 1086881 BC Ltd.) applied to the court for rectification of an agreement. Each brother owned 50 of the 100 issued and outstanding common shares of Crean Holdings. Thomas, who intended to retire, wanted to sell his shares in the Crean Group (which consisted of Crean Holdings and other entities) to Michael. The brothers wrote an initial agreement between themselves which provided, inter alia, that Michael would purchase all of Thomas's interest in the Crean Group, "direct or indirect," for $3.2 million, and that "the transaction will be structured, to the extent possible, so that Tom receives capital gains treatment for tax purposes."

After entering into this agreement, Thomas and Michael approached their tax adviser about the proposed sale. The adviser recommended that Michael incorporate a new company and use that corporation to purchase Thomas's shares in the Crean Group. Unfortunately, the adviser ultimately proposed a plan that did not contemplate the application of subsection 84.1(1), which resulted in a deemed dividend of $2.747 million, reversing the capital gains reported originally.

The brothers applied to the court for rectification on the basis that their tax adviser had made a "mistake" in interpreting and implementing the true intention of the brothers' original agreement.

The Crown resisted the application vigorously. It argued that the brothers wanted rectification of an instrument that had "provided [them] with adverse tax consequences" and that the petitioners' claim that their tax adviser made a "mistake" in effecting the true agreement was disingenuous. The Crown said that the only mistake was that the tax adviser did not consider the application of subsection 84.1(1), which resulted in a deemed dividend of $2.747 million. According to the Crown, rectification would give the taxpayers a "second chance, with the benefit of hindsight," at drafting an agreement to avoid any negative tax consequences.

The petitioners pointed to the language of the actual agreement, which explicitly provided that the transaction would be structured, to the extent possible, so that Thomas would receive capital gains treatment for tax purposes. They argued that the transactions that were implemented were inconsistent with the true agreement.

The petitioners also cited *Jean Coutu Group*, in which the SCC stated that the implementation documents could be rectified when necessary to bridge the gap between the contracting parties' common intention and the written expression thereof.

The court agreed with the petitioners that the doctrine of rectification is not limited to clerical errors. Furthermore, the court recognized that *Jean Coutu Group* is not legally binding in common-law matters because it was decided under the QCC. However, the court acknowledged (at paragraph 84) that it would be "guided by the Supreme Court of Canada's emphasis on the 'undoubtedly desirable' convergence of the common law and civil law in tax cases such as the case at the bar."

Ultimately, the court concluded that the SCC's decisions in *Fairmont* and *Jean Coutu Group* supported a grant of rectification for the taxpayers. It accepted the original agreement written by the brothers as the determinative evidence of their actual agreement.

In rejecting the Crown's positions, the court in *Crean* emphasized that the remedy of rectification is available to address mistakes beyond the limited ambit of mere clerical errors. Rectification remains a viable remedy when

1) there was a prior agreement whose terms are definite and ascertainable;
2) the agreement was still in effect at the time that the instrument was executed;
3) the instrument fails to record the agreement accurately; and
4) the instrument, if rectified, would carry out the parties' prior agreement.

The SCC's decisions in both *Fairmont* and *Jean Coutu Group* underscore the importance of documenting carefully the common intentions of all the parties in any contracts. With respect to tax planning, it is imperative that lawyers and accountants both describe and transcribe, in precise detail, the objectives of the transaction and the intended legal outcomes thereof, and that such objectives and intentions be consistent with the agreement of the parties.

Aasim Hirji
Moodys Gartner Tax Law LLP, Calgary

Reagan Ruslim
Moodys Gartner Tax Law LLP, Edmonton

GST/HST on Exports from Canada: Ships, Carriers, and Place of Delivery

Goods exported or otherwise delivered to a recipient outside Canada are typically not subject to GST/HST and are usually zero-rated. To qualify for zero-rated treatment, a GST/HST registrant must either (1) satisfy one of the zero-rating provisions in schedule VI of the ETA or (2) establish that the goods were delivered outside Canada. The place of delivery is determined with reference to the applicable sale-of-goods legislation.

Montecristo Jewellers Inc. v. The Queen (2019 TCC 31) is an important decision that closely examines the requirements for zero-rating under paragraph 12(a) of part V of schedule VI and adds to the jurisprudence on the meaning of "delivery" when one is determining the place of supply. For an importer or exporter of goods, *Montecristo Jewellers* provides a useful analysis of the requirements to zero-rate exports under paragraph 12(a) and the criteria to determine the place of delivery.

Overview of GST/HST Assessment

Montecristo disputed a GST/HST assessment for a failure to charge, collect, and remit GST/HST in the amount of $2,298,898.13 on its exported sales of jewellery. It argued that the subject sales were zero-rated exports under paragraph 12(a), or, alternatively, that the jewellery was delivered to the customer outside Canada and was not subject to GST/HST.

The TCC's Decision

The TCC concluded that the subject sales were not zero-rated and that the jewellery was delivered in Canada. Accordingly, Montecristo should have charged, collected, and remitted GST/HST on those sales. *Montecristo Jewellers* adopts a narrow interpretation of the meaning of "contract for carriage" and

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Canadian Tax Foundation
145 Wellington Street West, Suite 1400
Toronto, Ontario M5J 1H8
Telephone: 416-599-0283
Facsimile: 416-599-9283
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"shipped" for the purposes of paragraph 12(a) and the meaning of "place of delivery" under the BC Sale of Goods Act (BCSGA).

Background

During its April 1, 2010 to March 31, 2013 reporting period, Montecristo was a retailer of jewellery and luxury watches in Vancouver. Most of Montecristo's clientele were members of the Chinese community who lived in and around Vancouver; they purchased items from Montecristo as gifts to be delivered in person to family and business relations in China. Some customers requested a GST/HST exemption on their purchase because the goods were destined for China and thus effectively exported. Montecristo accommodated those clients by following a procedure to zero-rate the goods.

The Invoicing and Delivery Procedure

Montecristo produced a handwritten invoice that included the customer's flight information. Physical possession of the jewellery remained with Montecristo until the customer was ready to depart for China, at which point an employee took the jewellery, the invoice, and a partially completed form E15 ("Certificate of Destruction/Exportation") to the Vancouver International Airport, where the employee met the customer at the CBSA office. The employee handed the jewellery, boarding pass, and form E15 to the CBSA officer for inspection. If satisfied with the inspection, the CBSA officer completed the balance of form E15, stamped it, and gave the employee a copy. The customer took possession of the jewellery and boarded the flight.

Zero-Rated Exports: Paragraph 12(a) of Part V of Schedule VI

Paragraph 12(a) provides that a supply of tangible personal property (TPP) is zero-rated if the supplier ships the property to a destination outside Canada that is specified in the contract for carriage of the property. Lyons J read paragraph 12(a) to mean that a third-party carrier was required for a supply of TPP to satisfy the requirements of the paragraph:

> [71] [I]n my view the most plausible interpretation of paragraph 12(a), applying the unified approach, denotes an intention that a third party carrier would need to be engaged where the supplier "ships" the property to a destination outside Canada.

Montecristo argued that paragraph 12(a) did not preclude the customer from being a party to a contract to ship the jewellery outside Canada; it referred to form E15, the sales invoice, and the airplane ticket as evidence. The TCC said that the evidence did not show that paragraph 12(a) was satisfied: "As no third party carrier was engaged under a contract for carriage, I find that the appellant did not ship the Jewellery within the meaning of paragraph 12(a)" (paragraph 78).

The TCC adopted a narrow interpretation of paragraph 12(a), which excludes a contract for carriage other than a contract with a third party. For businesses that have not used a third-party carrier to export goods and have relied on paragraph 12(a) to zero-rate, this interpretation should be cause to revisit their contracts for carriage for compliance.

Delivery of Jewellery Was Made in Canada

Paragraph 142(2)(a) of the ETA provides that a supply of TPP will be deemed to be made outside Canada if the property is, or is to be, delivered or made available outside Canada to the recipient of the supply. Montecristo argued that the jewellery was delivered outside Canada, either on board the airplane or at the destination on the airline ticket.

To determine the place of delivery, the TCC relied on the BCSGA, which defined "delivery" as a "voluntary transfer of possession from one person to another." In finding that the place of delivery was in Canada, Lyons J explained (at paragraphs 105 and 108) that

> [a]t the time the Customers were physically handed the Jewellery at [the airport], they had full possession, use and assumed the risks inherent in the Jewellery thereby acquired it regardless of their intent. . . .
>
> I find that there was a full voluntary transfer of possession, without restriction, when supplies of Jewellery were physically handed to Customers who accepted possession of the Jewellery.

Under the BCSGA, parties may specify by contract, either express or implied, the place and the intended time of delivery of goods. Montecristo argued that the evidence demonstrated the customers' intent, whether express or implied, to deliver the goods outside Canada. Lyons J could not reconcile that intent with the fact that the customers had unencumbered possession and control of the jewellery while they were in Canada: she found the stated intent to be "implausible in the circumstances" (paragraph 104).

Montecristo has appealed the decision to the FCA.

Bobby Solhi
Borden Ladner Gervais LLP, Toronto