TAX FOR THE Owner-Manager

Editor: Thomas E. McDonnell, QC

Volume 20, Number 1, January 2020

Eyeball Networks Inc.: The Interaction Between Section 160 and a Related-Party Butterfly Transaction

Eyeball Networks Inc. v. The Queen (2019 TCC 150) considers the application of section 160 to a related-party butterfly. The appellant, Eyeball Networks Inc. (Newco), was incorporated for the purpose of receiving assets on a tax-deferred basis from an existing corporation (Oldco). Oldco had been involved in the online gaming industry and held some valuable technology assets and patents ("the Oldco property"), which the sole shareholder of Oldco, Mr. Piche, wanted to transfer to a new entity in order to fully exploit. The corporate reorganization involved several steps, summarized below.

On a rollover basis, Mr. Piche exchanged his existing shares of Oldco for class A shares and redeemable, retractable class C shares of Oldco (whose terms provided for an aggregate redemption amount equal to the FMV of the net assets of Oldco). He then sold the class C shares of Oldco on a rollover basis to Newco for shares of Newco, which purchased the Oldco property from Oldco on a rollover basis. Newco assumed certain liabilities and issued its class C shares to Oldco (the class C shares were redeemable and retractable and had an aggregate redemption amount equal to the FMV of the assets acquired less the amount of the liabilities assumed). Therefore, the aggregate redemption amounts of the class C shares of Newco held by Oldco and the class C shares of Oldco held by Newco were equal. The two sets of shares and/or the relevant agreements included price adjustment clauses that would adjust the redemption amounts in the event of a CRA challenge. Each set of shares was then redeemed by the issuer for the aggregate redemption amount, and a demand promissory note was issued in payment by Newco ("the Newco note") and by Oldco ("the Oldco note"). Finally, pursuant to a debt-cancellation agreement (DCA), the two notes were set off and cancelled.

On September 16, 2003, the minister reassessed Oldco for its taxation years ending July 31, 2000 and July 31, 2001 for tax and interest; on August 9, 2004, the minister reassessed Oldco's 2002 taxation year for tax, interest, and a penalty. Oldco failed to pay the reassessments, and on March 19, 2014 Newco was assessed pursuant to section 160 in respect of Oldco's tax debts.

The question before the TCC was whether section 160 applied so as to allow the minister to assess Newco for Oldco's unsatisfied tax liability. Legally, that liability existed at the time of the transfers, but the sole shareholder was unaware of it at that time. The TCC reviewed the jurisprudence relating to section 160 and the four requirements for the section's

In This Issue

Editor's Note

Philip Friedlan, along with the Hon. Karen Sharlow, was named a recipient of the Canadian Tax Foundation's Lifetime Contribution Award at the 2019 annual conference. The award celebrates and honours those individuals who, over their careers, have made substantial and outstanding contributions to the Canadian Tax Foundation and its purposes through their volunteer efforts and their body of work over a number of years.

Phil is a founding and a continuing contributor to *Tax for the Owner-Manager*. He has rendered exceptional service to the Foundation as a member of its Board of Governors (2006-2009) and as a member of the Program Committee for the Ontario Tax Conference for many years. I am very pleased to congratulate him on his receipt of this award. His articles for this newsletter, and the papers that he has delivered at Foundation conferences, are valued additions to the tax literature in Canada.

Information concerning the Lifetime Contribution Award, including the nomination process, is available on the Foundation's website.

Thomas E. McDonnell
Toronto

CTF CANADIAN TAX FOUNDATION
FCF FONDATION CANADIENNE DE FISCALITÉ

application set out in *Canada v. Livingston* (2008 FCA 89). The only point in dispute was the existence and FMV of the relevant consideration given for the property transferred by Oldco to Newco.

The minister accepted that the initial transaction—the issuance of the shares to Oldco—constituted sufficient consideration for the assets. However, the minister argued that the redemption of shares and the mutual debt-cancellation date nullified the consideration. The minister employed a "results-based economic reality" approach (that is, a net-result approach) and wanted to examine the transactions as a whole to determine whether Newco had given Oldco valid consideration.

The court undertook a textual, contextual, and purposive analysis of subparagraph 160(1)(e)(i). It held that the minister cannot assess under section 160 on the net results of the series of transactions and that the subparagraph is to be applied at the time at which each relevant property is transferred.

The court then turned to the question of the FMV of the relevant consideration given by Newco at each stage of the transactions. With respect to the last transaction in the series—the DCA—the minister argued that the consideration given by Newco was less than the FMV of the property transferred by Oldco. The court said that each of Newco and Oldco had received symmetrically equal consideration in the other transactions, given that the price adjustment clauses would adjust those values should the minister challenge the asset. However, the Newco note and the Oldco note were not equal in value at the time that they were set off. In fact, Bocock J held that the value of the Oldco note was nominal. He reached this conclusion because the Oldco note was a negotiable bill, and since Oldco was no longer backed by assets (which had been transferred to Newco), its note could not be equal in value to the Newco note. Bocock J also seems to have taken the view that the DCA was a legal mechanism to collapse a series of transfers of property for value and thus should be regarded as a transfer of property between the parties. In particular, he held that the DCA was "an abbreviation for a longer form sequence of duplicative presentment and transfer of payment under each promissory note." He concluded that the DCA resulted in an indirect transfer of the Newco note (with significant value) by Oldco in consideration of the surrender or forgiveness of the Oldco note (with nominal value). Therefore, section 160 applied.

With respect, although we agree that section 160 is properly applied on a point-in-time basis, we question whether the FMV of the Oldco note was nominal. After the asset sale to Newco, it appears that Oldco had no business assets of any value and no liabilities (other than its tax liability, which was then unknown); but it did hold the Newco note, which was issued by a corporation with value. What would an arm's-length third party have paid for the Oldco note? Furthermore, and again with respect, we also wonder whether the approach taken to determine that the DCA resulted in an indirect transfer of property was correct. Should the TCC have limited its analysis to the legal effect of that agreement?

The case is under appeal.

Philip Friedlan and Adam Friedlan
Friedlan Law
Richmond Hill, ON

The "Excluded Business" Exception to TOSI: Reorganized Businesses

In a technical interpretation (TI 2019-0814181E5, August 19, 2019), the CRA confirmed that the five-year test to qualify for the "excluded business" exception under the TOSI (tax on split income) rules should take into account all taxation years in which a taxpayer is involved in a business, regardless of whether the business was previously carried on in another form. The CRA notes that if a specified individual meets this test after all of those years are taken into account, then any dividends that the individual receives that are derived directly or indirectly from that business are not subject to TOSI. According to the CRA, reorganizations and other changes to the person or partnership carrying on the business should not affect the determination of whether the business qualifies as "an excluded business of a specified individual."

In the TI, the CRA considered two situations in which a specified individual is actively engaged in a business before and after certain reorganizations; one involves a business that is transferred from a sole proprietorship to a corporation, and the other involves a subsequent amalgamation of that corporation with another corporation. Note that the CRA commented only on whether the "excluded business" exception applies and did not address other potential TOSI exceptions.

Generally, the TOSI rules under section 120.4 apply to tax split income received by a specified individual in a taxation year at the highest marginal tax rate, unless the amount is an "excluded amount." For an individual who has attained the age of 17 years before the end of that year, an excluded amount includes an amount derived directly or indirectly from an "excluded business" of the individual under subparagraph (e)(ii) of the definition of "excluded amount." The term "excluded business" is defined in subsection 120.4(1) as a business in which the specified individual is actively engaged on a regular, continuous, and substantial basis in the year or any five prior taxation years of the specified individual ("the five-year test").

In the TI, the CRA first looked at situation 1, which involves a transfer from a sole proprietorship to a corporation. The CRA considered two individuals (spouse A and spouse B). Spouse A is an adult individual resident in Canada who operates a catering business as a sole proprietorship. Spouse B,

who is also an adult individual resident in Canada, has been actively engaged on a regular, continuous, and substantial basis as a full-time employee of spouse A's catering business, which has operated as a sole proprietorship for less than five years.

Spouse A transfers the business to a newly incorporated corporation (Opco A) in return for preferred shares of Opco A. A family trust, created for the benefit of spouse A, spouse B, and other family members, subscribes for the common shares of Opco A. Spouse B is an income beneficiary of the trust.

After the business is transferred to Opco A, spouse B continues working in the business as a full-time employee for a further period of less than five years. However, the total period of time during which spouse B has been employed in the catering business (including while it was carried on by spouse A as a sole proprietorship and while spouse B was employed by Opco A) exceeds five years.

After spouse B has ceased working in the business, Opco A pays a dividend to the trust; the trust designates the dividend as a taxable dividend received by spouse B under subsection 104(19).

The CRA was also asked if its conclusion with respect to whether spouse B meets the five-year test under the excluded-business exception would change if the facts differed slightly. In situation 2, spouse B continues to work full-time in Opco A's catering business for a period of at least five years. After spouse B stops working for Opco A, Opco A amalgamates with another corporation (Opco B), which also carries on a catering business, to form Amalco. Neither spouse A nor spouse B has ever been involved with Opco B's catering business.

Amalco continues to carry on a catering business, which remains a "related business" as defined in subsection 120.4(1) in respect of spouse B. Amalco pays a dividend to the trust, and the trust designates the dividend as a taxable dividend received by spouse B under subsection 104(19). Spouse B does not work for Amalco in the year that the dividend is received.

In its response, the CRA confirmed that spouse B may qualify for the five-year excluded-business exception in both situations. As a result, TOSI will not apply to the dividends that spouse B receives from the trust. The CRA noted that in both situation 1 and situation 2, spouse B did not work for either Opco A or Amalco in the year that the dividend was received. As a result, Opco A's business (in situation 1) or Amalco's business (in situation 2) can qualify as an excluded business of spouse B only if spouse B meets the five-year test under the "excluded business" definition.

In its comments, the CRA assumed that spouse B is a "specified individual" and spouse A is a "source individual" (as both terms are defined in subsection 120.4(1)) in respect of spouse B. The CRA also assumed that spouse A's Opco A preferred shares have an FMV of 10 percent or more of all of the issued and outstanding shares of Opco A; that Opco A's catering business is a "related business" in respect of spouse B; and that the dividends distributed from the trust will be derived directly or indirectly from that related business. The CRA also qualified its response with a general comment that whether an individual is actively engaged on a regular, continuous, and substantial basis is generally a question of fact that depends on the nature of the individual's involvement and the nature of the business itself.

In considering the transfer of the catering business from a sole proprietorship to a corporation in situation 1, the CRA stated that spouse B meets the five-year test under the excluded-business definition. The CRA noted that spouse B spent a combined period of at least five previous taxation years being actively engaged on a regular, continuous, and substantial basis in the catering business, which was carried on first by spouse A as a sole proprietorship and then by Opco A. As a result, the taxable dividend received by spouse B from the trust will be an excluded amount and will not be subject to TOSI.

The CRA said that the definition of "excluded business" should encompass taxation years in which a business may have been carried on in another form. The CRA stated that, generally, reorganizations and changes regarding the person or partnership carrying on a business should not affect the determination of whether a business is an excluded business of an individual, as noted by Finance in the explanatory notes for section 120.4. In the explanatory notes, Finance specifically said that if a business operating as a sole proprietorship is transferred to a corporation, an individual's involvement in that business before the transfer should be taken into consideration when one is assessing the excluded-business exception.

In considering situation 2, the CRA said that whether spouse B's dividend income from Amalco could qualify for the excluded-business exception depends on whether the business carried on by Amalco is the same business that was carried on by Opco A, which is generally a question of fact.

The CRA said that if Amalco is carrying on the same catering business as Opco A, the dividend that spouse B receives from the trust will be an excluded amount and thus will not be subject to TOSI. On the other hand, the CRA said that the dividend that spouse B receives from the trust will be subject to TOSI if (1) Opco B does not carry on a catering business before the amalgamation and (2) Amalco only carries on Opco B's business post-amalgamation (unless another TOSI exception applies). The CRA said that this is because Amalco's business will not be considered an excluded business in respect of spouse B because spouse B is not actively engaged in that business on a regular, continuous, and substantial basis, either in the relevant taxation year or in the five prior taxation years.

Finally, the CRA said that if Opco B does not carry on a catering business before the amalgamation, and if Amalco carries on both Opco A's catering business and Opco B's non-catering business after the amalgamation, then only the income that spouse B derives directly or indirectly from the catering business will be income from an excluded business and not subject to TOSI. According to the CRA, income that spouse B derives directly or indirectly from the non-catering business will be subject to TOSI unless another exception applies. In that case, Amalco must maintain separate books and records for each business, and the taxpayer must maintain documentation adequate to allow the tracing of funds from each business to the payment of dividends to determine whether the dividend is an excluded amount for spouse B.

Dino Infanti
KPMG Enterprise Tax, Vancouver

Section 48.1: TOSI Trap in Going Public

Shareholders of private corporations whose shares are soon to be traded on a publicly listed stock exchange are usually presented with a multitude of tax-planning considerations. One common planning opportunity is to elect under subsection 48.1(1) to utilize the lifetime capital gains exemption or other tax attributes before going public. In this article, we highlight how the expanded TOSI (tax on split income) rules present a trap that taxpayers should be aware of when they rely on this provision to undertake tax planning that was available under the old TOSI rules.

An election under subsection 48.1(1)—made by filing form T2101 ("Election for Gains on Shares of a Corporation Becoming Public")—allows taxpayers to obtain a step-up in the cost base of their shares without necessarily triggering tax payable and without having to sell their shares before the corporation goes public. The election deems the shareholders to have disposed of their shares for proceeds of disposition equal to the amount specified in the election. In essence, the shareholders can trigger the desired amount of capital gains to utilize the lifetime capital gains exemption, losses, or other tax attributes.

Private Company Tax Restructuring

In a private company context, it is common for shareholders to reorganize the corporate structure to multiply the lifetime capital gains exemption or make use of multiple tax brackets to eliminate or significantly reduce the tax realized on a capital gain. Typically, the corporate reorganization concludes with the shares of an operating company being owned by a family trust of which the family members are beneficiaries.

When the corporation goes public, the taxable capital gains realized by the trust can be allocated to the beneficiaries via a subsection 48.1(1) election, provided that the terms of the trust allow for such phantom income to be paid or made payable to the beneficiaries. The beneficiaries can then use the lifetime capital gains exemption and their individual tax brackets to shelter all or a portion of the gain allocated to them.

TOSI and Subsection 48.1(1): The Old and New Rules

Under the old TOSI rules, a capital gain became subject to the TOSI rules only under subsections 120.4(4) and (5). For instance, if the capital gain from the deemed disposition of private company shares to a non-arm's-length person was triggered by a minor, then subsection 120.4(4) would normally recharacterize the gain as a taxable dividend subject to the highest marginal personal tax rate. Fortunately, the taxable capital gain from the deemed disposition under subsection 48.1(1) was, and under the new TOSI rules still is, exempt from this recharacterization.

However, the expansion of the definition of "split income" has created an anomalous result related to the subsection 48.1(1) election. We do not describe in detail the intricacies of the TOSI regime in this article. We do, however, consider two key TOSI provisions that are relevant to this discussion—namely,

1) any individual resident in Canada who derives capital gains from private company shares may be subject to TOSI, and
2) capital gains arising from a disposition of shares that are qualified small business corporation (QSBC) shares are not subject to TOSI.

The Subsection 48.1(1) Election and the TOSI Trap

The election under subsection 48.1(1) is available to shareholders of any corporation that is a small business corporation (SBC). Two important factors should be noted. First, there is no requirement for a corporation's shares to be QSBC shares for a subsection 48.1(1) election to be valid. Second, the taxable gain triggered under subsection 48.1(1) is not restricted to the taxpayer's capital gains deduction. As a result, there are times when it is tax-advantageous to trigger a capital gain under subsection 48.1(1) even if the shares are not QSBC shares—for instance, to utilize tax attributes such as expiring losses. This is particularly the case when, for regulatory and securities law reasons, the founders are not able to sell large blocks of the shares of the company that is going public.

Under the old TOSI rules, shareholders of corporations that were not QSBCs but qualified as SBCs were able to elect under subsection 48.1(1) to trigger a taxable capital gain and distribute it to the beneficiaries via the terms of the trust. If there were a large number of beneficiaries, including minors, the

capital gain that was triggered could potentially be eliminated or greatly minimized by utilizing the beneficiaries' marginal tax rates or other tax attributes. The old TOSI rules did not apply to these beneficiaries for two reasons. First, subsections 120.4(4) and (5) did not apply to a subsection 48.1(1) deemed capital gain realized by minor beneficiaries. Second, the old TOSI rules did not apply to beneficiaries aged 18 or over.

The new TOSI rules thwart the type of tax planning that was available under the old rules. Under the new rules, taxable capital gains subject to TOSI are no longer limited to transactions under the purview of subsections 120.4(4) and (5). As mentioned above, the expanded definition of "split income" includes taxable capital gains from the disposition of all non-QSBC private corporation shares realized, or deemed to be realized, by most Canadian residents. Thus, it may no longer be beneficial to trigger a capital gain under subsection 48.1(1) when the shares do not qualify as QSBC shares in the situation discussed above, unless one of the other excluded-amount exemptions applies.

The difference between a TOSI and a non-TOSI capital gain can be significant to an individual shareholder. By virtue of the combined operation of subsections 120.4(2) and (3), a TOSI capital gain is taxed immediately at the highest marginal tax rate, and the TOSI tax otherwise payable can be reduced only by the dividend tax credit, the foreign tax credit, and the disability tax credit. No other tax credits or deductions can be used to offset the TOSI impact on a capital gain. Because the new TOSI rules do not apply to taxable capital gains arising from a disposition of publicly listed shares, it may be prudent (when it is practically feasible) to trigger a capital gain by other types of internal crystallization transactions after the company has gone public.

Martin Lee
LRK Tax LLP
Markham, ON

Manu Kakkar
Kakkar CPA Professional Corporation
Montreal

Thanusan Raveendran
LRK Tax LLP
Kitchener, ON

FAPI and TOSI Overlap: 107 Percent Tax Is Not Fair

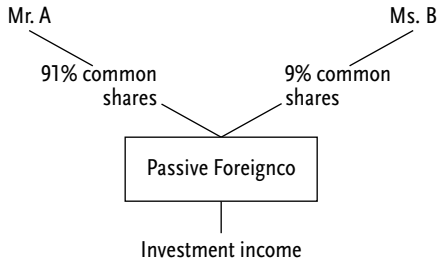
Most of the concerns about the relatively recent changes to the TOSI (tax on split income) rules have been in the context of dividends from Canadian corporations. However, the application of section 120.4 is not restricted to Canadian corporations. In fact, the definition of "split income" in subsection 120.4(1) refers to "an amount required to be included in computing the individual's income for the year in respect of taxable dividends received by the individual in respect of shares of the capital stock of a corporation" other than a public corporation. Therefore, the dividends that are paid from foreign private corporations to individual shareholders resident in Canada could be subject to the TOSI rules. As illustrated below, in certain circumstances such dividends may result in a very high effective tax rate for Canadian residents.

Consider the following example:

1) Mr. A and Ms. B are a married couple, residents of Canada for tax purposes, and between the ages of 25 and 65.
2) Mr. A and Ms. B own 91 percent and 9 percent, respectively, of the common shares of Passive Foreignco.
3) Mr. A and Ms. B have no income other than income from Passive Foreignco in the year that they receive dividends from Passive Foreignco.
4) Passive Foreignco is a corporation resident in a country other than Canada.
5) Passive Foreignco's only source of income is interest and dividends from a portfolio of stocks and bonds of foreign companies with which it deals at arm's length.
6) Passive Foreignco has no employees.
7) Passive Foreignco's corporate income tax rate in the foreign jurisdiction is 0 percent.
8) The shares of Passive Foreignco are not excluded shares for Ms. B; its business is a related business for Mr. A and Ms. B for the purposes of the TOSI rules.
9) Passive Foreignco is a controlled foreign affiliate (CFA) of Mr. A and Ms. B.
10) Mr. A and Ms. B will have a subsection 91(5) deduction for the amount of previously taxed foreign accrual property income (FAPI) when Passive Foreignco pays dividends.

This structure is set out in figure 1.

Figure 1



Passive Foreignco is a CFA of Mr. A and Ms. B pursuant to subsections 95(1) and 248(1). Thus, pursuant to subsection 91(1), each of Mr. A and Ms. B will include in his or her income a proportionate share of Passive Foreignco's FAPI. The same amounts will be added to the ACB of their shares.

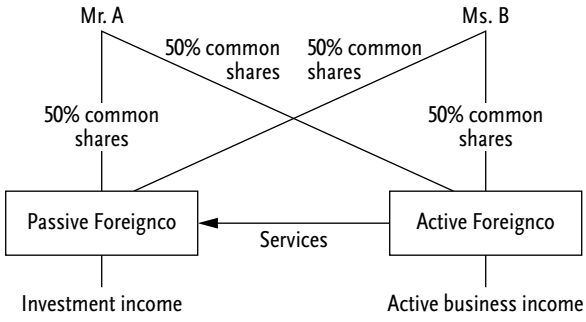
Assume that they receive dividends from Passive Foreignco. For TOSI purposes, Passive Foreignco carries on a related business with respect to either Mr. A or Ms. B. Therefore, the dividends paid from Passive Foreignco will not be subject to the related-business exclusions from TOSI. In the case of Mr. A, an excluded-share exclusion from TOSI may apply; it will not apply, however, in the case of Ms. B, since she owns less than 10 percent of Passive Foreignco. Because the dividends are subject to the TOSI rules, there will be a deduction from income pursuant to paragraph 20(1)(ww), which will reduce Ms. B's income to nil. Generally, the deduction pursuant to subsection 91(5) for the amounts of previously taxed FAPI will be available to Mr. A or Ms. B. However, for Ms. B there will be no benefit to claiming a discretionary deduction pursuant to subsection 91(5) because in the absence of a subsection 91(5) deduction, (1) there will be another deduction available pursuant to paragraph 20(1)(ww) for the amount of split income, and (2) there will be no reduction of the ACB of the shares of the CFA pursuant to subparagraph 92(1)(b)(ii), which will be required if the deduction under subsection 91(5) is claimed. On the other hand, TOSI cannot be reduced by the subsection 91(5) deduction, since subsection 120.4(2) provides that the amount of tax payable on split income is calculated as the highest tax rate multiplied by the amount of split income. Further, subsection 120.4(3) deductions are limited to the dividend tax credit, the foreign tax credit, and the disability tax credit.

Complications can also arise when Passive Foreignco has transactions with other foreign companies. Consider the following example:

1) Mr. A and Ms. B each own 50 percent of the common shares of Active Foreignco, to which they made no substantial capital contribution.
2) Active Foreignco is a corporation resident in a country other than Canada with which Canada has a tax treaty.
3) Active Foreignco earns active business income that is not subject to the FAPI rules (other than because of the application of paragraph 95(2)(b), described below).
4) Active Foreignco provides services to Passive Foreignco.
5) There is no net investment income in Passive Foreignco.
6) Mr. A and Ms. B's sole source of income is derived from Active Foreignco.
7) The fees for Active Foreignco's services to Passive Foreignco are deductible from Passive Foreignco's FAPI.
8) Active Foreignco's corporate income tax rate in the foreign jurisdiction is 0 percent.
9) The shares of Active Foreignco are not excluded shares because Active Foreignco is a service business and there is a related business for the purposes of the TOSI rules.
10) Active Foreignco and Passive Foreignco are CFAs of Mr. A and Ms. B.

This structure is set out in figure 2.

Figure 2



The fees for the services of Active Foreignco will be considered deductible in the FAPI calculation of either Mr. A or Ms. B (because they will be deductible from the investment income of Passive Foreignco). Thus, pursuant to paragraph 95(2)(b), the income of Active Foreignco from such services will be deemed to be income from a separate business other than an active one for the purposes of subdivision i of the Act. Therefore, that income will result in a FAPI addition to the incomes of Mr. A and Ms. B in respect of their shares of Active Foreignco.

Similarly, as in the analysis of the first example, the dividends paid to Mr. A or Ms. B from Active Foreignco will be considered split income of Mr. A or Ms. B. Because the dividends are subject to the TOSI rules, the incomes of both Mr. A and Ms. B will be reduced to nil pursuant to paragraph 20(1)(ww). Since their incomes are already nil, a deduction pursuant to subsection 91(5) will not be beneficial.

Therefore, in both situations double taxation is likely to arise: the income will be taxed as FAPI and the dividends will be taxed under the TOSI rules. Assuming that FAPI is taxed at a rate of 53.53 percent (Ontario's highest rate) and the dividends are taxed under the TOSI rules at the same rate, the combined tax on such income will be 107.06 percent.

It is uncertain whether any relief would be provided in the situations described above pursuant to subsection 248(28), which is intended to prevent certain cases of double taxation. To date, the CRA has not published any guidance in this regard; it would be very helpful to practitioners if the CRA would do so. However, it should be noted that the policy intention of TOSI is not to promote double taxation—otherwise, there would be no need for a paragraph 20(1)(ww) deduction.

In conclusion, given such potentially adverse results, a careful tax analysis should be undertaken when one is considering

the payment of dividends from private CFAs to individual Canadian shareholders, since such dividends may result in the simultaneous application of the FAPI and TOSI rules.

Stan Shadrin
CPA Solutions LLP, Toronto

Manu Kakkar
Kakkar CPA Professional Corporation
Montreal

Alex Ghani
CPA Solutions LLP, Toronto

Intercorporate Dividend Planning: More Complexity

Since 2006, private corporations have been faced with a series of changes that affect intercorporate dividend planning. In this article, I note the most significant rule changes and outline three situations in which careful planning may be beneficial.

In 2006, the general-rate income pool (GRIP) and its complement, eligible dividends, were introduced. These concepts provided close to full integration of private corporation and shareholder income for corporate active business income (ABI) taxed at the top rate (subject to provincial dividend tax credit rates). To qualify for full integration, dividends paid from income taxed at the top rate must be designated as eligible dividends when they are paid.

In April 2015, significant changes were made to section 55. The purpose tests were extended to include virtually any dividend that either significantly reduced the FMV of the payer corporation's shares or significantly increased the cost of an asset. At the same time, the changes to the related-party exception in paragraph 55(3)(a) and to the part IV tax exception in subsection 55(2) leave many private corporations reliant on the safe income on hand (SIOH) exception when they pay dividends.

The next series of changes, which were made in 2016, affected the ABI taxed at the top rate. Although superficially they appear to have had little impact on intercorporate dividends, they may increase GRIP, and planning is required to ensure that the maximum amount of GRIP is available so that eligible dividends can be paid to individual shareholders. The specified corporate income (SCI) rules and the specified partnership income (SPI) changes, both in section 125, are effective for taxation years beginning after March 21, 2016. The absence of a de minimis test for ownership in both the SPI and the SCI rules means that the GRIP rules now apply to more corporations than might be expected; thus, careful dividend planning is necessary to maximize the amount paid out of GRIP to individual shareholders.

The 2018 addition of the adjusted aggregate investment income (AAII) grind in paragraph 125(5.1)(b) also reduces access to the small business deduction for taxation years starting after 2018. AAII includes taxable dividends, except for taxable dividends from connected corporations, and is not reduced by capital or non-capital losses of other years. As a result, AAII can easily exceed taxable income. Once again, these changes may increase GRIP balances and thus the need for appropriate planning.

The transition from the single refundable dividend tax on hand (RDTOH) pool to the non-eligible refundable dividend tax on hand (NERDTOH) and eligible dividend tax on hand (ERDTOH) pools is effective for taxation years starting after 2018. Although the pools are often described as tracking GRIP and ERDTOH through eligible dividends, and NERDTOH through sources other than eligible dividends (referred to in this article as "non-eligible dividends"), this is not the way these pools will work for private corporate groups. For them, one must consider first the dividend refund in the payer corporation and then the addition to the pools and GRIP in the recipient corporation.

Subsection 129(1) specifies the ordering of the rules to be applied in calculating the amount of any dividend refund. As with RDTOH, all calculations are made at the end of the year. The amount of the refund is the total of three amounts:

1) the lesser of 38⅓ percent of the eligible dividends paid and the ERDTOH balance;
2) the lesser of 38⅓ percent of the non-eligible dividends paid and the NERDTOH balance; and
3) the lesser of
   a) 38⅓ percent of the non-eligible dividends paid less the refund in step 2 and
   b) the ERDTOH in excess of the refund in step 1.

The recipient corporation has two possible additions to its ERDTOH. The first is any part IV tax paid on eligible dividends received from sources other than connected corporations. The second is that part of any taxable dividend received from a connected corporation "to the extent that such [a dividend] caused" a refund of ERDTOH in the connected payer corporation. As noted in point 3 above, any dividend refund that is triggered can generate a refund of ERDTOH without the payment of eligible dividends and, in the case of a connected recipient corporation, an addition to its ERDTOH.

The NERDTOH balance can be increased in two ways: either by the payment of refundable part I tax on aggregate investment income, or by the payment of part IV tax to the extent that it does not result in an addition to ERDTOH. For dividends received from connected corporations, NERDTOH will be increased only if the dividend does not increase the recipient's ERDTOH.

As a result of the addition of AAII and the ERDTOH and NERDTOH accounts, the recipient's status as a connected corporation has become more important. Dividends from connected corporations are subject to part IV tax only to the extent of a refund in the payer corporation, can result in an addition to ERDTOH on the payment of non-eligible dividends, and are excluded from AAII. The definition of a connected corporation in subsection 186(4) is unchanged: it essentially requires that the recipient directly own shares representing more than 10 percent of the votes and value of the payer corporation, or that the payer corporation be controlled by persons not at arm's length with the recipient corporation.

When one is planning the payment of dividends, it is important to take account of the times at which the balances in the relevant accounts are calculated. The GRIP, NERDTOH, and ERDTOH balances are all calculated at the year-end; SIOH is calculated immediately before the series of transactions that includes the payment of the dividend; eligible dividend designations are made when the dividend is paid.

To summarize, a private corporation contemplating the payment of a dividend should consider the following points:

1) When a subsidiary corporation has NERDTOH, ERDTOH, or GRIP balances, careful planning is necessary to ensure that dividends from the subsidiary result in additions to the same pools in the parent company. Eligible dividends may add to the parent company's GRIP and ERDTOH, but will not recover NERDTOH in the subsidiary. Non-eligible dividends can increase the parent company's ERDTOH, but not its GRIP. If a combination of large dividends is paid to ensure that all three pools move to the parent company, the dividends may be recharacterized as capital gains under section 55 if the payer corporation has insufficient SIOH.
2) Is the payer corporation connected with or controlled by the recipient? In the case of a trust with corporate beneficiaries, additional factors should be considered:
   a) Does the corporate beneficiary directly own more than 10 percent of the shares representing votes and value? Shares held by the trust will not qualify for the votes and value test in paragraph 186(4)(b).
   b) If not, does the corporate beneficiary otherwise meet the control test? (See "Family Trusts and the 'Connected' Status Rules," *Tax for the Owner-Manager*, April 2011, and "Corporate Beneficiaries of Discretionary Family Trusts: The Part IV Tax Trap," *Tax for the Owner-Manager,* April 2012.) If a payer corporation (Opco) has an ERDTOH balance and pays non-eligible dividends to the trust, which then distributes them to Holdco, and if Opco and Holdco are not connected, the ERDTOH in Opco will be reduced, Holdco will pay part IV tax on the full amount of the dividend, the part IV tax paid will be an addition to Opco's NERDTOH, and the dividends will be included in its AAII.
3) Staggered year-ends create a planning challenge. Consider, for example, a payer corporation with a December year-end that pays a dividend in January to a corporation with a June year-end. The recipient corporation must file its tax return before the payer corporation knows what its ERDTOH and NERDTOH refunds, if any, will be. This was a problem under the RDTOH system, and now advisers will need to know both ERDTOH and NERDTOH balances so that the correct combination of eligible and non-eligible dividends can be paid, all of which will make the planning more difficult.

A.G. (Sandy) Stedman
Schibli Stedman King LLP
Victoria

Planning Possibilities Resulting from CRA Policy Reversal on Section 84.1

At the 2019 APFF Table ronde sur la fiscalité fédérale, the CRA reconsidered its position on whether a deemed dividend under paragraph 84.1(1)(b) would generate a dividend refund.

Subparagraph 129(1)(a)(i) provides a refund of eligible or non-eligible refundable dividend tax on hand (RDTOH) in respect of eligible or non-eligible "taxable dividends paid by the corporation on shares of its capital stock in the year" at a rate of 38⅓ percent of the dividends paid. Paragraph 84.1(1)(b), when applicable, deems a dividend to be paid "to the taxpayer by the purchaser corporation and received by the taxpayer from the purchaser corporation." Because subparagraph 129(1)(a)(i) requires that the dividend be paid by the corporation on shares of its capital stock, the CRA has debated whether a paragraph 84.1(1)(b) deemed dividend would in fact be paid "on shares of its capital stock," which would then qualify for a dividend refund. This debate also applies to the capital dividend election under subsection 83(2), which requires that the dividend subject to the election be payable to "shareholders of any class of shares of its capital stock."

Initially, in TI 9729855 (January 19, 1998), the CRA opined that a dividend refund would be available in respect of a deemed dividend pursuant to paragraph 84.1(1)(b). However, the CRA changed its position in TI 2002-0128955 (September 26, 2002), where it disallowed a subparagraph 129(1)(a)(i) dividend refund and the subsection 83(2) election in respect of a section 84.1 deemed dividend. The CRA's rationale for the change was that the language in paragraph 84.1(1)(b) did not specifically state that a dividend was to be paid on shares of the corporation's capital stock. This was widely seen as an

overly narrow interpretation: it causes tax non-integration, and the position that a dividend can be paid on anything except shares of the capital stock of a corporation was unconvincing.

At the 2019 APFF round table, the CRA said that a dividend refund can indeed be generated by the application of paragraph 84.1(1)(b). Although the CRA did not comment on its previous position on the subsection 83(2) capital dividend election, the same policy reversal should apply, since the underlying rationale was the same. At the Canadian Tax Foundation's 2019 annual conference, the CRA confirmed (at question 4 of the CRA Round Table) that a section 84.1 deemed dividend can benefit from both the paragraph 129(1)(a) dividend refund and the capital dividend account (CDA) mechanism.

The purpose of section 84.1 is to prevent the tax-free extraction of surplus from a corporation by an individual. Where the section applies, non-share consideration received by an individual may be recharacterized as a deemed dividend. Because section 84.1 applies only to non-arm's-length transactions, it is often of concern when an individual transfers shares of a private corporation to a personal holding company or sells shares of a private corporation to the holding company of a family member (including on generational transfers). The consequences of an unintentional triggering of section 84.1 could be dire: for example, the amount received on a transaction that utilizes the lifetime capital gains exemption on a sale could potentially be recharacterized as a taxable dividend of the full amount.

The CRA's policy reversal creates interesting tax-planning opportunities for individuals with private corporations. For example, section 84.1 may be used to recover a dividend refund or pay out a CDA balance from a corporation that cannot legally declare a dividend because of the applicable corporate law statute. Furthermore, the intentional triggering of section 84.1 on a sale may prove advantageous.

Consider, for example, a situation in which Bob holds all of the outstanding shares of Opco, with an FMV of $1 million and an ACB of $1. The shares are not QSBC shares. Bob receives an offer to sell all of his shares in Opco for $1 million in cash from a third-party purchaser. Ordinarily, Bob would realize a capital gain of $999,999 on the sale of the shares, which would result in approximately $240,000 of tax.

Alternatively, Bob could transfer 50 percent of his shares in Opco to a newly formed Holdco on a rollover basis. Holdco subsequently triggers a gain on the Opco shares (for example, by using an internal section 85 share exchange), resulting in a $500,000 capital gain on which Holdco pays approximately $127,000 of corporate tax while generating $250,000 in the CDA and $77,000 of non-eligible RDTOH.

Bob then sells his remaining $500,000 of Opco shares to Holdco in two tranches of $250,000 for promissory notes, at which point section 84.1 deems both payments of $250,000 to be dividends. Pursuant to subsection 83(2), Bob elects to treat the first dividend of $250,000 as a capital dividend, resulting in no further tax to him. The second dividend of $250,000 is considered a taxable dividend sufficient to generate a dividend refund that fully recovers Holdco's $77,000 of non-eligible RDTOH.

Finally, Holdco sells the shares of Opco to the third-party purchaser for $1 million cash without incurring an additional gain (because Holdco has full tax basis in the shares). Holdco then transfers $500,000 of this cash to Bob tax-free as a repayment of the promissory notes. As a result of these steps, the following tax consequences arise:

1) Bob is deemed to have received a dividend of $250,000, all of which is declared to be a capital dividend and not subject to tax.
2) Bob is deemed to have received another dividend of $250,000, which is taxed at Bob's marginal rate. Assuming a 41 percent rate, this amounts to $102,500 in personal tax.
3) Holdco has net corporate tax of $50,000 after the dividend refund ($127,000 − $77,000) and is left with $450,000 of after-tax cash.

The total tax is $152,500 rather than $240,000 because there is a deferral of tax until further dividends are paid from Holdco. However, careful advisers will consider whether in any individual case there is a risk of the CRA's invoking GAAR or another anti-avoidance provision, such as subsection 129(1.2).

Absent legislative changes, the CRA's present position with respect to a dividend refund and section 84.1 opens up planning opportunities for individuals with private corporations. But planners should be aware of the associated risks and should consider whether the additional tax benefits outweigh those risks or whether more traditional sale-planning techniques are preferable.

Aasim Hirji and Kenneth Keung
Moodys Gartner Tax Law LLP, Calgary

Are Tenant Improvements a Shareholder Benefit?

Because the existence and quantum of a benefit conferred pursuant to subsection 15(1) are questions of fact, much of the guidance on those determinations emerges from jurisprudence. Guidance on shareholder benefit principles in the real estate context can be found in *Wise v. The Queen* (2019 TCC 196), where a shareholder successfully argued that tenant improvements made by a related corporation did not confer an immediate benefit for the purposes of subsection 15(1) due to the provisions of the specific legal agreements between the landlord and the tenant.

The appellant and her husband were the owners of a building in Toronto, part of which constituted their residence. A corporation owned by the appellant and her son, Wise Victoria Mortgages Inc. (WVM), later decided to occupy a commercial space within the building. A five-year commercial lease was executed pursuant to which WVM was entitled to renew for a further five years, and to make alterations, additions, or improvements to the premises with the appellant's consent. Substantial renovations, with costs totalling more than $621,000, were undertaken by WVM with the appellant's consent. WVM paid for the renovations and capitalized them for financial statement and income tax purposes.

The TCC reviewed the case law on subsection 15(1)—in particular, the requirement that it must be determined first that a benefit has been conferred, and then what the shareholder would have had to pay for the same benefit in the same circumstances if it had not been a shareholder of the company. Tenant improvements have been addressed in various cases where a subsection 15(1) assessment was raised. For example, in *Saint-Germain v. MNR* (1969 CanLII 69 (SCC)), an immediate benefit conferral was found to exist where a tenant made additions and improvements in the absence of a lease agreement. The principle in *Saint-Germain* was subject to a caveat in *Kennedy v. MNR* ([1973] CTC 437 (FCA)), where the FCA reduced the minister's benefit assessment on the basis that the value of the benefit depended on the extent to which an improvement increased the value of the reversionary interest to the landlord. Citing *Black's Law Dictionary*, the court endorsed the definition of "reversionary interest" as a "right to the future enjoyment of property, at present in the possession or occupation of another."

In *Wise*, the presence and provisions of a commercial lease were paramount and dictated the outcome of the appeal. WVM's occupancy of the premises continued at the time of the hearing, and the parties' intention was that WVM would continue to occupy the building thereafter. The Crown's contention that an arm's-length tenant would never pay for such extravagant renovations while also paying rent was rejected by the court on the basis of the evidence and the speculative nature of the argument. Given that it was unclear when, if ever, WVM would cease to occupy the building, the court referred to the principle in *Kennedy* and concluded that "it is not possible for the Court to quantify the value of the alleged shareholder benefit or to speculate as to the life-expectancy or residual value to the Appellant." Notwithstanding the language in subsection 15(1) that calls for its application "at any time" that a benefit is conferred, the court held that any shareholder benefit assessed must be real and the shareholder must be shown to have received a benefit. In this case, the Crown failed to meet either dimension of this test, and the court concluded that it was not possible, at present, to quantify the value of the alleged shareholder benefit.

In allowing the appeal, the TCC provided some indirect guidance to the Crown, indicating that an expert report that addressed the value of a reversionary interest would have been helpful. The court also noted that the value of any reversionary interest to the appellant will have to be evaluated in the future when the leasehold reverts back to the shareholder. Had the Crown taken a different approach to leading evidence on the value of the improvements, or had the minister raised an assessment when the value of the reversionary interest was more certain, the appeal might have been decided differently.

It also remains to be seen whether this is a pyrrhic victory for the appellant, insofar as the CRA may issue a later assessment once the value of the reversionary interest is determinable. Nonetheless, *Wise v. The Queen* is a reminder that clear, well-drafted legal agreements memorializing the intentions of the parties—preferably drafted contemporaneously with the entering into of the arrangement—can protect a landlord from realizing an immediate shareholder benefit due to improvements by a non-arm's-length tenant in circumstances similar to those at issue in this appeal.

Robert A. Neilson and Ashvin R. Singh
Felesky Flynn LLP, Edmonton

Rectification Is Back—Is Rescission Next?

In *5551928 Manitoba Ltd. (Re)* (2018 BCSC 1482; aff'd 2019 BCCA 376; herein referred to as "*Manitoba*"), the court allowed a claim for an order rectifying a directors' resolution declaring a dividend from the capital dividend account (CDA) of a private corporation. On October 30, 2019, the BCCA dismissed the attorney general's appeal. (For additional background on the lower court's decision and other recent decisions involving rectification, see "Rectification: Where Are We Now?" *Canadian Tax Focus*, May 2019.)

The BCSC's Decision in Manitoba

The attorney general appealed the BCSC's decision in *Manitoba* on the following grounds:

- the BCSC misapplied the test for rectification by focusing on "intention as to [the] tax consequences" of the resolution rather than on whether it correctly recorded the unilateral act that the directors resolved to undertake; and
- the BCSC gave insufficient weight to the availability of alternative remedies.

The Application of Fairmont Hotels

The BCCA distinguished *Manitoba* from *Fairmont Hotels* (2016 SCC 56) on the basis that the taxpayer in *Manitoba* did not

request rectification after discovering an adverse tax consequence; once that consequence was discovered, the parties sought to change their agreements. In *Manitoba*, rectification was requested to properly accomplish the directors' original intention (a tax-free distribution out of the corporation's CDA), fitting within the narrow test in *Fairmont Hotels*.

Further, the BCCA found that the test for rectification applied equally to written instruments (such as "unilateral" resolutions) and arm's-length agreements. In both contexts, rectification requires that the parties who signed the document show that they had a definite and ascertainable intention when they signed it, and that the document failed to reflect that intention because of a mistake. Although the resolution was premised on a mistaken fact regarding the quantum of the CDA balance, the ascertainable intention to "clean out" the CDA by the directors was properly recorded in the resolution.

Alternative Remedies

The BCCA found that the BCSC's determination that the possible alternative remedies (such as a remission order, a professional negligence suit against the accountant who made the mistake, or an election to treat the excess amount declared as a taxable dividend) "involved such risk and expense that they did not outweigh the equities that favoured rectification." The BCCA commented that equity would not force upon a party an "alternative" that is neither practical nor certain and whose cost might well exceed the penalty imposed. Accordingly, the BCCA found that rectification was the appropriate and reasonable remedy, and the attorney general's appeal was dismissed.

Post-Fairmont Developments

The *Manitoba* decision is a welcome development for taxpayers who may be forced to turn to equitable relief to fix unintended tax mistakes. Advisers initially feared that the SCC's landmark decision in *Fairmont Hotels* would eliminate rectification in the tax context. Subsequent appellate-level decisions that considered *Fairmont Hotels* denied the requested relief and did not appear promising (see, for example, *Harvest Operations*, 2017 ABCA 393, and *Canada Life*, 2018 ONCA 562). It can be argued, however, that the facts surrounding such earlier decisions did not fit the legal test for rectification (that is, the relief requested would result in a different transaction altogether), and that rectification was appropriately denied.

Despite this jurisprudence, I suggest that although *Fairmont Hotels* may have narrowed the legal test for rectification, the decision did not eliminate rectification or other equitable remedies (such as rescission) altogether. *Manitoba* and other recent BC cases appear to support this position. In 2019, the BCSC granted both rectification (*Crean*, 2019 BCSC 146) and rescission (*Collins Family Trust*, 2019 BCSC 1030); when combined with *Manitoba*, those decisions suggest that the pendulum may be swinging in favour of taxpayers and away from earlier decisions in which *Fairmont Hotels* was used to deny equitable relief.

The courts in British Columbia appear to have resolved the apparent conflict between the legal test and the policy concerns raised in *Fairmont*, and they are prepared to grant equitable relief in appropriate cases. It remains to be seen whether more complex planning fits within the *Fairmont Hotels* framework, but it is clear that rectification remains available to allow parties to complete transactions when the documents fail to properly execute their plan but demonstrate a prior ascertainable agreement.

Is Rescission Next?

Although the *Manitoba* decision demonstrates that rectification is still possible in certain circumstances, it is unclear whether this will be the case with rescission. Unlike rectification, which can modify an instrument, rescission can be used to set aside an instrument entirely. Accordingly, the test for rescission is different from that of rectification. Equitable rescission affords relief for a fundamental mistake if it would be unconscionable, unjust, or unfair to leave the mistake uncorrected.

Prior to *Fairmont Hotels*, rescission was granted in *Re Pallen Trust* (2015 BCCA 222) and *Stone's Jewellery* (2009 ABQB 656). The BCCA in *Pallen Trust* specifically found that rescission involved a fact-focused analysis that could address any concerns about aggressive tax avoidance. Even though both decisions carefully considered retroactive tax planning (and concluded that neither circumstance involved aggressive tax planning gone wrong), it was unclear how those decisions would be reconciled with *Fairmont Hotels*.

In *Canada Life*, the OCA found that rescission was not available in the circumstances of that case. However, the court specifically declined to comment on whether *Pallen Trust* remained good law following *Fairmont Hotels*. In *Collins Family Trust*, the BCSC followed *Pallen Trust* and granted the taxpayer's petition for rescission. In doing so, however, the BCSC stated that *Fairmont Hotels* may have undermined the precedential value of *Pallen Trust*, but the court left it to the BCCA to determine whether the 2015 decision remained good law. A request for leave to appeal the decision in *Collins Family Trust* was filed on July 24, 2019. It appears that taxpayers and advisers may have an answer if the appeal is ultimately heard.

Conclusion

The case law surrounding equitable relief in the tax context continues to evolve. There is no doubt that the courts have reconciled *Fairmont Hotels* and are comfortable granting rectification for tax mistakes under the *Fairmont Hotels* framework.

The BCCA may cause the pendulum to swing further if it determines that *Pallen Trust* is still good law in light of *Fairmont Hotels*. I remain of the view that *Fairmont Hotels* should not automatically overrule *Pallen Trust*. Rather, the policy considerations identified in *Fairmont Hotels* should be considered and applied in a fact-intensive and objective analysis in each specific circumstance (as they were in *Pallen Trust* and *Stone's Jewellery*).

Rami Pandher
Field Law LLP, Calgary

The editor of *Tax for the Owner-Manager* welcomes submissions of ideas or of written material that has not been published or submitted elsewhere. Please write to Thomas E. McDonnell at 1tmcdonnell2@rogers.com.

Published quarterly

Canadian Tax Foundation
145 Wellington Street West, Suite 1400
Toronto, Ontario M5J 1H8
Telephone: 416-599-0283
Facsimile: 416-599-9283
Internet: http://www.ctf.ca
ISSN 1496-0427 (Online)