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Eligible Dividends – A Prediction

As I have mentioned on a couple of occasions, if you hope to be a good tax advisor, it isn't sufficient that you are familiar with countless pages of tax fine print, nor to leap tall buildings in a single bound. A really good tax practitioner should be able to predict the future – the income tax environment that your clients will face years from now, when the CRA has reviewed current tax returns, issued reassessments, and – oy vey – what will happen if your client lands up in tax court.

In that spirit, I would like to be the first to make a prediction; as is apparent from the title of this article, it relates to eligible dividends. But you have to keep reading – I will reveal my prediction only at the end of the article. Before I do so, here are some clues.

The birth of the eligible dividend system was not exactly auspicious. In its waning days in the fall of 2005, the former Liberal government ushered in the rules, supposedly to level the playing field between income trusts and public companies. The rules were designed to eliminate the double tax (under-integration) that occurred when public companies paid dividends to individuals. Of course, they missed the point: it's the exempt entities – stupid – that were pocketing income trust distributions with little or no tax being paid on either end. A year later, lest public companies disappear completely, the Conservative government was forced to move against this with the SIFT regime.

While eligible dividends continued, they really started to unravel last fall, when the government announced that corporate rates would be dramatically reduced, on a phase-in basis to 2012. At the time, it was indicated that adjustments to the eligible dividends gross-up and tax credits were being considered, in order to compensate for these lower tax rates.[1]

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In the 2008 federal Budget, the government did just that, announcing a phased-in reduction to the gross-up and credit for eligible dividends.[2] In 2012, the gross-up would be 38% (as opposed to 25% on ineligible dividends), with the dividend tax credit being 6/11 of that amount. The idea behind these reductions is that, as we get closer to 2012, the system of integration would be maintained, rather than the dropping corporate tax rates causing "over-integration" – i.e., where income pumped through a corporation would be taxed more favourably than had it been earned directly.

The various Budget night releases slavishly picked up the formulas, but I don't remember much in the way of analysis beyond this. Some days later, when I started to do my revisions to some CCH services to which I contribute, I made some calculations – and just about fell off my chair. By 2012, when the proposals are fully phased-in, the difference in federal rates applicable to eligible and ineligible dividends will be just .29%!

So we have all of these complications – calculation of GRIP, LRIP accounts, change of status rules, deemed year-ends, and so on – for a lousy .29%. That's not quite the end of the story, though. At time of writing, there are fairly significant differences in terms of provincial tax – but more on this later.

From Here to Eternity

First, a problem: the integration may work nicely in 2012. But right now it's 2008 – and the corporate rates are significantly higher than the 2012 rates. This means that, for 2008, income earned at the general business rate and retained at the corporate level may tend to give rise to significant under-integration (depending on the particular province) if the earnings are distributed later – i.e., to take advantage of deferral in the meantime due to low corporate rates. In Ontario, for example, corporate income earned in 2008 and distributed as eligible dividends in 2012, or later, will face under-integration of about 4.88% – and it looks like fairly similar rates apply in a number of provinces. My feeling is that this is enough to make many owner-managers reconsider whether income should be bonused out, rather than retained at the corporate level, to take advantage of the deferral (thus facing a 46.4% personal rate in Ontario, rather than a 33.5% corporate rate). Of course, if owner-managers decide to bonus out corporate income, this defeats the purpose of lowering corporate rates.

In plain words, in order to preserve the niceties of the system when it is fully phased-in, owner-managers will face material tax penalties if they wish to try to take advantage of the corporate tax deferral that is available in the next few years. Oh, did I mention that many economists are predicting a slowdown, if not an outright recession? So this isn't exactly the best time for this sort of effect.

But where under-integration really gets out of hand is if the Ontario small business deduction "clawback" applies. This will be the case where corporate taxable income is between $500,000 and $1.5 million – an income range in which a great many small businesses find themselves.[3] In this case, the under-integration will be about 8%, so that the total tax rate where 2008 profits are distributed as eligible dividends in 2012 or later will be about 54.4%, as opposed to the 46.4% personal rate where bonuses are paid.[4] Very few, if any, owner-managers with corporate income in the clawback zone would opt to leave these profits in their corporations – where the tax rate, including the clawback, weighs in at a fairly hefty 37.75%. In my view, the clawback seriously undermines the federal initiative to lower corporate tax rates. Not only is this dumb tax policy, but just after the federal corporate tax reduction initiative was announced, the Ontario government actually had the *cohones* to issue a press release claiming that Ontario has a competitive tax system.[5]

A while ago, I mentioned that the provincial taxation of eligible dividends may provide a material advantage *vis-à-vis* ineligible dividends. However, with the feds virtually eliminating the advantage of eligible dividends, it remains to be seen whether, over the next few years, the provinces will maintain these advantages. I find it rather ironic that, when the eligible dividend regime was first announced, the federal government implored the provinces to bring in similar changes. As we stand, most provinces have done so, only to find that the federal government has turned in its tracks – talk about being deaked out!

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But even if provinces do not reduce the eligible dividend incentives over the next few years, one may question whether the complexities of the system are worth the few points of tax reduction that occur in most provinces. For example, the difference between eligible and ineligible dividends in 2012 will be 4.6% in Ontario,[6] and 3.54%[7] in Quebec.[8]

I have pointed out the quirks of the system in previous articles[9] – they are numerous. It seems that every few weeks another bunch of technical interpretations are released, explaining the esoterica of this system.

Eligible Dividends: 2006–2012

As a tax old-timer, I can tell you that "surplus systems" which are designed to provide advantages for corporate distributions tend to be short-lived.[10] So, if you haven't already guessed, here's my prediction: the eligible dividend regime will be repealed after 2012. "Eligible dividends", "GRIP", "LRIP", and the like will go the way of such arcane corporate surplus terminology as "TPUS" and "CSOH".

When tax oldtimers (including myself, I guess) get together, they have a habit of dropping this terminology and watching younger tax practitioners' eyes glaze over. Perhaps the ultimate legacy of the eligible dividend system is that it will eventually give younger tax practitioners the opportunity to do the same thing one day. My advice to them: there's nothing more boring than tax history.

– David Louis, J.D., C.A., Minden Gross, Toronto, a member of MERITAS law firms worldwide.

Notes:

[1] Economic Statement, October 31, 2007, Annex – Tax Measures: Supplementary Information and Notices of Ways and Means Motion, p. 97.

[2] The following table shows the phase-in of gross-up and dividend tax credits for eligible dividends (per the 2008 federal Budget) as well as federal corporate tax rates, as originally proposed in the October 30, 2007 federal Economic Statement.

Year	Gross-up	Dividend Tax Credit	Federal Corporate Tax Rate
2007	45%	11/18	22.12%
2008	45%	11/18	19.5%
2009	45%	11/18	19.0%
2010	44%	10/17	18.0%
2011	41%	13/23	16.5%
2012	38%	6/11	15.0%

[3] The clawback thresholds include taxable income of associated corporations, including investment-type income. For example, if there is a purification structure in place in respect of the capital gains exemption, cash jettisoned from an Opco to an associated Holdco may generate investment income that might push the associated group's taxable income into the clawback zone. (Thanks to Michael Goldberg for pointing this out.)

[4] Ignoring Employer Health Tax.

[5] "McGuinty Government Enhances Ontario's Tax Competitiveness Businesses Ringing in the New Year with Tax Breaks", December 28, 2007

[6] The tax rate in Ontario for eligible dividends is:

2008	2009	2010	2011	2012
23.96%	23.06%	23.65%	25.33%	26.74%

[7] The tax rate in Quebec for eligible dividends is:

2008	2009	2010	2011	2012
29.69%	29.69%	30.68%	31.85%	32.81%

[8] If Ontario followed Finance Minister Flaherty's "suggestion" to lower provincial corporate taxes, the provincial eligible dividend system may no longer be necessary. If Ontario corporate rates were dropped to 10%, the combined personal corporate rate with ineligible dividends would be 48.6%, whereas eligible dividends would result in a combined tax rate of 45.1% – over integration of about 1.3%.

[9] See, for example, "Eligible Dividends – The Good, the Bad, and the Ugly", *Tax Notes*, No. 523, August 2006.

[10] With the exception of the capital dividend account.

Lease Cancellation Payment Received by Landlord

Spezzano et al. v. The Queen, 2007 DTC 5580 (F.C.A.)

The Canada Revenue Agency (the "CRA") states that amounts received by a landlord from a tenant for cancelling a lease or sublease always constitute income to the landlord.[1] The CRA's view has generally been upheld by the courts.[2]

In the recent decision in *Spezzano et al. v. The Queen*, 2007 DTC 5580 (F.C.A.), the courts have again considered the proper characterization of a lease cancellation payment received by a landlord as consideration for terminating the tenant's lease prior to its regular termination date. In *Spezzano*, the taxpayers argued that the value of their building had been reduced, and that the lease termination payment was a capital payment to compensate for the decrease in value. The taxpayers also argued that their commercial lease was a capital asset and, accordingly, the lease cancellation payment was a capital receipt from the disposition of a capital asset.

The Tax Court judge identified the issue at hand as being the correct characterization of the lease cancellation payment. The Tax Court judge applied the *surrogatum* principle[3] and concluded that the purpose of the tenant in making the payment to the taxpayers was to relieve itself of its obligation to pay the outstanding rent for the remaining life of the lease. Likewise, the taxpayers' purpose in accepting the lease cancellation payment was to recover foregone rent. The Tax Court rejected the taxpayers' contention that the purpose of the payment was to compensate for a decrease in the value of the property as there was no evidence to suggest that the compensation was calculated or based on the reduced value of the building, nor

was there any link between the lease cancellation payment and any reduced value. Accordingly, the Tax Court concluded that the lease cancellation payment was on income account.

The taxpayers appealed further. The Federal Court of Appeal agreed with the Tax Court judge that, based on the finding of fact that the purpose of the payment from both the perspective of the taxpayers and the tenant, was to compensate for foregone rent, the lease cancellation payment was properly included in the taxpayers' income on the basis of the *surrogatum* principle. The Federal Court of Appeal agreed with the Tax Court judge's conclusion that the sole capital asset acquired by the taxpayers was the building, and that the long-term lease was simply a means of exploiting that asset. The Court did note that there may be circumstances where a long-term lease may be regarded as a capital asset in the hands of a tenant, but no case was found where a lease was considered a capital asset in the hands of a landlord.[4]

The decision in *Spezzano* is a relatively straightforward application of the *surrogatum* principle. The settlement documentation drawn up between the parties, and other evidence produced clearly demonstrated that the lease cancellation payment was intended to replace the rent commitment under the lease.

The Federal Court of Appeal did leave open the possibility that, in another case, it might be possible to structure a lease cancellation payment as a capital receipt in the hands of a landlord. It was suggested that if a lease contained a provision making the tenant responsible for a loss in value of the rented property or to provide for compensation of such a loss, perhaps the purpose of any payment by a tenant to make good on such loss might be viewed as a capital receipt to the landlord since the payment would be intended to remedy the decease in value of the landlord's asset. It would seem unusual to find such a clause in a commercial lease; however, there might be some scope in a lease cancellation negotiation to draft documentation that includes language to describe the lease cancellation payment as a compensatory payment to the landlord to compensate for the decrease in value of its building. At the end of the day, however, such an attempt may only be "window dressing" as it would seem difficult in the usual case to regard a lease cancellation payment as anything other than a substitute for the remaining rent otherwise owing on the lease.

– Ian V. MacInnis, Fogler, Rubinoff LLP (Barristers & Solicitors)

Notes:

[1] See Interpretation Bulletin IT-359R2, paragraph 4.

[2] See, for example, *Monart Corporation v. M.N.R.*, 67 DTC 5181 (Ex. Ct.); *M.N.R. v. Farb Investments*, 59 DTC 1058 (Ex. Ct.); and *Israel Grader v. M.N.R.*, 62 DTC 1070 (Ex. Ct.), where lease termination payments were held to be taxable as ordinary income to the landlord as a normal incident of the business of the landlord, and in lieu of future profits.

[3] This principle was summarized in *Tsiaprailis v. Canada*, 2005 DTC 5119 (S.C.C.) at para. 7, where the Supreme Court indicated that one must look to the nature and purpose of the payment to determine what it is intended to replace, in the context of a damage or settlement payment. In other words, the tax treatment of the item will depend on what the amount is intended to replace. The approach is known as the *surrogatum* principle.

[4] The decisions in *Westfair Foods Limited v. The Queen*, 91 DTC 5625 (F.C.A.) and *T. Eaton Company Limited v. The Queen*, 99 DTC 5178 (F.C.A.) were cited as examples where a lease was considered to be a capital asset in the hands of a tenant.

Recent Cases

Proceeds from sale of corporation did not include portion allocable to non-compete clause

The taxpayer appealed the Minister's assessment to include, as income, the full purchase price from the sale of the shares of one corporation ("A Co.") to another ("B Co.") as proceeds of disposition (the "proceeds"). The taxpayer contended that a portion of the proceeds was allocable to a non-compete agreement concluded between the taxpayer's sole shareholder, at the closing of the share sale, and B Co., so that the proceeds were required to be reduced accordingly.

The taxpayer's appeal was dismissed. The taxpayer was not a party to the non-compete agreement concluded between A Co. and B Co. and, accordingly, it was not reasonable to regard the value of the non-compete agreement as part of the consideration for disposition of the shares by the taxpayer. The Minister's assessment was affirmed accordingly.

Robert Glegg Investment Inc., 2008 DTC 2466

Amounts for therapy and products not eligible for medical expense tax credit

The taxpayer suffered from chronic fatigue syndrome. In reassessing her for 2002, the Minister disallowed all but $3,253.74 of an $18,259.79 medical expense tax credit claim. The Minister's position was that the disallowed portion of the taxpayer's claim (involving the costs of therapists, a water purification unit, organic products and food, products for personal and house hygiene, and natural supplements) did not come within the scope of the medical expense tax credit provisions of subsection 118.2(2) of the Act. On her appeal to the Tax Court of Canada, the taxpayer argued, in part, that subsection 118.2(2) violates the discrimination provisions of subsection 15(1) of the Charter.

The taxpayer's appeal was allowed in part. None of the costs incurred by the taxpayer for medical services or medical products was paid to a "medical practitioner". None of these costs, therefore, qualified as a "medical expense" under subsection 118.2(2) of the Act. There was also no

benefit under subsection 118.2(2) by which discriminatory treatment could be alleged, since that subsection does not purport to cover all persons with disabilities. Nor was there any differential treatment based on one or more enumerated or analogous grounds under subsection 15(1) of the Charter, since the distinction made in subsection 118.2(2) is based on types of therapeutic substances, and not on physical characteristics of people. Subsection 118.2(2), therefore, did not meet the three-part test set out by the Supreme Court of Canada in *Law v. Minister of Employment and Immigration* for determining whether section 15 of the Charter has been violated. However, the Minister was ordered to reassess in order to give effect to his concession that the taxpayer was entitled to a medical expense tax credit of $3,253.74 for 2002.

Chevalier, 2008 DTC 2477

Court did not have jurisdiction to amend consent judgment containing errors

The taxpayer brought a motion requesting the Court to amend a consent judgment issued on February 3, 2006 to correct an error in the monetary amounts set forth in the judgment. In the consent judgment, the amounts the taxpayer was entitled to deduct in computing its income were shown in Canadian as opposed to U.S. funds. Both the taxpayer and the Minister consented to the requested amendment.

The motion was dismissed. The Court did not have jurisdiction to amend the judgment, as the error was made by the parties. The Court was only authorized to correct an error of the Court arising from an accidental slip or omission under paragraph 172(1)(*a*) of the Tax Court of Canada Rules.

Highway Customs Warehouse Ltd., 2008 DTC 2500

Taxpayer jointly liable for tax debts of spouse following fund transfers

During 1997, the taxpayer received two separate fund transfers (the "Transfers") in her bank account from her spouse ("S") to acquire a family home (the "Property"). The Property was purchased in the names of both the taxpayer and S, with each person acquiring a one-half interest. At the time of the Transfers, S had an outstanding tax liability of approximately $20,800. In reassessing the taxpayer for 1997, the Minister held the taxpayer jointly and severally liable for S's outstanding tax debt under subsection 160(1) of the Act. The taxpayer appealed to the Tax Court of Canada.

The appeal was allowed in part. The Transfers made by S to the taxpayer's bank account constituted non-arm's length transfers of property within the meaning of subsection 160(1), justifying the imposition of joint and several liability against the taxpayer. However, the taxpayer was only liable for half the value of the Transfers made, to correspond with the taxpayer's acquisition of a one-half interest in the Property.

Lamothe, 2008 DTC 2510

Corporate taxpayer entitled to deduct dividends received on shares

In a bid to raise capital, the corporate taxpayer, a life insurance company, issued a subordinated debenture to a financial institution (the "Caisse") for $60 million under a subscription agreement (the "Agreement"). Transactions were executed on January 24, 1994, and the taxpayer acquired debentures and shares valued at $60 million. Under the Agreement, the taxpayer was obligated to pay the Caisse the equivalent of any income received on its debentures and the shares (the "Shares"). The taxpayer sought to deduct the dividends it received on the Shares in computing its taxable income for 1997 and 1998 under subsection 138(6) of the Act. In reassessing the taxpayer, the Minister denied the taxpayer's dividend deductions for both years, contending that the taxpayer did not hold legal title to the Shares. In the alternative, if the taxpayer did own the Shares, it did not have rights to the dividends on the Shares, and it had failed to include the dividends in computing its income as required under the Act. The taxpayer appealed to the Tax Court of Canada.

The appeal was allowed. The taxpayer owned the Shares and had rights to the dividends payable on the Shares. The taxpayer had also included the dividends it received on the Shares in computing its income under the Act, and was therefore entitled to deduct the dividends in line with subsection 138(6). The Minister's assessments were accordingly referred back to the Minister for reconsideration and reassessment.

L'Industrielle Alliance Assurances et Services Financiers Inc., 2008 DTC 2513

Corporate taxpayer generated non-capital loss on disposition of interest in land

On December 23, 1996, the corporate taxpayer obtained an interest in a parcel of land (the "Property") as repayment for an outstanding debt from a corporation ("MAALSA"). Together with the Manitoba Pool Elevators and the Alberta Wheat Pool (known collectively as the "Pools"), the taxpayer was a 40% shareholder of MAALSA. The Pools were the creditors of MAALSA and had acquired the Property as repayment for the loans it had advanced to MAALSA. MAALSA had initially acquired the Property from another corporation ("WCFL") in 1983 as part of a financial restructuring arrangement. WCFL was also owned by the

Pools and had, in turn, acquired the Property together with other real estate in the 1960s and 1970s. On June 30, 1997, the Pools sold the Property at a gain but generated a loss for tax purposes, representing the difference between the deemed cost of the Property under subsection 79.1(6) of the Act and the net proceeds of disposition. The taxpayer sought to deduct its share of the loss in computing its income for the year. In reassessing the taxpayer, the Minister disallowed the taxpayer's loss deduction on the basis that the loss was on account of capital, prompting the taxpayer's appeal to the Tax Court of Canada. As part of the proceedings, the parties also sought the Court's approval of a settlement reached between the parties regarding other outstanding issues documented in the taxpayer's opening statement.

The appeal was allowed. As shareholders of MAALSA, the Pools had acquired the Property from MAALSA to resell it at the best available market price. As a result, the loss generated on the sale of the Property was a non-capital loss, and the taxpayer was entitled to deduct its share of the loss in computing its income under the Act. The Minister's assessments were accordingly referred back to the Minister for reconsideration and reassessment. The Court also approved the settlement reached between the parties regarding other outstanding issues presented to the Court.

Saskatchewan Wheat Pool, 2008 DTC 2520

Farming equipment leased by corporate taxpayer to customers was qualified property

The corporate taxpayer leased agricultural equipment (the "Equipment") to customers under leases financed by a credit institution ("C") under the terms of Finance Lease Agreements ("FLAs"). Under an FLA, the taxpayer transferred to C legal title to Equipment purchased by the taxpayer on credit. The taxpayer also assigned to C the lease payments it received from customers, including the termination value for Equipment at the end of a lease. Legal title to the leased Equipment was restored to the taxpayer at the end of a lease. The taxpayer claimed investment tax credits ("ITCs") for its Equipment for 1998, 1999, 2000, and 2001. In reassessing the taxpayer, the Minister denied the ITCs on the basis that the Equipment was inventory and not "qualified property" under the Act. The taxpayer appealed to the Tax Court of Canada.

The appeal was allowed. The taxpayer remained the beneficial owner of the Equipment it leased to customers. At the start of a lease, the Equipment became depreciable capital property, satisfying the definition of "qualified property" under subsection 127(9) of the Act, and the definition of "prescribed machinery and equipment" under subsection 4600(2) of the Regulations. Accordingly, the taxpayer was entitled to the ITCs claimed for the Equipment for the assessment period under appeal.

Good Equipment Limited, 2008 DTC 2527

Recent CRA Technical Interpretations

Deemed Dividend

In a situation the CRA was asked to comment on:

1. XCO and YCO are "taxable Canadian corporations" within the meaning of the definition in subsection 89(1).

2. The issued and outstanding share capital of XCO consists of 100 common shares. The paid-up capital ("PUC"), within the meaning of the definition in subsection 89(1), of the 100 common shares of the capital stock of XCO is $1.

3. Mr. A is a person resident in Canada for the purposes of the *Income Tax Act*.

4. Mr. A is the owner of the 100 common shares of the capital stock of XCO and of all the issued shares of the capital stock of YCO. The adjusted cost base (within the meaning of the definition in section 54) of the 100 common shares of XCO held by Mr. A is $1.

5. Mr. A disposes of his 100 common shares of the capital stock of XCO in favour of YCO for a sale price of $800, the sole consideration consisting of a promissory note issued by YCO, payable on demand to Mr. A, with a principal amount and fair market value ("FMV") equal to $800. The contract for the transfer of shares does not include a price adjustment clause.

6. Following the transfer by Mr. A to YCO of the 100 common shares of the capital stock of XCO, it is determined that the FMV of the 100 common shares of XCO is $1,000 at the time of the transfer of the common shares to YCO.

In this situation, Mr. A would receive a deemed dividend of $799 as a result of the application of section 84.1, and a capital gain of $200 (based on the deemed proceeds of $1,000 under paragraph 69(1)(*b*) less the sale price of $800). The $1,000 deemed proceeds would not increase the deemed dividend.

Document No. 2007-0228281E5, November 30, 2007

Designation of Eligible Dividends

Under subsection 184(2), a corporation that designates a dividend as a capital dividend or a capital gains dividend in excess of the amount eligible to be designated is subject to tax on the designated amount. The tax can be avoided where, with the concurrence of the shareholders, the excess amount is designated as a separate, taxable dividend. However, there is no provision that would allow the corporation to designate the separate dividend as an eligible dividend.

As indicated in the Department of Finance technical notes for subsection 89(14), "the designation set out under subsection 89(14) will not be prescribed for the purposes of section 600 of the Income Tax Regulations". In a July 10, 2007 press release concerning the designation of eligible dividends, the CRA indicated that the designation requirement for non-public corporations must be met each time a dividend is paid.

It is also the CRA's view that the decisions in *The Queen v. Nassau Walnut Investments Inc.*, 97 DTC 5051 (FCA), *Administration Gilles Leclair Inc. v. The Queen*, 97 DTC 880 (TCC), and *Jeannette Lussier v. The Queen*, 2000 DTC 167 (TCC), do not apply to allow a late-filed designation under subsection 89(14). Unlike the *Nassau Walnut* line of cases, the designation under subsection 89(14) is not made in a tax return and is required to be "given on or before a specified date to persons other than the Minister".

Document No. 2007-0244111I7, January 29, 2008

Calculation of GRIP – 2005 Deemed Dividend

In a situation involving a Canadian-controlled private corporation ("CCPC") that the CRA was asked to comment on:

> Aco, a CCPC, had a taxation year that commenced on May 1, 2005 and ended on April 30, 2006. During that taxation year, but prior to January 1, 2006, Aco redeemed a number of its shares, with the result that Aco was deemed to have paid taxable dividends at the time of the share redemptions pursuant to paragraph 84(3)(a).

The concern was the effect of the deemed dividend on the corporation's GRIP account.

The general rate income pool (GRIP), as defined in subsection 89(1), for a CCPC or a deposit insurance corporation is determined for the taxation year as "A - B" where "A" is the amount from the formula "C + 0.68 (D - E - F) + G + H - I".

Eligible dividends paid by the corporation in excess of any "excessive eligible dividend designation" for the taxation year reduce the GRIP in the following year (variable "I" in the GRIP formula). As eligible dividends (as defined in subsection 89(1)) can only be paid after 2005, the deemed taxable dividends paid prior to January 1, 2006 would not reduce the corporation's GRIP account. Variable "B" in the formula in subsection 87(9), which reduces the 2006 opening GRIP for dividends paid in taxation years that end after 2000 and before 2006, also excludes the pre-January 1, 2006 deemed dividend.

Document No. 2007-0257721E5, January 9, 2008

Income Earned by U.S. Pension Fund Through Partnership

Under Article XXI(2) of the *Canada–United States Income Tax Convention (1980)*, the income of a U.S. pension fund is exempt from tax in Canada. In a situation the CRA was asked to comment on, the pension fund was a member of a partnership that earned investment income.

Subject to the exclusion in Article XXI(3) of the treaty, for income from carrying on a business or that is earned from a related person, it is the CRA's view that the partnership should be treated as a conduit provided that partnership is not taxed as a separate entity in either Canada or the U.S. Also, as noted in Question 21 of the Round Table at the 1996 Canadian Tax Foundation Corporate Management Tax Conference, "where a person is a member of a partnership, we [the CRA] will look-through to the members in determining whether a particular member is related to the person from which the income is derived".

In their comments, the CRA noted that they would generally not rule on whether a partnership carries on business. However, they might consider ruling on "a particular situation where the only activity of the partnership is the investment in shares and debts of various corporations".

Document No. 2005-0140291E5, January 18, 2008

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