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The Federal Budget's Interest Restrictions – Clear and Present Danger?

Last week's federal Budget contained proposals (Budget Resolutions 24–29) that do nothing less than disallow interest deductions in respect of investments in foreign affiliates in the vast majority of situations. While one firm's Budget night release described this as the "most significant tax policy development in the international area since . . . 1972", I am not sure that a lot of practitioners fully appreciated the ramifications of the proposals, at first anyway. In fact, some of the Budget papers themselves gave the impression that the interest disallowance applies to investments in "tax havens". However, the significance of the proposals became more apparent as the week wore on, and by the weekend, were becoming almost tantamount to the Budget itself.[1]

Make no mistake: the proposals potentially apply to any corporation that borrows to acquire the shares of a foreign affiliate, whether it resides in the United States or somewhere in the Caribbean. Contrary to the impression that some commentary gave, the proposals are not confined to exotic international financing structures. They potentially apply to any borrowing to finance a foreign affiliate. It's that basic.

The restrictions on interest deductibility are on a tight time frame. They will apply to interest payable after 2007 on debt incurred on or after Budget day.[2] Pre-existing non-arm's length debts will be subject to the restrictions after 2008;[3] and the restrictions will apply to interest payable on pre-existing arm's length debts after 2009.[4] Although the Budget indicates that the last-mentioned deadline is in recognition of difficulties companies might have in restructuring debt, since such debt typically has a fairly long term with stringent penalties often applying to prepayment, it is questionable whether many borrowers will be able to restructure in time.

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As the Budget papers indicate, the disallowance rules (which apply separately to each foreign affiliate) will be achieved through an adaptation of the existing "tracing" rules for interest. While (in general) the deductibility of an interest expense will continue to depend on what the borrowed money giving rise to that expense is used for, the financing of a foreign affiliate (in particular) will no longer support an immediate deduction. Instead, the interest expense will be "pooled" for a deduction "if and as the foreign affiliate shares generate non-exempt income". More precisely, the amount included in income so as to allow the deduction will be net of deductions in respect of foreign affiliate dividends, etc.[5]

While there has been some suggestion about counter-measures to achieve deductibility, e.g., so-called "cash damming", these must contend with a broadly worded anti-avoidance rule which is built into the proposals.[6] In any event, cash damming is difficult to achieve in the best of circumstances; the prospect of using cash to invest in what is often a speculative foreign venture may pose additional risks.

Rationale for the Proposals

The rationale for these proposals is that Canada's current tax system allows tax deductions for interest on money borrowed to finance affiliates, while income from active businesses of a foreign affiliate does not attract Canadian tax as it is earned and, in the case of treaty countries, can be repatriated to the corporate level in the form of exempt surplus dividends. Thus, the Budget characterizes the deduction as a "subsidy". This concept is not new. A similar recommendation was made in the Mintz Committee Report[7] released almost a decade ago, and was highlighted as an issue in the Auditor General's reports of 1992 and 2002.[8]

The policy concerns that have been expressed over Canada's existing rules are not groundless. But the increasing cries of impairing competitiveness of Canadian businesses have a great deal of justification. Very often, especially with small or medium-sized businesses, expansion into a foreign country will give rise to start-up losses so that foreign financing would not be immediately deductible. Another issue is whether such companies would be able to obtain foreign financing to begin with.[9] While borrowing in, say, New York State may not pose much of a problem for even a fledgling business, how about South Carolina? Brazil? Ukraine?[10]

Especially for larger public corporations, international investment decisions are made taking the tax effects into account. Knocking out tax deductions in midstream could make an important difference to the company's financial performance – to the point that vulnerability to foreign takeovers has been suggested.[11] A comparison of the current proposals and the Mintz Committee Report recommendations reveals the severity of these proposals in these respects. While the Mintz Committee Report likewise recommended the disallowance of interest expenses on indebtedness incurred to invest in foreign affiliates,[12] it also called for a "generous transition period" in view of transactions committed to under the existing rules, as well as a threshold amount of accumulated indebtedness in order to lighten the load for small and medium-sized businesses. (I think that the ability of these businesses to finance international expansion is much more critical than it was a decade ago, when much of the expansion was south of the border. Consider such initiatives as outsourcing in developing countries, expansion into the former Soviet Bloc, and so on.[13]

Even with these exemptions, the proposals were nonetheless described as, commercially, "the most provocative" in the Mintz Committee Report.[14] If Mintz was "provocative", what is the appropriate term for a proposal that appears without current consultation, and with no exemptions whatever? As I peer out from my office onto the TD Centre behemoths, my guess is that the tax drones in the neighbouring towers spend a big chunk of their waking hours doing outbound financing transactions, virtually all of which must have been blown to bits by the proposal. Canadian financial institutions will not only lose a lot of transactions, they may also lose customers to foreign-based banks which are better equipped to finance outside of Canada.[15] (Ironically, this might be heightened by other Budget proposals which may adversely affect Canadian lenders: the Canada–U.S. Treaty is to be

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amended so that withholding tax and cross-border interest payments will be eliminated.[16] Once the Canada–U.S. withholding exemption is fully phased in, withholding on interest will be eliminated for all arm's length non-residents.)

To make such fundamental changes without warning does little to build confidence in Canada's business environment, especially when this is hard on the heels of other proposals in the international area which the business community is finding problematic.

Not that I raise this as a shining example of how new legislation should work, but the other current international proposals, including those pertaining to foreign affiliates, as well as non-resident trusts and FIEs have been subject to several – OK, innumerable – rounds of drafts. In view of this, to spring something this fundamental on the business community with no real warning just isn't the right thing to do. And the $40 million in additional tax revenue estimated in the Budget papers is nothing short of mysterious – Unless of course this factors in tax losses from the disruption that these proposals will wreak on Canadian multinationals and financial institutions.

There is no point in debating whether these proposals should have been put forward – we're in it, and the potential for economic damage is significant. The biggest damage will occur if they drag on like the other proposals in the international area. Each day that goes by where there continues to be a real possibility that they may come to pass, there will be a clear and present danger of serious financial damage, as uncertainty will mean that financing business will leave the country. Another fundamental issue is how a "provocative" – and seemingly dormant – suggestion can suddenly re-emerge a decade later, without further discussion, or safeguards for pre-existing transactions and smaller businesses. I can understand a surprise announcement when there is a clear and present danger to the tax base, as was the case with income trusts. However, I am not aware of any similar threat which would justify these proposals. So on reflection, perhaps as disturbing as the proposals themselves is the process involved: the government seems to be following a course of ushering in fundamental changes to tax policy without consultation with the business and tax communities.

– David Louis, B. Com., J.D., C.A., tax partner Minden Gross LLP, a member of MERITAS Law Firms Worldwide.
Thanks to Joan Jung and Michael Goldberg of Minden Gross and to Guy Dubé of Montreal MERITAS affiliate BCF.

Notes:

[1] Some of the articles that appeared after Budget night include "Tax Tweak Puts a Kink in Foreign Acquisitions", *Report on Business*, March 21, 2007; "Tax Move Threatens Businesses Abroad", *Financial Post*, March 21, 2007; "Flaherty May Revisit Tax Change", *Financial Post*, March 22, 2007; "Ottawa Firm on Scrapping Tax Break", *Report on Business*, March 23, 2007; and "Ottawa May Get Windfall from Tax Crackdown", *Report on Business*, March 24, 2007.

[2] Otherwise than pursuant to an agreement in writing entered into before that date.

[3] Or after the expiry of its current term, if sooner.

[4] Or after the expiry of its current term, if sooner.

[5] Budget Resolution 24 provides that no deduction be allowed in respect of "interest relating to an investment in a foreign affiliate", except as allowed by Budget Resolution 28. Budget Resolution 26 specifies what is included in "interest relating to an investment in a foreign affiliate" and contains anti-avoidance provisions targeted at indirect financing, as well as transactions designed to avoid the restrictions. Budget Resolution 27 defines the "disallowed interest pool" of a taxpayer as consisting of: (a) the amount of the pool at the end of the preceding taxation year; (b) current non-deductible amounts per Budget Resolution 24; in excess of: (c) amounts deductible under Budget Resolution 28 for the immediately preceding taxation year. Also subtracted are: (d) the net non-taxable portion of the capital gain computed in (c); and (e) a number of deductions for the particular year; namely foreign accrual tax applicable (subsection 91(4)), as well as dividends deductible under subsection 91(5) or paragraphs 113(1)(*a*) to (*c*). Perhaps the justification for the offsets in (e) is that the corporation, having received tax-free income, should therefore lose entitlement to interest deductions.

Budget Resolution 28 allows a deduction computed based on amounts included in income, including taxable capital gains from the disposition of shares or debt of the foreign affiliate, less various offsets, including foreign accrual taxes applicable, as well as dividends deductible under subsection 91(5) or 113(2), or paragraphs 113(1)(*a*) to (*d*). It seems to me that these deductions would generally provide a high offset (i.e., restrict deductions relating to the disallowed interest pool) unless income was earned in a low-tax jurisdiction where exempt surplus is not generated.

[6] Budget Resolution 26(b) potentially catches any amount that is otherwise deductible by the taxpayer and may reasonably be considered to be in connection with a transaction or event or a series of transactions or events a main purpose of which was to avoid the rules. It remains to be seen how such a provision would "play out" in respect of large multinational corporations with complex corporate structures.

[7] 1997 *Report of the Technical Committee on Business Taxation*, hereinafter the "Mintz Committee Report".

[8] In the 1992 report, the Department of Finance defended the rules on the basis of competitiveness. In the 2002 report, the Department argued that corporate tax reductions would mean that Canada will become a relatively less attractive jurisdiction for multinationals to locate their debt financing and interest expenses, but that it would "continue to assess . . . the treatment of expenses incurred to make investments in . . . affiliates".

[9] Although the Canadian parent might furnish guarantees and the like, this may mean little to a foreign financial institution.

[10] One possibility is to borrow in Canada and on-lend at interest; however, foreign tax credit restrictions may arise where foreign withholding tax is applicable; a subsection 20(12) deduction is, of course, inefficient. The preferable course of action may be to borrow outside of Canada.

[11] See "Ottawa May Get Windfall from Tax Crackdown", *Report on Business*, March 24, 2007, in which a senior tax practitioner cited the proposals as the "most misguided . . . I've seen out of Ottawa in 35 years".

[12] The Mintz Committee Report recommended that the disallowed interest should be added to the cost base of the shares of the relevant foreign affiliate and accumulated in a "disallowed interest account". To the extent that dividends are received on those shares from taxable surplus, a deduction would be available; however, unlike the current proposals, accumulated balances in the disallowed interest account would not be available as an offset against FAPI. As noted previously, instead of an ACB increase, Budget Resolution 28 provides that the disallowed interest pool would be deductible against capital gains from the disposition of shares or debt of the foreign affiliate.

[13] Consideration should be given to possible competitive advantages of providing a transitional period/grandfathering.

[14] See "Taxing Foreign Business Income", Nick Pantaleo and Scott Wilkie, *1998 Corporate Management Tax Conference*, p. 8:18. Ironically, an edi-

torial on the Budget by Jack Mintz appearing in the March 21, 2007 edition of the *Financial Post* made no mention of the proposals.

[15] A partner in my firm, who asked to remain anonymous, thinks that one of the beneficiaries of this proposal may well be foreign banks doing business in Canada. "They already potentially have a competitive advantage over Canadian banks in targeting Canadian companies that also operate outside of Canada because of their infrastructure in other parts of the world. This may give them another leg up because they can lend to the foreign sub and be more comfortable in taking guarantees and security from the Canadian parent, if required to support the credit".

It has been stated that the (very similar) Mintz Committee Report proposal "... will raise the cost of capital of Canadian-based multinational companies. This could result in Canada's suffering adverse economic effects in terms of foreign and domestic investment, industrial growth, international trade, income, and employment". See Pantaleo and Wilkie, *op. cit.* p. 8:24.

[16] For interest paid to non-arm's length persons, withholding tax will be limited to 7% in the first year following the entry into force of the changes, to 4% in the second year, and nil thereafter. For arm's length persons, withholding tax on interest will be eliminated beginning with the first calendar year that commences after entry into force, i.e., when both countries have completed the procedures to enact the treaty changes into their laws.

There are several other proposals in the international area. For example, the Budget proposes that exempt surplus be extended to include non-treaty countries with which Canada has a comprehensive tax information exchange agreement ("TIEA"). On the other hand, non-TIEA-country earnings (including from active business) will be taxed as FAPI. Although a country will generally be a non-TIEA country only if five years have elapsed from the time TIEA negotiations begin or from the time that Canada invited the country to enter into such negotiations, one may still ask whether it is fair to force investors to either report FAPI or pull up stakes in the particular jurisdiction.

For taxation years of foreign affiliates commencing after 2008, deemed active business income, per various provisions in paragraph 95(2)(*a*) will be conditional on the taxpayer having a "qualifying interest". The Budget also indicates that treaty benefits will be extended to U.S. LLCs. However, there is no indication in the Budget that other issues pertaining to LLCs will be addressed.

2007 Federal Budget Tabled on March 19, 2007

On March 19, 2007, the Minister of Finance tabled the 2007 federal Budget. Subscribers of the CANADA INCOME TAX GUIDE print, CD, and online will have received CCH's Budget SPECIAL REPORT No. 025H containing the Department of Finance's documents, including *The Budget Plan* and the Notice of Ways and Means Motion outlining income tax proposals, as well as expert commentary on such proposals. The full text of the Budget documents has been posted on CCH Tax PROTOS® and CCH's News Tracker.

Reproduced below is Department of Finance News Release No. 2007-022, dated March 19, 2007, concerning the tabling of the Budget.

> The Honourable Jim Flaherty, Minister of Finance, today tabled a balanced budget that moves to restore fiscal balance in Canada, cuts taxes for working families, reduces the national debt and invests in key priorities like improving health care and environmental protection.
>
> "Budget 2007 will strengthen the federation by restoring much-needed fiscal balance," said Minister Flaherty. "And Canadians come out ahead through real tax relief that benefits working families."
>
> Budget 2007 builds a stronger, safer, better Canada by delivering the following benefits for Canadians:
>
> - **Restoring fiscal balance** by providing $39 billion in additional funding over seven years, which will allow provinces and territories to better provide services and infrastructure that matter to Canadians – everything from roads, bridges and public transit, to better-equipped universities and colleges, improving health care, clean rivers, oceans and air, and job training that helps Canadians compete with the best in the world.
> - **Further tax relief for working families** with the Working Families Tax Plan, which includes a new $2,000-per-child tax credit. Budget 2007 also helps parents save for their children's education by strengthening the registered education savings plan program, and supports seniors by raising the age limit for registered pension plans and registered retirement savings plans to 71 from 69 years.
> - **Further debt reductions** resulting in savings for Canadians. After paying down $13.2 billion on Canada's national debt in September 2006, Budget 2007 further reduces the debt by $9.2 billion. Thanks to the government's Tax Back Guarantee, the interest savings on this year's debt repayment will be returned to Canadians in the form of further tax cuts.
> - **Investing in Canadians** by providing $550 million per year for the Working Income Tax Benefit and $140 million over two years to establish a Registered Disability Savings Plan.
> - **Preserving the environment** with a balanced action plan including rebates on fuel-efficient vehicles and efficient alternative fuel vehicles, an incentive to get older polluting cars off the road and a Green Levy on fuel-inefficient vehicles; by developing a new National Water Strategy; and by providing $1.5 billion to establish a Canada ecoTrust for Clean Air and Climate Change.
> - **Improving health care** by investing $400 million for Canada Health Infoway to support the development of electronic health records and up to $612 million to support jurisdictions that have made commitments to implement patient wait time guarantees, and by providing the provinces with $300 million for a vaccine to prevent cancer of the cervix.
> - **Supporting our troops** by providing $60 million to increase the field operations allowance, establishing five new trauma centres to help veterans and their families deal with stress injuries related to their military service, and creating the position of Veterans' Ombudsman.

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- **Supporting our farmers** by providing $1 billion in commitments for improvements to national farm income programs, including $600 million to kick-start contributory style producer savings accounts and a direct payment of $400 million to producers to help address high production costs.

A companion document, *Creating a Canadian Advantage in Global Capital Markets*, outlines the Government's plan to strengthen our capital markets, which will make Canadian businesses more competitive and increase returns for investors.

Further information on Budget 2007 can be obtained by visiting the Department of Finance website or by phoning 1 800 O-Canada (1 800 622-6232) or 1 800 926-9105 (TTY for the speech and hearing impaired/deaf).

Amended Regulations

Section 7400 was added by P.C. 2007-205, SOR/2007-35, dated February 22, 2007, to set out prescribed forest management plans for woodlots for the purposes of subsections 70(9), (9.3), (10), and 73(3) of the Act.

Prescribed Interest Rates – Second Quarter of 2007

The prescribed interest rates for the second quarter of 2007 are as follows:

- 5% to calculate a deemed interest taxable benefit on subsidized employee and shareholder loans;
- 7% on refunds of income tax overpayments; and
- 9% on payments of overdue income taxes, insufficient income tax instalments, unremitted employee source deductions, CPP contributions or EI premiums, and unpaid penalties.

These rates will be in effect from April 1, 2007 to June 30, 2007.

A listing of the prescribed interest rates for each quarter, dating back to 1994, is found at ¶12,745.

Technical News No. 35 – Treaty Residence – Resident of Convenience

On February 26, 2007, the CRA released Technical News No. 35, which outlines the CRA's position on the meaning of "liable for tax" in order for a person to qualify as a resident of a country for purposes of Canada's tax treaties. Technical News No. 35 is reproduced below, and has been incorporated in place in Volume 2 of the CANADA INCOME TAX GUIDE.

Treaty Residence – Resident of Convenience

In order to qualify for the benefits under Canada's tax treaties, a person must be considered a resident of a contracting state for the purposes of the relevant treaty. Treaty residence is also a prerequisite for certain dividend deductions under Canada's domestic foreign affiliate rules and regulations. To be a resident of a contracting state, a person must be "liable to tax" in that state by virtue of a criterion referred to in the residence article of the relevant tax treaty.

It has been the long-standing position of the Canada Revenue Agency ("CRA") that, to be considered "liable to tax" for the purposes of the residence article of our treaties, a person must be subject to the most comprehensive form of taxation as exists in the relevant country. For Canada, this generally means full tax liability on worldwide income. This is supported by the comments found in the Supreme Court decision *The Queen v. Crown Forest Industries Ltd. et al.* (95 DTC 5389) as well as the Commentary to the OECD Model.

We were recently asked to clarify the meaning of the term "liable to tax". This request arises because of the fact that, in certain countries, the tax system generally taxes entities that have a particular attachment to that country on a worldwide income basis at a rate comparable to Canadian tax rates, but some of these entities are, according to special rules, either exempted from taxation or taxed at a very low rate. CRA's position has previously been that entities benefiting from such special regimes may not be subject to the most comprehensive form of taxation and therefore, would not be "liable to tax".

Tax professionals have suggested that the same rationale should adversely affect charities and pensions, but we nonetheless consider such entities as "residents" under our treaties and grant them treaty benefits. To clarify any ambiguity and as announced at the 2005 Canadian Tax Foundation conference, CRA agreed to undertake a review of its position regarding the level of taxation a jurisdiction must levy on a person's income before that person would be considered "liable to tax" under a tax treaty. The CRA has recently completed the review.

It remains CRA's position that, to be considered "liable to tax" for the purposes of the residence article of Canada's tax treaties, a person must generally be subject to the most comprehensive form of taxation as exists in the relevant country. This, however, does not necessarily mean that a person must pay tax to a particular jurisdiction. There may be situations where a person's worldwide income is subject to a contracting state's full taxing jurisdiction but that state's domestic law does not levy tax on a person's taxable income or taxes it at low rates. In these cases, the CRA will generally accept that the person is a resident of the other Contracting State unless the arrangement is abusive (e.g. treaty shopping where the person is in fact only a "resident of convenience"). Such could be the case, for example, where a person is placed within the taxing

jurisdiction of a Contracting State in order to gain treaty benefits in a manner that does not create any material economic nexus to that State.

As confirmed by the Supreme Court in *The Queen v. Crown Forest Industries Ltd. et al.* (95 DTC 5389), reviewing the intention of the parties of a tax treaty is a very important element in delineating the scope of the application of the treaty. Accordingly, the determination of residency for the purposes of a tax treaty remains a question of fact, and each case will be decided on its own facts with an eye to the intention of the parties of the particular convention and the purpose of international tax treaties.

CRA Notice Re Partnership Information Returns

Reproduced below is a CRA notice, released March 26, 2007, regarding the filing of partnership information returns ("PIRs").

For fiscal periods ending before 2007, the CRA will extend the exemption policy for filing a T5013, Partnership Information Return, for partnerships that have five members or fewer, where throughout the fiscal period of the partnership, any of the members are corporations or trusts.

For fiscal periods ending after 2006, a partnership that has a corporation or trust as a member at any time throughout the fiscal period of the partnership, will be required to file a T5013 Partnership Information Return. Partnerships that have five members or fewer, where all of the members are individuals (excluding trusts), will remain exempt.

If you are a partner of a partnership that has to file a PIR, you should get **two** copies of a T5013 slip, Statement of Partnership Income, from the partnership. If you **do not** receive this form, contact the person who prepares the forms for the partnership.

On your income tax return, report the gross partnership income and your **share of the net partnership income or loss**. You will get these amounts from your T5013 slip. Attach a copy of your T5013 slip to your income tax return. **Do not** attach the partnership's income and expense statement.

You **may need to adjust** your share of the net partnership income or loss shown on your T5013 slip. Do this to deduct any business expenses you incur for which the partnership **did not** repay you, and for any other deductible amounts. If this is your situation, read topic Line 9943 – Other amounts deductible from your share of net partnership income (loss). You may also have expenses related to the business use of your home.

Recent Technical Interpretation

Transfer of Property to Corporation Prior to Sale of Shares

To qualify for the enhanced capital gains exemption with respect to a disposition of a qualified small business corporation share, the share cannot have been owned by anyone other than the individual or a related person or partnership during the 24 months prior to the sale. Where shares are issued by the corporation in exchange for property transferred to the corporation, paragraph 110(1)(*f*)(ii) deems the shares to have been owned before they were issued by a person that was not related to the purchaser, unless the shares were issued in exchange for "all or substantially all the assets used in an active business carried on by that person or the members of that partnership".

In a situation the CRA was asked to comment on:

(1) Shareholders A and B are 50% common shareholders in a company ("OPCO") that carries on an active business. OPCO was incorporated in 1983 and continues to carry on the same business.

(2) OPCO holds all operating assets of the business except for the land on which the business is situated.

(3) Shareholder B personally owns the land on which OPCO's business is situated.

(4) The shares of OPCO and the land on which its business is carried on are about to be sold to a third party by Shareholders A and B as applicable.

(5) Prior to the sale of shares of OPCO, Shareholder B will transfer the land to OPCO in exchange for retractable preferred shares equal to the fair market value of the land.

(6) The preferred shares issued in exchange for the land will have been held for less than 24 months by Shareholder B prior to the sale of all OPCO shares by Shareholders A and B to the third party.

In this situation, the business was not carried on by Shareholder B prior to the transfer; therefore, the requirement in clause 110.6(14)(*f*)(ii)(A) is not met and the preferred shares issued in exchange for the land will be deemed to have been owned by a person that was not related to Shareholder B.

Document No. 2006-0208691E5, January 15, 2007

Recent Cases

No shareholder's benefit arises where redemption of shares results in deemed dividend

In December 2000, Centre Financier Iberville/Champlain Inc. ("CFIC") issued 300 Class J shares to the corporate taxpayer for $300. The Class J shares were redeemable for $1,000 per share at the taxpayer's demand, and were redeemed for $300,000 on January 16, 2001. In assessing

the taxpayer for 2001, the Minister added to its income $299,700 (i.e., $300,000 less the paid-up capital value of $300) as a subsection 15(1) shareholder's benefit. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was allowed. The provisions in the relevant corporation legislation permit the issuance of shares with a redemption value in excess of their issuance price, subject to certain provisos. Subsection 15(1) specifically states that no shareholder's benefit arises where a redemption of shares results in a deemed dividend, which would have been the case under subsection 84(3) with the redemption of the Class J shares. As well, the Minister's argument that the benefit occurred when the Class J shares were issued, and not when they were redeemed, was untenable. Clearly any benefit could only have arisen upon their redemption. The Minister was ordered to reassess on the basis that no subsection 15(1) shareholder's benefit arose upon redemption of the Class J shares.

Gestion Léon Gagnon Inc., 2007 DTC 267

Lump sum paid for retroactive support not deductible

The taxpayer and his spouse separated on December 1, 2001 due to the breakdown of their marriage. Under an interim order of the Ontario Superior Court of Justice (Family Court), the taxpayer paid $6,600 in support payments from July to December 2004, and these were allowed by the Minister as a deduction. Under minutes of settlement executed on December 22, 2004 (the "Minutes of Settlement"), the taxpayer paid his former spouse a lump sum of $27,800, made up of a series of retroactive monthly amounts from December 2001 to June 2004. However, there was no prior written agreement requiring these payments to be made. In reassessing the taxpayer for 2004, the Minister disallowed the deduction of the $27,800 on the ground that it was not periodic. On his appeal to the Tax Court of Canada, the taxpayer argued that the $27,800 represented deductible arrears of retroactive periodic monthly spousal support payments for the period from December 2000 to June 22, 2004.

The taxpayer's appeal was dismissed. When the parties signed the Minutes of Settlement, there were no pre-existing obligations requiring the taxpayer to make support payments prior to the interim order. The Minutes of Settlement created this obligation for the first time, albeit retroactively. This was a new obligation, which was the converse of an obligation to pay arrears. The $27,800 was not a deductible payment of arrears of spousal support, but a non-deductible capital lump sum.

Stoikos, 2007 DTC 205

Voluntary spousal support payments not deductible

In assessing the taxpayer for 2003, the Minister disallowed the deduction of $11,489.54 in voluntary support payments made by him to his former spouse. The Minister's position was that these payments were not made under "an order of a competent tribunal or under a written agreement", and were not deductible under subsection 56.1(4) of the Act. On his appeal to the Tax Court of Canada, the taxpayer alleged that documentation relating to criminal charges against him for assaulting his wife (e.g., the restraining order, etc.) constituted "an order of a competent tribunal" within the meaning of that phrase in the definition of "support amount".

The taxpayer's appeal was dismissed. None of the documentation submitted by the taxpayer contained any provisions regarding support. Also, endorsed cheques proving that the taxpayer made the support payments did not constitute a written agreement. The $11,489.54 in voluntary support payments made by the taxpayer was not deductible. However, because of the hardship caused to the taxpayer, it was recommended that he apply for relief under the *Financial Administration Act*.

Skipkariuk, 2007 DTC 209

Taxpayer not entitled to deduct computer expenses under conditional sales contract

In 2003, the taxpayer received gross employment income of $104,091, including commission income of $20,000. In assessing the taxpayer for 2003, the Minister disallowed the deduction of telephone expenses totalling $1,411.31 and computer expenses of $1,650.72. The $1,650.72 was made up of 12 monthly instalments of $137.56 paid under a contract with Future Shop for the acquisition of a computer. On the taxpayer's appeal to the Tax Court of Canada, the Minister conceded that she was entitled to the telephone expense deduction. The Minister's position on the computer was that the contract with Future Shop was a conditional sale, which prevented the taxpayer from deducting the $1,650.72.

The taxpayer's appeal was allowed in part. The taxpayer met all of the conditions required for the deduction of expenses as contemplated in paragraph 8(1)(*f*). However, the contract with Future Shop was not a leasing contract, but a conditional sales contract. The Minister was ordered to reassess, but only to give effect to the concession respecting the deductibility of the telephone expenses.

Collette, 2007 DTC 212

Corporate officer entitled to deduct settlement amount paid in tort action

The taxpayer was a real estate developer and a minority shareholder of 152817 Canada Inc. ("152817"). In a judgment of the Quebec Superior Court dated December 10, 1999 (the "December 1999 Judgment"), 152817 and other defendants were held liable to the plaintiff Trisud for the balance owing to it after selling its rights under an emphyteutic lease to 152817. On January 28, 2000, Trisud brought a further action to add individual defendants, including the taxpayer, to its action. Trisud's object was to render these added defendants solidarily liable to it with the defendants already condemned in the

December 1999 Judgment. The taxpayer paid $350,000 in 2000 to settle his liability in Trisud's additional action, which was an action in tort alleging that the taxpayer was the guiding mind behind at least one of the corporate defendants condemned in the December 1999 Judgment. The Minister disallowed the deduction of the $350,000 and the taxpayer appealed to the Tax Court of Canada. His argument was that the $350,000 had been paid during his ordinary business activities to protect his reputation and his business as a corporate officer.

The taxpayer's appeal was allowed. Although he derived rental income from properties, the taxpayer's main business activities were carried on as a corporate officer. Hence, there was a business purpose for his payment of the $350,000 in dispute. Also, he was carrying on business with the corporate entity whose tortious act was the subject matter of Trisud's additional action. That corporate entity would have been entitled to deduct the $350,000. Therefore, the same entitlement should accrue to the taxpayer as if he were carrying on that corporation's business himself. The Minister was ordered to reassess accordingly.

Nisker, 2007 DTC 230

Taxpayer did not meet deemed residency rules

The taxpayer was an Air Canada pilot. From 1996 to 2000, he did not spend more than 183 days in Canada in any one taxation year. He had accommodations and financial investments in TCI, a jurisdiction with which Canada has no tax convention. He had a mailing address, a driver's licence, and financial links to Florida. He had employment obligations, social relations, and professional services connecting him to Canada. The Minister assessed him for 1996 to 2000 as a resident of Canada, while conceding that he was also a resident of TCI.

The judgment was deferred. An individual can be a resident of Canada for tax purposes either under the deeming rules in subsection 250(1) , or by being "ordinarily resident" in Canada under subsection 250(3). The Minister conceded that the taxpayer did not meet the 183-day sojourning text in paragraph 250(1)(*a*). It was unnecessary to determine whether the taxpayer was "ordinarily resident" in Canada, since this allegation was not pleaded in the Minister's reply. However, on the evidence, the taxpayer was not "ordinarily resident". This left for determination the question of how the taxpayer's Air Canada salary should be allocated to Canada. Formal judgment was deferred for two weeks to permit counsel for the parties to determine how they wished the allocation issue to be handled by the Court.

Laurin, 2007 DTC 236

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