CCH
a Wolters Kluwer business

Tax Notes

June 2007
Number 533

Clear and Present Danger – The Saga Continues

If you ask me, the still ongoing saga of the federal Budget's restricted interest proposals may be the most bizarre incident coming out of the Department of Finance since Alan MacEachan's 1981 federal Budget. Because of Budget secrecy, it is doubtful we will ever know the full story behind these ill-fated proposals. But what is on the record raises some serious questions about the inner workings of the group of bureaucrats in whose hands responsibility for our tax laws resides.

In case you've been in hibernation, here's a brief rundown of the events to date. On March 19th, the federal Budget announced the now-infamous restricted interest proposals – that did nothing less than disallow interest deductions in respect of investments in foreign affiliates.[1]

It took the financial press a couple of days to figure out what was going on, but once it did, the proposals rightfully became big news, with Canada's financial establishment heaping derision on the beleaguered Finance Minister. On Monday, May 14th, the proposals were withdrawn and replaced by the announcement of measures specifically directed against tower and double-dip financing structures.[2] (These structures use interest charges to drain an affiliate's profits subject to foreign tax without having to pay Canadian tax on interest income on "the other end".) These proposals would be delayed until 2012 – and vetted, Flaherty promised – by a panel of experts. Even so, it took less than 24 hours before establishment CA and law firms started to issue releases protesting the new proposals.[3]

On Thursday of that week, Flaherty addressed the International Fiscal Association meeting – populated by members of the aforesaid firms. How can you kill double-dips – reps of the organization beseeched – when they don't cost Canadian taxpayers a cent? (They actually asked twice.) Finance Minister Flaherty said something about "morality", plus some hints that the heat could be coming from his G8 colleagues.

Inside

This was rapidly followed by a bizarre article in Friday's *Globe*,[4] in which Flaherty recognized that tax advisors would be able to figure out ways to get around the narrowly focused legislation – almost an invitation to Bay Street drones to do so.[5] The article also cited Jack Mintz for saying that the new proposals could hamper Canada's global competitiveness. Huh? Wasn't it his committee that came up with the original Budget proposals a decade earlier?

Unanswered Questions

Actually, this is just one of many unanswered questions raised by the saga. Are the double-dip proposals an attempt by Flaherty to save face? Is he really under pressure from other countries, as he hinted? Or is this an exercise in "tax morality", as the Finance Minister has now indicated on a number of occasions? If so, isn't the job of the Finance Minister to advance Canadian business interests?

But as I indicated in my article on the original proposals,[6] what disturbs me is the process by which the legislation came to pass.

It is true that mention in the Auditor General's reports and the Mintz Committee gives the original proposals some pedigree. But if the more constrained double-dip/tower proposals are to be vetted by a panel of experts, shouldn't there have been even more safeguards with respect to the original – much farther reaching – proposals? Changes this fundamental should be the subject of extensive consultation, as was the case in their previous incarnation as part of the Mintz Committee recommendations.

TAX NOTES

Published monthly by CCH Canadian Limited. For subscription information, see your CCH Account Manager or call 1-800-268-4522 or (416) 224-2248 (Toronto).

For CCH Canadian Limited

ROBERT SPENCELEY, Editor
(416) 224-2224, ext. 6279
e-mail: Robert.Spenceley@wolterskluwer.com

ROBIN MACKIE, Director of Editorial
Tax, Accounting and Financial Planning
(416) 228-6135
e-mail: Robin.Mackie@wolterskluwer.com

TR ISLAM, Marketing Manager
(416) 228-6166
e-mail: TR Islam@wolterskluwer.com

PUBLICATIONS MAIL AGREEMENT NO. 40064546
RETURN UNDELIVERABLE CANADIAN ADDRESSES TO
CIRCULATION DEPT.
330–123 MAIN ST
TORONTO ON M5W 1A1
email circdept@publisher.com

So why weren't they? On Budget night, did the Finance Minister really understand the proposals? Or was he ultimately forced to defend the doings of bureaucrats who did not fully appreciate their widespread effect?

If I were in Mr. Flaherty's shoes, I would be taking a close look at the goings-on in my department. If so, he may find that these are not the only troublesome items that have gotten all the way through the Tax Policy bureaucracy. Consider, for example, some other international tax proposals that are passing through Parliament even as I speak:[7]

- A Canadian beneficiary of a foreign estate or trust will normally have to report annual imputed interest (currently 7%) based on the total carrying values of the assets in the estate or trust, even though he or she may ultimately receive little or none of the income or capital (i.e., because there are other beneficiaries).[8]
- A person who has immigrated to Canada with a foreign life insurance policy will ultimately have to revalue the policy every year and pay tax on the increase.[9]

How many people will (can?) actually comply with these off-the-wall rules? The obvious answer begs the question of continued respect for the self-assessment system.

You may recall *Dr. Strangelove*, a movie which centered on a deranged lower-level military officer who was given the power to drop nukes. Is something like this going on in Ottawa? Is anyone minding the Tax Policy store?

– David Louis, B. Com., J.D., C.A., tax partner Minden Gross LLP, a member of MERITAS Law Firms Worldwide

Notes:

[1] This would occur in the vast majority of situations. Deductions could be allowed to the extent of taxable income in respect of the foreign affiliate.

[2] Release 2007-041 ("Canada's New Government Improves Tax Fairness with Anti-Tax-Haven Initiative") and related documents, May 14, 2007. In a nutshell, the proposals restrict deductions for interest relating to investments in foreign affiliates in respect of periods beginning after 2011, to the extent of the corporation's "double-dip income" for the taxation year. Double-dip income is based on "recharacterized income" which in turn is based on deemed active business income per paragraph 95(2)(*a*) that is attributable to a "specified debt" owing to the foreign affiliate.

[3] Including the use of terms such as "disturbing", "inherently unfair" and "destructive" – pretty strong stuff.

[4] "Flaherty says double-dipping not doomed", May 18, 2007

[5] The article indicates that Flaherty stated: "There are other issues that we could focus on. . . . There are other ways, I'm sure. Lots of people get paid lots of money to develop tax avoidance schemes, and that's to be expected . . .".

[6] "The Federal Budget's Interest Restrictions – Clear and Present Danger?" TAX NOTES No. 531, April 2007.

[7] Bill C-33.

[8] See, in particular the definition of "specified interest" in a trust (which exempts an interest in a totally-discretionary trust), per proposed subsection 94.1(1), and paragraph 94.1(2)(*c*) re the calculation of "designated cost". These provisions appear to potentially affect the beneficiaries of so-called "five-year immigration trusts". Paragraph (*c*) of the definition of "exempt taxpayer" contains a 60-month exclusion from the FIE rules for new Canadian residents. However, besides the recent immigrant, the ben-

eficiaries of an immigration trust may also include beneficiaries that are longer-standing Canadian residents.

[9] See proposed subsection 94.2(10) *et seq.* Paragraph (*c*) of the definition of "exempt taxpayer" (mentioned in footnote 8) would exempt new Canadian residents – i.e., for the first 60 months of residence. However, it seems that a pre-existing exemption, potentially applicable to persons who acquire a policy more than five years before becoming Canadian residents, has been removed in Bill C-33.

Lipson (FCA): All-Purpose Logic?

Lipson[1] is the first General Anti-Avoidance Rule ("GAAR") case to reach the appellate level since the decisions of the Supreme Court of Canada in *Canada Trustco*[2] and *Mathew*.[3] *Lipson* is essentially a "version 2.0" of *Singleton*,[4] but this time under the GAAR. The decision of the Federal Court of Appeal raises several questions in that it gave particular weight to the purpose of the series of transactions undertaken by the taxpayer, and effectively carried out a disguised "economic reality" test.

Facts

The facts are fairly similar to those in *Singleton*. Mr. Lipson wished to purchase a house. He owned all the outstanding shares of a private corporation. Mr. Lipson's wife borrowed from a bank to purchase a certain number of those shares at fair market value for $562,500, the proceeds from which were used by Mr. Lipson to finance the purchase of the house. The next day, the house was mortgaged in favour of the bank and the proceeds of the mortgage were used to repay Mrs. Lipson's bank loan.

Mr. Lipson chose not to elect out of the attribution rules and, as such, the sale was deemed to take place at Mr. Lipson's adjusted cost base with future income realized on the shares sold being attributable to him. Mr. Lipson complied with the attribution rules in section 74.1 of the *Income Tax Act* (the "Act") by reporting dividend income and deducting the interest expense borne by Mrs. Lipson on the loan to purchase the shares. The CRA initially denied the deduction on the basis of "true economic purpose", which basis was subsequently shifted to abuse under GAAR after the Supreme Court judgment in *Singleton* was rendered.

The Tax Court of Canada held that an "avoidance transaction" occurred (which was later admitted at the appellate level) and applied the GAAR based on the following paragraphs:

> [31] This case is, in my view, *an obvious example of abusive tax avoidance*. Whatever commercial or other non-tax purpose, if any, is served by transferring Earl's shares to Jordanna, it is subservient to the objective of making the interest on the purchase of the house deductible by Earl.
>
> [32] In this case I am not looking to any "overarching policy" that supersedes the specific provisions of the ITA. I am simply looking at *the obvious purpose* of the various provisions that are relied on and have concluded that *those purposes have been subverted and those sections turned on their heads*. I mentioned above that section 245 must itself be subjected to a textual, contextual and purposive analysis. If there ever was a case at which section 245 was aimed, it is this one. (emphasis added)

Discussion

Relevance of the Purpose of the Series

The GAAR analysis in *Lipson* turned solely on abuse, as contemplated by subsection 245(4), since both the tax benefit and the avoidance transactions had been admitted by the appellant. In its analysis, the FCA gave preponderant weight to the *purpose of the series of transactions* in the context of the misuse and abuse analysis. Arguably, while the overall purpose may be relevant in the context of a subsection 245(3) analysis of an avoidance transaction, in accordance with the following passage in *Canada Trustco*, "any finding in this respect would form only one part of the underlying facts of a case, and would be insufficient by itself to establish abusive tax avoidance".[5]

In *Lipson*, the purpose of the provisions at issue was particularly relevant due to the fact that as Mr. Justice Bowman, C.J., mentioned, there is no "overarching policy" of the Act that would supersede the said provisions.[6] Arguably, the application of the GAAR based on a conclusion as to the *purpose of the series* – rather than the *purpose of the provisions* at issue – leaves no room at all for subsection 245(4) to operate. In our view, the FCA compressed the analysis of subsections 245(3) and (4) into one single test, with the result that subsection 245(4) is essentially read out of the Act. In effect, the GAAR analysis in *Lipson* ended with subsection 245(3). This would impliedly permit a *subjective* test to be applied in a subsection 245(4) analysis as to the intent of the taxpayer. As other authors have noted, "the 'overall purpose' of the use of the borrowed funds is irrelevant at this stage".[7]

The reasoning of the Court also appears to set aside the guidelines set out by the Supreme Court in *Mathew*. In *Mathew*, the Court looked at subsection 18(13), a provision which is intended to defer a loss. When subsection 18(13) is used to buy a loss, the purpose of the provision is subverted and violated, particularly in a context where the scheme of the Act reflects a general policy that losses not be traded. In *Lipson*, the taxpayer used paragraph 20(1)(*c*), a rule intended to provide deductibility of interest, *inter alia*, when one purchases shares of a company, and the taxpayer did just that. This prompts one to wonder how this is an "obvious example of abusive tax avoidance"[8] when a provision of the Act was used specifically for the purpose for which it was intended to be used?

The true economic effect in *Lipson* is that Mrs. Lipson got shares of the company. Accordingly, attribution is a red herring as the identity of who is permitted a deduction is irrelevant: only the fact that a deduction is allowed is relevant in this context. To conclude otherwise would simply recharacterize the transactions that were actually carried out. As discussed below, this is not permitted by the jurisprudence of the Supreme Court.

The facts in *Lipson* were arguably more favourable to the taxpayer than those in *Singleton*, as the transactions were carried out by two separate taxpayers. The reality of the situation is that if Mr. and Mrs. Lipson divorced, Mrs. Lipson would keep the shares and the attribution rules would cease to apply. Perhaps part of the confusion stems from the fact that, although Mr. and Mrs. Lipson are distinct taxpayers, while married they are a single economic unit.

Disguised "Economic Reality" Test

The analysis under subsection 245(4) hinges on the interpretation of the purpose of the provisions relied upon by the taxpayer and whether the transactions frustrated that purpose. Courts should also refrain from determinations of abuse that are wholly based on "substance", as explained by the Supreme Court in the following paragraphs of *Canada Trustco*:

> [55] In summary, s. 245(4) imposes a two-part inquiry. The first step is to determine the object, spirit or purpose of the provisions of the *Income Tax Act* that are relied on for the tax benefit, having regard to the scheme of the Act, the relevant provisions and permissible extrinsic aids. The second step is to examine the factual context of a case in order to determine whether the avoidance transaction defeated or frustrated the object, spirit or purpose of the provisions in issue.
>
> * * *
>
> [58] Whether the transactions were motivated by any economic, commercial, family or other non-tax purpose may form part of the factual context that the courts may consider in the analysis of abusive tax avoidance allegations under s. 245(4). *However, any finding in this respect would form only one part of the underlying facts of a case, and would be insufficient by itself to establish abusive tax avoidance*. The central issue is the proper interpretation of the relevant provisions in light of their context and purpose.
>
> * * *
>
> [60] A transaction may be considered to be "artificial" or to "lack substance" with respect to specific provisions of the *Income Tax Act*, if allowing a tax benefit would not be consistent with the object, spirit or purpose of those provisions. *We should reject any analysis under s. 245(4) that depends entirely on "substance" viewed in isolation from the proper interpretation of specific provisions of the Income Tax Act or the relevant factual context of a case*. However, abusive tax avoidance may be found where the relationships and transactions as expressed in the relevant documentation *lack a proper basis relative to the object, spirit or purpose of the provisions that are purported to confer the tax benefit, or where they are wholly dissimilar to the relationships or transactions that are contemplated by the provisions.*[9] (emphasis added)

In fact, analyses based wholly on substance are more specifically proscribed in *Singleton*:

> [43] In summary, it is irrelevant that by his own admission the respondent structured the transaction for tax purposes. Courts cannot search for the "economic reality" or the "*bona fide*" purpose of the transaction in this case. . . .[10]

as well as in *Shell*:

> [T]his Court has never held that the economic realities of a situation can be used to recharacterize a taxpayer's *bona fide* legal relationships. To the contrary, we have held that, absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases.[11]

While section 245 constitutes such a provision to the contrary, recharacterization is only permitted once a court concludes that the GAAR applies. A court certainly cannot recharacterize a transaction in order to apply the GAAR.

At paragraphs 50–52 of the *Lipson* decision, the FCA appears to divert from these principles. In doing so, the FCA and the TCC are essentially applying an "economic reality" test in disguise. In our view, applying such a test indirectly achieves that which is specifically proscribed by the SCC in *Singleton*, *Shell*, and *Canada Trustco*.

Conclusion: Should the SCC Grant Leave?

The SCC should grant leave for all of the reasons set out above but, in addition, we feel that the question of whether guidelines set out by the SCC in *Mathew* should be followed by the lower courts is inevitably a question that ought to be submitted to the SCC and, as such, the SCC must intervene to send a clear message as to such guidelines.

Other factors which justify leave include the fact that interest deductibility is also one of the driving forces of business investment in Canada and, therefore, of the Canadian economy. In fact, if the SCC granted leave in *Singleton*, it should grant the same in *Lipson*.

Lastly, and in all deference to the TCC and FCA, it may be opportune for the SCC to clarify its position as to the application of subsection 245(4) so as to avoid interpretations from the lower courts that are summarized as "an obvious example of abusive tax avoidance", or "if there was ever a case at which section 245 was aimed, it is this one". To most taxpayers, this conclusion may not seem so obvious and, as such, this type of reasoning though clearly based on the Court's interpretation of the relevant facts and law, may nevertheless appear gratuitous to some.

Certainty, Predictability, and Fairness

The SCC in *Canada Trustco* suggests that the courts should strive to "achieve balance between the need to address abusive tax avoidance while preserving certainty, predictability and fairness in tax law so that taxpayers may manage their affairs accordingly".[12] It is our view that the Court's conclusions in *Lipson*, though one small step for the CRA, are also a giant leap towards the end of certainty, predictability, and fairness in tax law.

– Olivier Fournier and Michael N. Kandev, Davies Ward Phillips & Vineberg LLP. The authors would like to thank Nathan Boidman for offering his insight concerning the Lipson *case. Any errors or omissions are, of course, the responsibility of the authors.*

Notes:

[1] *Lipson v. The Queen*, 2006 DTC 2687 (TCC), affirmed at 2007 FCA 113.

[2] *Canada Trustco Mortgage Co. v. The Queen*, 2005 DTC 5523 (SCC).

[3] *Mathew v. The Queen*, 2005 DTC 5538 (SCC).

[4] *Singleton v. The Queen*, 2001 DTC 5533 (SCC).

[5] *Canada Trustco*, *supra* note 2, at paragraph 58.

[6] *Lipson* (TCC), *supra* note 1, at paragraph 32.

[7] Sohmer, D.H., "*Lipson v. The Queen*: The Federal Court of Appeal Muddies the GAAR Water", (2007) *The Canadian Taxpayer*, April 17-30, 2007, pp. 61 *et seq.*, at p. 63.

[8] *Lipson* (TCC), *supra* note 1, at paragraph 31.

[9] *Canada Trustco*, *supra* note 2, at paragraphs 55, 58, and 60.

[10] *Singleton*, *supra* note 4, at paragraph 43.

[11] *Shell Canada Ltd. v. The Queen*, 99 DTC 5669, at paragraph 39.

[12] *Canada Trustco*, *supra* note 2, at paragraph 61.

Minister Gambles on "Sucker Bet" and Loses in *Leblanc*

Brian Leblanc and Terry Leblanc v. The Queen, 2007 DTC 307 (Tax Court of Canada)

One could understand the Minister of National Revenue's ire at the Leblanc brothers. These two self-described indolent young men ate pizza and watched televised sports all day long, for seemingly years on end. They lived off the spoils of their exhaustive sports lottery gambling, and all the while, had not paid any taxes thereon, or at least not any income taxes, that is. But good fortune seems to have smiled once more on the Leblanc brothers, as the Tax Court of Canada considered their uncontrolled compulsive gambling to be truly that – a gamble, and not, as the Minister contended, a business.

The facts of the *Leblanc* case are simply as follows. During the taxation years at issue, Brian and Terry Leblanc gambled massively, irrationally, on government-run sports lotteries and against all odds, won massively. The Minister assessed the taxpayers to include in their income their net lottery winnings - an amount agreed by the parties to be approximately $5,500,000 – on the basis that wagering on government-run sports lotteries was a business of the taxpayers. The issue before the Court was whether the taxpayers' net lottery winnings constituted income from a business or tax-exempt capital gains.

The taxpayers argued that lottery winnings, by their very nature, regardless of the circumstances surrounding the purchase of lottery tickets, are always tax-exempt capital gains, and as such are not taxable by virtue of paragraph 40(2)(*f*) of the Act. Alternatively, the taxpayers argued that, even if lottery winnings could constitute income from a business, they were not operating a business in this circumstance. The Crown argued that the taxpayers' conduct in purchasing extreme volumes of lottery tickets in a managed and organized fashion, with the sole object of realizing a profit, bore all the hallmarks of a business; therefore, the taxpayers' lottery winnings were taxable under subsection 9(1) of the Act.

The Tax Court (*per* Bowman, C.J.) noted the unusual facts of the case, particularly the bizarre and obsessive behaviour of the taxpayers. The taxpayers, whom the Court noted had no formal training in gambling, embarked with rash abandon into government-run sports lotteries during the taxation years at issue. They moved to a location which enabled them to purchase lottery tickets in multiple provinces, and testified that it was not unusual for them to purchase thousands of tickets per week, betting upwards of $200,000 to $300,000. The taxpayers initially bought their tickets from multiple retailers due to the limitations placed on how many tickets a retail outlet could sell to one individual, and for a period of time they were able to negotiate a volume purchase discount from some of those retailers. In the beginning, the taxpayers themselves would pick up their pre-ordered tickets, but soon tired of this chore, choosing instead to enlist upwards of 15 "helpers" to do this cumbersome legwork. The taxpayers testified that they were "lazy" and only wanted to do the fun activities, which were, in their opinion, placing their sports wagers and watching the games.

The taxpayers testified that they bet on predominantly long-shot outcomes, which the Court noted increased the potential payout, but significantly increased the risk of losing. At one point, one of the taxpayers created a computer program that enabled them to input their sporting event choices and it then calculated their preferred wager combinations. Betting on such long-shot combinations resulted in losses estimated by the taxpayers to be 95% of the time. Although the accuracy of the figures was initially questioned by the Court, it was agreed that the taxpayers might have spent an estimated $10,000,000 to $13,000,000 per year in sports lottery bets, totalling upwards of $52,000,000 over the course of the taxation years in issue. Given the taxpayers' net winnings were $5,500,000, the Court noted that, accepting they spent $50,000,000 to produce such net winnings, the taxpayers must have had gross winnings of a mind-boggling $55,500,000. The taxpayers testified that this was because they were "lucky"; the Crown argued that this was because the taxpayers had developed a "system".

Apparently, the taxpayers kept all the losing tickets in their basement to establish, if questioned, where the money came from; whereas, winning tickets were kept initially in jars or boxes until a theft prompted the taxpayers to purchase a safe. The remainder of the taxpayers' time, being that portion uncommitted to playing lottery games, was spent watching televised sports, playing golf and ping pong, or sitting around their house eating pizza and

drinking beer. Despite their winnings, the taxpayers lived cheaply, reinvesting their winnings back into the lottery games they so ardently played. Such was the unabashed testimony of the taxpayers which formed the shaky foundation of the Crown's firm assertion of the taxpayers' business acumen.

The Crown suggested that the volume of tickets purchased, the significant dollar value of such tickets, and the multiple outcomes of such tickets demonstrated that the taxpayers had developed a system, and that it must therefore follow that they were engaged in a business. This system, it was argued, was evident from the fact that the taxpayers were so successful. Further, since the system was predicated on buying significant numbers of tickets on long-shot outcomes, this, argued the Crown, constituted a form of risk *minimization*, since it ensured higher payout outcomes in the event that the taxpayers won.

Unfortunately, the Crown's position was fully rebutted by the testimony of the taxpayers' expert witness, Dr. Smith, who had extensive experience in gambling matters. The Tax Court held that Dr. Smith's expert report demonstrated that: the odds of winning the sports lotteries that the taxpayers played were astronomical; there was no way (or system) to beat the odds in sports lottery games; and skill or sports-related knowledge played no part in winning sports lotteries. Further, Dr. Smith's evidence was that, because there was no such system to beat those odds, professional gamblers do not play sports lottery parlay bets, which they call "sucker bets". The Court agreed with Dr. Smith's evidence that the taxpayers' sports lottery purchasing pattern could be more accurately characterized as a "risk-maximizing" system.

With all of the above in mind, the Tax Court determined that the judicial definitions of "business" and "carrying on a business" were of little assistance in this case. The Court acknowledged that compulsive gamblers (if not all gamblers) spend time and money with a view to winning, and may develop a certain degree of expertise; however, traditionally, their gains are not taxed, and their losses are not deductible. Considering both Canadian and older English jurisprudence dealing with gambling as income, the Court concluded that the cases fall into three broad categories. (1) Where gambling is a pleasurable pursuit, or hobby, the gains are not taxable, regardless of regularity, compulsivity, and organization behind the gambling. (2) Where gambling is an adjunct or incident of a business carried on, the gains are taxable (e.g., a casino owner who gambles in his own casino). (3) Where gambling is undertaken as a professional pursuit where the gambler uses expertise and skill to earn a livelihood and skill is a significant component, the gains are taxable (e.g., the classic professional riverboat gambler).

Given the above categories, the Tax Court considered that, regardless of any profit motivation, betting on games of pure chance, such as lotteries, simply lacks the badges of trade. The Court's conclusion is consistent with the above gambling jurisprudence which considers that a significant feature of a business is the steps taken to minimize risk. The taxpayers' actions in the present case were held to be the antithesis of risk minimization, and if anything, pointed to compulsive gambling.

One wonders whether the Minister will appeal this decision based on the Court's reliance on case law which predates the Supreme Court of Canada's decision in *Stewart* (2002 DTC 6969). The Tax Court's failure to apply the factors outlined in *Stewart* in lieu of older "business" jurisprudence was recently vocalized by the Federal Court of Appeal in *Raghavan* (2007 FCA 27). According to *Stewart*, where there are mixed personal and commercial elements to the taxpayer's activity, which perhaps could be said with gambling, factors such as the taxpayer's subjective intention to profit and evidence of businesslike behaviour (or, more likely in this case, the lack thereof) is relevant in determining whether there is a source of income from a business.

If one accepts the fact that the Leblanc brothers spent well over $50,000,000 on government-run sports lotteries, then the Minister's ire was perhaps misplaced, given that the majority of those funds invariably ended up in the fisc for public purposes. However, in the end, the Leblancs' roundabout fiscal philanthropy was not considered relevant by the Minister in his assessment of those taxpayers.

– C. Gerrits, McCarthy Tétrault LLP

CRA Q&A Re Effect of 2007 Budget Proposals on Registered Plans

Reproduced below is a series of questions and answers released by the CRA's Registered Plans Directorate regarding proposals in the 2007 federal Budget, including resolutions 15–17 which, among other things, proposed increasing the age limit for maturing RPPs and RRSPs to 71 years from 69 years, applicable after 2006.

Will my RPP, DPSP, RRSP, or RRIF have to be amended to take advantage of the increase to the age limit?

It is proposed that benefits must start to be paid by the end of the year in which the individual becomes 71 years of age. If plan sponsors, issuers, and carriers want to apply the new age limit, they will have to review their plan wording to determine if an amendment to the plan is required.

If the wording of the age limit is general to what is permitted under the *Income Tax Act*, then the payment of benefits can be made no later than the end of the year in which the individual becomes 71 years of age. For

example, if the plan terms specify that "payments must begin no later than what is required under the *Income Tax Act*" then the new age limit would apply without an amendment to the plan.

If the plan simply describes the age limit to be 69 (e.g., "payments must begin no later than the end of the year in which the member attains 69 years of age"), then the plan would have to be amended to take advantage of the increase in the age limit to 71.

Can an employer, issuer, or carrier use the proposed increase in the age limit before the proposed changes to the *Income Tax Act* are enacted?

If the plan accommodates the increase in the age limit proposed in the March 2007 budget, then the employer, issuer, or carrier can use the proposed increased age limit. If the plan does not accommodate the increase, then the plan will have to be amended before allowing for the increased age limit. Employers, issuers, and carriers can amend and administer their plans in accordance with the proposed requirements.

Can I make a contribution to an RRSP in 2007, if I'm 70 or 71 years of age?

Yes, you can make contributions to an RRSP until the end of the year in which you become 71 years of age. You should verify your RRSP deduction limit to ensure that you have room to make contributions so they are not considered excess contributions.

If I'm 70 or 71 years of age at the end of 2007, under the proposed changes to the age limit, can I transfer the funds from my RRIF to an RRSP?

Yes, you can transfer the funds from your RRIF to an RRSP. However, you must convert the RRSP to a RRIF before the end of the year in which you become 71 years of age.

What is phased retirement?

The Income Tax Regulations currently prohibit employees from accruing further benefits under a defined benefit provision of a pension plan if they are currently receiving retirement benefits under a defined benefit provision of the plan or from another defined benefit plan of the employer or a related employer. Subject to certain requirements, the budget proposes to allow employees to receive pension benefits from a defined benefit plan, and to simultaneously accrue further benefits.

Who can qualify for phased retirement benefits?

To qualify for phased retirement benefits, employees must be at least 55 years of age and must be eligible for a pension that is not reduced because of their age, pensionable service, or a combination of both their age and pensionable service.

What phased retirement benefits can employers offer their employees?

Employers will be allowed to offer qualifying employees up to 60% of their accrued defined benefit pension. The 60% limit will be based on the amount of pension benefits (including bridging benefits) that would be paid from the plan if the employee were fully retired. As well, current rules that enable benefits to accrue for periods of absence or reduced pay will not apply to employees who receive phased retirement benefits and continue to accrue further benefits under the plan.

Will employees be required to reduce work time while receiving phased retirement benefits?

There will be no requirement that the partial pension be based on a reduction in work time, or that there be a corresponding reduction in salary. As a result, qualifying employees will be able to receive up to 60% of accrued pension benefits while continuing to work, part-time or full-time, as well as continuing to accrue benefits for that work.

How will other pension rules be affected by phased retirement benefits?

There will be no restrictions on when, or how often, an employee's accrued pension amount can be recalculated to take into account the employee's additional pensionable service and increased annualized earnings (if any) during a period of simultaneous benefit accrual and pension payment. Employers will not be prevented from limiting participation to specific employees under the plan terms. The prohibition against the payment of bridging benefits on a stand-alone basis will not apply for qualifying employees.

The prohibition on accruing additional benefits, while receiving pension payments, will continue to apply to designated plans as well as to persons who are connected with their employer.

When will employers be able to offer phased retirement benefits to their employees?

In order to provide for an appropriate period of consultation on the technical aspects of this measure, it is proposed that 2008 be the first year of service for which an employee will be permitted to accrue benefits under a defined benefit plan while in receipt of a partial pension.

Where can I get more information about the phased retirement benefits?

More information about phased retirement benefits will be available shortly. Please check the CRA's website

regularly for updates. The draft Regulations will be released by the Department of Finance in the near future.

Progress of Legislation

The House of Commons is not sitting during the week of May 21, 2007, but returns May 28, 2007. June 8 is the last scheduled sitting day for the House of Commons, but according to the Parliamentary calendar, possible sitting days can be extended to June 22, 2007. Proposed amendments to the *Income Tax Act* that have been tabled in a bill, released as draft legislation, or announced in a News Release, are set out below.

- Bill C-52, *Budget Implementation Act, 2007*, received second reading in the House of Commons on May 15, 2007 and was referred to the Standing Committee on Finance. It contains some of the income tax, GST/HST, excise tax, and customs measures that were included in the March 19, 2007 federal Budget. It also includes the income trust measures released as draft legislation on December 21, 2006, as well as the pension income splitting measures, change in the age amount, and future reduction of the corporate tax rate, which were tabled in a Notice of Ways and Means Motion in November 2006 (CCH Special Report 026H).

- Bill C-43, the *Senate Appointment Consultations Act*, received first reading in the House of Commons on December 13, 2006. It contains consequential amendments to subsections 127(3) and 230.1(1) and (2) of the *Income Tax Act*.

- Bill C-33, *Income Tax Amendments Act, 2006*, received second reading in the House of Commons on May 14, 2007 and was referred to the Standing Committee on Finance. It amends the *Income Tax Act* with respect to foreign investment entities, non-resident trusts, technical amendments, and bijuralism. This replaces the draft legislation for these amendments that was previously released on July 18, 2005, and also includes the proposals that were released on November 17, 2005, concerning the cost of property acquired in certain option and other transactions (CCH Special Report 021H).

- On May 14, 2007, the Department of Finance announced its anti-tax-haven initiative in a response to concerns voiced by various members of the tax and business communities about proposals in the March 19, 2007 federal Budget regarding the deductibility of interest on debt borrowed to finance foreign affiliates.

- On March 19, 2007, the 2007 federal Budget was tabled and the Notice of Ways and Means Motion included with the Budget contained several proposed amendments to the *Income Tax Act*. Some of these proposals are contained in Bill C-52 (noted above) but many, such as proposals relating to international taxation and foreign affiliates, certain tax credits, and amendments to various remittance and instalment thresholds will be included in a future bill (CCH Special Report 025H).

- On February 2, 2007, the Department of Finance released draft legislation to amend subsection 182(2) of the *Income Tax Act* regarding the Tobacco Manufacturer's Surtax.

- On December 28, 2006, the Department of Finance announced proposed changes to the taxation of financial institutions as a result of new accounting standards that took effect on October 1, 2006.

- On February 27, 2004, draft legislation was released concerning foreign affiliates and technical amendments. The technical amendments were included in Bill C-33 (see above); however, the foreign affiliate amendments have not yet been re-released. (See CCH Special Report No. 007H.)

- On October 31, 2003, proposed amendments to the *Income Tax Act* concerning the deductibility of interest and other expenses related to a source were released. (See CCH Special Report No. 006H.)

CCH a Wolters Kluwer business

CCH Canadian Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
416 224 2248 • 1 800 268 4522 tel
416 224 2243 • 1 800 461 4131 fax
www.cch.ca