Tax Notes

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Inside

Resulting Trust Still Trumps Section 160 . . . 4

Recent Cases

Taxpayer was employee under Quebec law. 5

Judge justified in applying American accounting principles . . 6

Settlement payment correctly added to corporate taxpayer's income 6

"Transfer" of funds between spouses beyond usual household expenditures 7

Taxpayer bound to make spousal support payments under agreement 7

Allowances for employment at special work site or remote location not taxable . . . 7

Move to start new work at same location was "eligible relocation". 8

Corporation and sole shareholder reassessed on unreported income 8

Corporate Deferral Strategies, Dalton McGuinty and Joe the Plumber

Over the last number of years there have been a multitude of changes in corporate tax rates as well as the methodology behind taxing corporate distributions. Fortunately, these changes have generally enhanced opportunities to build corporate capital through integrated corporate tax deferrals.

Falling Corporate Tax Rates and the Eligible Dividend Regime

Traditionally, the small business corporate tax rate applicable to active business income has been much lower than the top personal tax rate. This, of course, encourages the retention of earnings at the corporate level, up to the annual "small business limit" ($500,000 per associated group of corporations, starting in 2009). Some years ago, the general corporate tax rate for business income rivaled the top marginal personal tax rate; however, in recent years, the general corporate rate has dropped dramatically. The latest group of federal changes (stemming from the November 2007 Economic Statement) will see the general business tax rate eventually dropping to 15% by 2012, for a "target" federal–provincial corporate rate of 25%.[1] This, of course, is considerably lower than top personal tax rates. Therefore, there is a substantial incentive to retain profits at the corporate level rather than distribute them as dividends or salaries and thus incur additional tax exposure.

In spite of these dramatic changes, our experience suggests that there continue to be many situations where business profits are still blindly bonused out to owner-managers, so as to pass up these significant deferral opportunities, perhaps because past practices are followed by rote[2] – go figure.[3]

The incentive to retain profits at the corporate level has been enhanced by the eligible dividend regime.[4] The intent of this regime is to reduce the element of double taxation ("under-integration") that would otherwise occur upon the distribution of corporate profits as dividends. In other words, the eligible dividend regime is designed to provide "integration" in respect of high-rate business income (i.e., income not subject to the small business deduction), so that the combined corporate and personal tax rate would be more or less equal to the rate that would apply if the income had been earned directly by an individual in the top tax bracket.

The exact degree of under-integration depends largely upon provincial tax rates applicable to eligible dividends. But in general it can be said that the eligible dividend regime is designed such that, at worst, the ultimate burden when profits are taxed in a corporation and paid to its shareholders as taxable dividends may be only modestly higher than the top personal tax rate that would have been paid by an individual had the income been earned directly.[5] The 2008 federal Budget increased the effective tax rate on eligible dividends as lower corporate tax rates are phased in; however, this increase was advisable only because the drop in corporate rates mentioned above would have otherwise eventually resulted in "over-integration" – that is, a combined corporate–personal tax rate on general business income distributed as dividends which would be lower than the top personal tax rate on bonuses.[6]

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So the bottom line is that, not only does the tax system encourage the retention of profits at the corporate level (i.e., as opposed to bonusing them out), the eligible dividend regime is designed to result in little or no downside[7] when profits are eventually distributed as dividends.[8]

Ontario Alone Again – But This Time in a Good Way . . .

Prior to changes proposed in the Ontario Budget, the tax rules in this province might have resulted in an exception to the retention strategy. That's because Ontario was alone in imposing an income-based "clawback" of its provincial small business deduction. In recent years, the clawback consisted of a surtax in excess of 4% which was applied against corporate income between $500,000 and $1.5 million, at which point the entire benefit of the Ontario small business deduction would be eliminated. The additional tax was high enough to result in a material degree of under-integration with respect to corporate profits distributed as dividends. Of course, this undermined the retention of profits at the corporate level where such profits were subject to the clawback, and encouraged bonusing-down to the small business limit in order to avoid the potential double-tax effect. Michael Goldberg's article "Ontario Alone"[9] encouraged the Ontario government to scrap the clawback because it was "an ill-advised fiscal policy that constitutes a penalty causing its greatest negative impact on modestly successful Ontario small businesses and is damaging to the province's growth prospects as a whole."

We don't know if anyone was listening, but happily, the 2009 Ontario Budget proposes to eliminate the clawback, effective starting on July 1, 2010, levelling the playing field for Ontario businesses. In fact, the Ontario Budget papers appear to indicate that Ontario corporate taxes would not even be subject to the federal clawback of the small business deduction – so Ontario is alone again, but this time in a good way. (Technical Note: outside of Ontario, the small business deduction is gradually phased out based on capital thresholds. In particular, the federal small business deduction is phased out for corporations having "taxable capital"[10] of between $10 and $15 million, after which it will be completely eliminated.[11] As a result, the clawback rules are generally applicable to relatively large and successful small business corporations.[12])

A Couple More Kudos to Our Red Friends

Since we have done our share of slagging the McGuinty government in the past, it seems only fair to give them credit where credit is due. In addition to scrapping the clawback, their 2009 Budget made a number of surprising and business-friendly moves. In particular, Ontario's general corporate tax rate will fall from 14% (applicable to

June 30, 2010) down to 10% by July 2013[13] – thus moving the federal–provincial corporate rate to the 25% "target rate" we mentioned earlier. Further reductions to the small business deduction rates from 5.5% to 4.5% will be helpful;[14] reductions to the corporate minimum tax ("CMT") rate from 4% to 2.7% and a corresponding increase in the CMT thresholds from $5 million in revenue to $50 million in revenue and from $10 million in assets to $100 million in assets are all positive steps.[15] (Note: we are leaving comments on HST to the HST mavens.)

At the Minden Gross tax department, we're no shrinking violets when it comes to pumping some numbers. Courtesy of Michael's calculations, let's run down some of the key results of the tax system, using Ontario and its 2009 budget proposals as an example:

	2009	Ontario Budget Proposals Fully Phased In (2014)
Deferral – top personal rate less general business rate	13.4%	21.4%
Over-integration (under-integration)[16]	(1.0%)	0.3%
Deferral – CCPC investment income rate less general business rate[17]	15.7%	19.7%
Deferral – top personal rate less small business rate	29.9%	30.9%
Top personal rate less rate on CCPC investment income distributed as:		
Ineligible dividends[18]	(0.7%)	2.4%
Eligible dividends[19]	6.0%	4.8%

These numbers are spectacular. For example, when the changes are phased in, the retention of profits at the corporate level – taxed at general business rates – will mean a 46% deferral.[20]

Joe – Meet Dalton (and Jim the Finance Guy)

Generally, in the last dozen or so years, federal and provincial governments of both parties have crafted a clever corporate tax system designed to encourage capital formation, particularly for small businesses.

Joe the Plumber would be very happy here – if he immigrated to Ontario, his company would pay tax at a small business corporate tax rate of a mere 15.5% (by 2014). Although he would face higher taxes if he withdrew the funds for personal and living expenses, he looks to us like he lives pretty modestly. Maybe President Obama should consider this tax system: he and Joe could be friends.

For readers who miss our kvetching about the McGuinty government, we offer this: it would have been nice if the abolition of the clawback had been pushed forward to this July – or better still, the beginning of January, so that Ontario business people could have reaped the benefits of tax deferral sooner – in these challenging economic times. But better late than never.

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Notes:

[1] As recently as 2001 the federal corporate rate alone was more than 28% and when combined with provincial rates, such as in Ontario, the combined rate was more than 42%.

[2] As is discussed further below, bonusing down in Ontario has continued to be a common practice due to the soon-to-be-scrapped Ontario small business deduction clawback.

[3] Of course, the retention of corporate surplus results in higher "death tax" exposure. As a result, the trend toward lower corporate tax rates means that undertaking an estate freeze will become increasingly important to the owner-manager and his or her family's succession planning.

[4] This was enacted early in 2007, applicable to dividends paid after 2005.

[5] In addition, if the corporation subsequently incurs tax losses, carry backs (within the normal three-year period) should be more tax effective, since corporate losses cannot shelter income bonused out to the owner–manager.

As noted previously, the eligible regime also encourages taxpayers to enter into estate freezes, since it encourages the retention of income at the corporate level (and therefore growth in corporate value), without significant tax penalties when such income is distributed as dividends. The ability to generate eligible dividends also facilitates tax-effective redemption of freeze shares to the freezor/surviving spouse, as well as post-mortem reorganizations after the deemed disposition on death occurs.

An estate freeze may affect the requirements in respect of eligible dividends themselves. Per subsection 89(14), the Act requires that a corporation that designates an eligible dividend must notify in writing each person to whom the eligible dividend is paid, at the time of payment. The CRA's current policy is that, where all of the shareholders are directors of the corporation, a notation in the corporation's minutes is sufficient. However, where growth shares are held by a family trust, this will no longer be the case. For non-public corporations, the CRA's policy in this regard is that contemporaneous notification of an eligible dividend may be made by letters to shareholders, or dividend cheque stubs.

Eligible dividends can also result in a dividend refund, i.e., if the payor corporation has refundable-dividend-tax-on-hand balances. However, as an eligible dividend must be a taxable dividend, a capital dividend cannot be an eligible dividend.

[6] Because the phased-in eligible dividend rate is premised on the lower corporate tax rates that are also being phased in, there may be a more significant degree of under-integration during the earlier years of the phase-in period if distributions are deferred – i.e., because the applicable corporate tax rates will be higher than those assumed in the setting of the phased-in eligible dividend rate. In Ontario, for example, by 2014, the combined personal corporate rate when profits for that year are distributed as eligible dividends will only be about 47.2% (a rate which is slightly lower than personal tax on a bonus, with EHT factored in). However, 2009 corporate profits will attract a combined personal/corporate tax rate of about 52.8% if distribution is deferred until 2012 or later, when the increases to the eligible dividend tax rate are phased-in.

[7] Depending on the province.

[8] Or if not distributed, subject to capital gains tax on death, ignoring the benefits of an estate freeze.

[9] "Dividend Taxation – Ontario Alone", TAX NOTES No. 532, March 2007.

[10] As that term is defined in Part I.3 of the Act.

[11] In general, the provincial clawback rules outside of Ontario follow the rules in the federal system.

[12] It appears that the last time the quantum of the limit was increased was in 1996. A good argument could be made that the quantum of the limit is due for another increase or, to keep up with Ontario (see below), due to be eliminated altogether.

[13] Provided that Alberta does not further reduce its corporate rates once these rate reductions are fully phased-in, the rate will be the same as corporations in Alberta pay. It is also worth noting that the M & P rates will fall from 12% to 10% by July 2010. Incidentally, the fact that these changes

come into effect on July 1 of the particular year, while federal rate reductions are on a calendar year basis may lead to some confusion and makes for more complex calculations.

[14] Although a positive step, the Ontario small business rate is far from the most competitive. Manitoba will completely eliminate its small business rate by December 1, 2010.

[15] A host of other targeted tax measures affecting corporations have been discussed in detail in budget summary papers and will not be repeated here.

[16] This factors in the effects of EHT.

[17] Of course, this differential will encourage structures where specified investment income status does not apply, notably by the retention of more than five full-time employees. For commentary on recent administrative developments in this respect pertaining to corporate partnerships, see "SIB Rules and Employees of Partnerships: Next Time Maybe An Announcement?", Michael Goldberg, TAX NOTES No. 546, July 2008.

[18] An interesting side effect of the phase-in of general federal and Ontario corporate rate reductions is that, in the absence of other tax rate changes, investing through holding companies will soon be slightly more tax efficient than earning such income directly. In particular, by July 2013, an Ontario investor earning investment income through a CCPC will only pay about 44.7% tax (about 44.1% if the income is distributed as an ineligible dividend) instead of about 46.4% if he or she had earned the same income directly.

[19] On the other hand, due to changes in the dividend tax credit rates applicable to federal and Ontario eligible dividends (and most other provinces as well), if funds are required from an investment holding company that also has a positive GRIP account, 2009 will be the most tax efficient year to pay out such funds as eligible dividends.

[20] I.e., 21.41% divided by 46.41%.

Resulting Trust Still Trumps Section 160

In *Warren v. The Queen*, 2009 DTC 1024, the Tax Court provided a useful review of the law regarding the way in which resulting and constructive trusts interact with section 160 of the Act, and correctly concluded that section 160 should not apply to the extent that a resulting trust can be demonstrated by the transferee. This case, with respect, missed several chances to clarify the law.

Resulting and constructive trusts were created by the courts of equity to avoid injustices of various kinds. Resulting trusts are based on the parties' express or implied intention that property registered in the name of one be held in whole or in part for another. Constructive trusts, on the other hand, may be imposed to prevent one party from being unjustly enriched at another's expense without any evidence of intent in that regard.

Warren is in most ways a typical section 160 case. Mrs. Warren, the appellant, was married to Dr. Warren, a chiropractor. In 1997, Dr. Warren owed the Crown income tax in the amount of $261,921. During that year, he transferred their matrimonial home to Mrs. Warren. She took the position that section 160 did not apply because of a resulting trust that arose from contributions she made toward that property's acquisition by Dr. Warren, as well as the consideration she gave him when he transferred it to her. The Crown's position was that the Tax Court did not have jurisdiction to determine whether Mrs. Warren had an equitable interest in the property, and that in any event, Mrs. Warren did not provide most of the consideration she claimed.

Mr. Justice Miller first addressed the jurisdictional issue. He noted that in *Darte v. The Queen*, 2008 DTC 2567 (TCC), the Tax Court held that constructive trusts must be declared by a court of equitable jurisdiction and that the Tax Court was not such a court. Mr. Justice Miller did not describe the conflicting jurisprudence on this point that *Darte* outlined, but indicated that the Court sidestepped the issue in *Darte* by finding that the right to obtain a declaration of an equitable interest is valuable and its surrender constitutes valid consideration for a transfer of property. Mr. Justice Miller then referred to *Livingston v. The Queen*, 2008 DTC 6233 (FCA). There, the Federal Court of Appeal considered the possibility that a resulting trust may override section 160, and did not mention any concern with regard to the Tax Court's jurisdiction in that regard. He also noted the decision of Chief Justice Bowman (as he then was) in *Savoie v. The Queen*, 93 DTC 552 (TCC), to which the Tax Court in *Darte* also referred. Mr. Justice Miller used *Savoie* for the proposition that constructive trusts may be considered in determining the fair market value of property transferred in circumstances to which section 160 applies. But he did not mention Bowman, C.J.'s express finding that in section 160 cases, the Tax Court must determine "true ownership" by taking both resulting and constructive trusts into account.

The only case to which Mr. Justice Miller referred that seemed to favour the Crown's position was *Burns v. The Queen*, 2006 DTC 3383 (TCC). He did not analyze it, perhaps because it did not refer to *Savoie* and because there are a variety of ways in which *Burns* can be distinguished from cases involving resulting or constructive trusts that are based on anything other than the matrimonial rights that arise on marital dissolution. For example, in *Burns*, the taxpayer came before the Court with little evidence of her contribution to the property in question, and with "dirty hands". It is not surprising that the Tax Court refused to provide relief rooted in equity.

Mr. Justice Miller concluded that the Tax Court has the jurisdiction to determine the existence of a resulting trust for purposes of identifying the property to which section 160 applies. Regrettably, he did not take the opportunity to clarify the law as to how section 160 and equitable property interests interact. As noted above, both resulting and constructive trusts are creatures of equity. Therefore, *Darte* and the other cases that require a declaration from a court of equity to bring equitable property interests into being apply as much to resulting as to constructive trusts. This makes Bowman, C.J.'s holding on this point in *Savoie* particularly important. It would have been helpful for Mr. Justice Miller to emphasize *Savoie* in this regard, and to lay out his reasoning in support of it and against the conflicting cases. This would help to prevent the Crown from taking positions that follow the less well-reasoned cases in this area, or question the fair market value of unproven equitable rights.

Mr. Justice Miller then considered the nature of Mrs. Warren's resulting trust and the consideration she gave Dr. Warren when the matrimonial home was transferred to her. To determine the amount contributed by each of Dr. and Mrs. Warren toward the property, the Tax Court traced funds from the sale of a prior matrimonial property they

owned as joint tenants and considered various other factors, including the extent to which Mrs. Warren may have contributed to mortgage payments. On the basis of sketchy evidence in that regard, he found that Mrs. Warren owned one-third of the matrimonial property by way of resulting trust.

The final issue for determination was the extent to which Mrs. Warren provided consideration to Dr. Warren for his two-thirds interest in the matrimonial property. The conveyance documents stated that the transaction was a "conveyance from husband to wife for natural love and affection". However, Mrs. Warren assumed a $90,000 mortgage in that regard, and minutes after the transfer of title, a mortgage in the amount of $168,000 was registered against the property. Dr. Warren guaranteed this, and he used the mortgage proceeds in a debt consolidation.

The Tax Court accepted without question the assumed mortgage as consideration. Mrs. Warren took the position that the second mortgage constituted additional consideration. The Crown argued that, technically speaking, that mortgage was registered after the transfer of title to Mrs. Warren, and so it could not be consideration for the transfer. It appears that the Crown also took the position that there was inadequate evidence of the use to which the mortgage proceeds were put to justify treating them as consideration. Mrs. Warren did not produce documentary evidence as to Dr. Warren's receipt or use of the funds.

Mr. Justice Miller, again, dealt with this issue pragmatically. He was satisfied that the second mortgage proceeds went to Dr. Warren. That mortgage transaction was prearranged relative to the transfer of title to Mrs. Warren, and was intended to finance Dr. Warren's debt consolidation. This was sufficient to find that the $168,000 second mortgage proceeds were consideration for the matrimonial property. This ruling is consistent with many other cases in which the Tax Court has found that the erroneous accounting records and incomplete legal documentation do not tell the transactional story, and so are not determinative for tax purposes. Instead, the reality of the transactions should be determined by the Court and tax consequences specified on that basis. That being said, better documentation with regard to the consideration issue and more evidence with regard to how the mortgage funds made their way to Dr. Warren would have simplified this case and perhaps avoided litigation.

Mr. Justice Miller concluded by expressing concern with regard to the value of the $168,000 mortgage for section 160 purposes. In particular, he wondered whether Mrs. Warren bore that mortgage's financial burden, and if not, whether it was appropriate to accept the mortgage at face value to offset what would otherwise be her liability under section 160. Since the Crown did not argue this point, he did not rule on it.

The rest of the decision is mathematical. Mr. Justice Miller calculated the value of two-thirds of the equity in the matrimonial home at $223,333. This is what Dr. Warren transferred to his wife. From that, he deducted the $90,000 assumed mortgage and the subsequent $168,000 mortgage. This resulted in a shortfall of $55,333 to which section 160 applied. Mrs. Warren apparently did not take the position that her labour in the home, raising children, etc. entitled her to a further interest in the matrimonial home by way of constructive trust. This claim appears to have been open to her and could have increased the value of her interest so as to completely avoid the application of section 160.

Warren does not break new ground, but is worth reading for a number of reasons. Among those are that it reiterates the Tax Court's jurisdiction to take resulting trusts into account for purposes of applying section 160, although unfortunately not making it clear that resulting and constructive trusts require the same treatment for section 160 purposes. By negative example, it also reminds taxpayers that the effect of section 160 can be minimized by making both resulting and constructive trust claims in the same case. And finally, *Warren* illustrates the importance of transactional reality, and how that can overcome technical deficiencies in written documentation. However, the fact that Mr. Justice Miller was called upon to render this decision, and could well have decided differently, also demonstrates how costly lack of attention to detail can be.

– Bob McCue, McCarthy Tétrault LLP

Recent Cases

Taxpayer was employee under Quebec law – Worked under employer's direction and control

The taxpayer was a medical specialist residing in Sherbrooke, Quebec. From 1995 to 1998, he worked under contract in Montreal as a medical assessor for an administrative tribunal established under the *Act respecting industrial accidents and occupational diseases* of Quebec. This tribunal was replaced in 1998 by la Commission des lésions professionelles ("CLP"). The taxpayer rented an apartment in Montreal for use as an office while continuing to reside in Sherbrooke. In his tax returns for 1995 to 1998, the taxpayer reported his income from his medical assessment work as professional income, from which he deducted both the rental and other expenses incurred with respect to his apartment in Montreal, as well as the expenses incurred in travelling back and forth between Montreal and Sherbrooke. In assessing the taxpayer for 1995 to 1998, the Quebec Revenue authorities disallowed all of the business expense deductions claimed, characterizing his relationship with CLP as one involving a contract of employment, and not a contract of enterprise or for services under article 2098 of the Quebec *Civil Code*. The taxpayer's appeals from these assessments to the Court of Quebec and to the Court of Appeal for Quebec were both dismissed. The Minister of National Revenue (the "Minister") also reassessed the taxpayer for 1995 to 1998, disallowing the business expense deductions claimed on the ground that the taxpayer's relationship with CLP was one of employment, rather than of independent contractor. In dismissing the

taxpayer's appeal, Archambault, J. of the Tax Court of Canada determined, in part, that under Quebec law, the taxpayer's relationship with CLP involved a contract of employment in which he was working under CLP's direction and control, and the taxpayer's travelling expenses between Sherbrooke and Montreal were non-deductible personal expenses (2008 DTC 4640). The taxpayer appealed to the Federal Court of Appeal.

The taxpayer's appeal was dismissed. Archambault, J. was correct in basing his findings on the provisions of the Quebec *Civil Code* relating to contracts of employment and of enterprise. Quebec law defines the elements required for the existence of a contract of employment or of enterprise, whereas the common law enumerates a number of factors or criteria which, if present, determine the existence of an employment relationship or a relationship involving an independent contractor. Article 2099 of the Quebec *Civil Code* specifically provides that, in a contract of enterprise, no relationship of subordination can exist between the contractor and the client in respect of which the services are being provided. The common law criteria governing an employment or independent contractor relationship, however, are not entirely irrelevant in carrying out an analysis, under Quebec law, of the existence of a contract of employment or a contract of enterprise. The notion of control is only one of the criteria to be examined in a common law analysis of the employment relationship, whereas, under Quebec law, control is an essential characteristic in a contract of employment. In reaching his conclusions as to the taxpayer's work relationship with CLP, Archambault, J. correctly applied Quebec law, analyzed the relevant Federal Court of Appeal Quebec-related jurisprudence as well as the common law criteria, and recognized that in this context, Quebec law complements the common law, as required by s. 8.1 of the *Interpretation Act*. There was, therefore, no reason to interfere with Archambault, J.'s conclusions. The Minister's reassessments were affirmed accordingly.

Grimard, 2009 DTC 5056

Judge justified in applying American accounting principles respecting partnerships' SR&ED expenses and promissory notes

The taxpayers acquired interests in two Canadian medical research partnerships, ARMC and ARMC 2 (the "Partnerships"), financed in part through interest-bearing promissory notes in Brazilian currency. The Partnerships carried out scientific research and experimental development ("SR&ED") through a research corporation, Coral, and paid Coral, in part, with promissory notes in Brazilian currency. Due to a devaluation of the Brazilian currency accompanied by rampant inflation in Brazil, the Partnerships sustained significant unhedged losses on payments made on their Brazilian currency promissory notes. In assessing the taxpayers for 1985 and 1986, the Minister disallowed the deduction of their share of the Partnerships' SR&ED expenses and the Partnerships' promissory note-related losses for those years. In dismissing the taxpayers' appeals, Angers, J. of the Tax Court of Canada concluded, in part, that the Partnerships were not engaged in SR&ED through Coral, and that the promissory notes in dispute were not issued for valid commercial purposes, but merely to generate expenses that artificially reduced the taxpayers' incomes contrary to s. 245(1) of the Act as it read for the tax years under appeal (2008 DTC 2647). In reaching his conclusions, Angers, J. determined that the CICA Handbook was mute as to the Canadian Generally Accepted Accounting Principles ("GAAP") to apply to the Partnerships' financial statements in evaluating their SR&ED expenses and their promissory notes. As a result, he approved the application of American accounting principles to justify significantly discounting the Partnerships' SR&ED expenses and promissory notes, in order to take into account the rampant rate of inflation in Brazil during the years under appeal. On their appeals to the Federal Court of Appeal, the taxpayers argued, in part, that Angers, J. erred in resorting to American accounting principles, since the CICA Handbook allegedly contained comparable Canadian GAAP principles that should have been applied.

The taxpayers' appeals were allowed in part. Anger, J.'s conclusion that the CICA Handbook was mute as to the applicable Canadian GAAP in this situation was supported by the expert opinions of very reputable accounting firms, and should not, therefore, be disturbed. Angers, J., therefore, was justified in resorting to American accounting principles to justify discounting the Partnerships' SR&ED expenses and promissory notes. This finding was sufficient to dispose of the taxpayers' appeals. However, the Minister had made certain concessions before Angers, J. that were not taken into account in his judgment. The Minister was therefore ordered to reassess in order to give effect to these concessions which recognized the deductibility of some of the Partnerships' SR&ED expenses.

Romar et al., 2009 DTC 5057

Settlement payment correctly added to corporate taxpayer's income – Compensation for expenses on capital account

A third party agreed to purchase vacant land from the corporate taxpayer, subject to obtaining favourable rezoning. The Ontario Municipal Board (the "OMB") dismissed an appeal by the taxpayer and the third party, and found them both jointly and severally liable for costs of \$1.35 million. On the taxpayer's further appeal, the OMB reduced the cost award against the taxpayer to \$135,000. In 1996, the taxpayer instituted proceedings for negligence against the law firm that had erroneously purported to represent it at the initial proceeding before the OMB. In 1999, this action was settled and the taxpayer received \$400,000 (the "Settlement Payment"), which it characterized not as income, but as a non-taxable capital receipt. On reassessment, the Minister included the Settlement Payment in the taxpayer's income for 1999 as income from business under s. 9(1) of the Act. In dismissing the taxpayer's appeal, C. Miller, J. of the Tax Court of Canada concluded that: (a) the Settlement Payment was intended

to compensate the taxpayer for expenditures incurred by it on capital account (i.e., the OMB cost award of $1.35 million and the expenses incurred in having that award reduced); (b) this cost award and the expenses of having it reduced, however, were deductible under s. 20(1)(*cc*) of the Act; and (c) because the Settlement Amount was intended to compensate the taxpayer for deductible expenditures, it had to be included in its income (2008 DTC 4102). The taxpayer appealed to the Federal Court of Appeal.

The taxpayer's appeal was dismissed. The tax consequences of a damage award depend on the tax treatment of the amount for which the award is intended as compensation. The cases cited by the taxpayer were distinguishable, since they did not deal with compensation for a capital expenditure, which, nevertheless, was deductible for tax purposes. The Minister's reassessment was affirmed accordingly.

Goff Construction Limited, 2009 DTC 5061

"Transfer" of funds between spouses beyond usual household expenditures

At a time when he owed tax in excess of $485,000, the taxpayer's spouse, Y, released his interest in two joint bank accounts to her on December 23, 2002. Effective that date, and throughout 2003, Y also deposited his paycheques (totalling $54,406.20) into a bank account owned by the taxpayer. On September 12, 2004, the Minister reassessed the taxpayer under the joint liability provisions of s. 160(1) of the Act because of Y's tax owing when he released his interest in the two accounts and deposited his paycheques in the taxpayer's account. In dismissing the taxpayer's appeal, McArthur, J. of the Tax Court of Canada concluded that there had clearly been "transfers" of funds from Y to the taxpayer and, because these transfers went beyond the usual expenditures permitted in satisfaction of Y's legal obligation to support his family, the taxpayer was liable under s. 160(1) as assessed (2007 DTC 1446). The taxpayer appealed to the Federal Court of Appeal.

The taxpayer's appeal was dismissed. McArthur, J. was correct in finding that there were "transfers" of funds by Y to the taxpayer within the meaning of s. 160(1) of the Act. However, he made a palpable and overriding error in concluding that any "vital household expenses" paid by Y could escape the purview of s. 160(1), since the rule in s. 160(1) admits of no exception apart from the one provided in s. 160(4). Therefore, there clearly was a "transfer" and no fair market value consideration for that transfer was given, regardless of whether any part of Y's transfers were effected to discharge an obligation to meet household expenses. The Minister's reassessments were affirmed accordingly.

Yates, 2009 DTC 5062

Taxpayer bound to make spousal support payments under agreement

After separating in September 2001, the taxpayer and his former common-law spouse, F, executed an Interim Agreement on November 21, 2001 (the "Agreement"). Clause 6 of the Agreement required the taxpayer to pay F $2,000 per month "for her support". Clause 7 of the Agreement said that the Agreement should not be "construed as any indication that the appellant is able or liable to pay spousal support in the amount set out herein, or at all". In reassessing the taxpayer for 2001 to 2004, the Minister disallowed the deduction of the payments made to F under the Agreement between December 2001 and December 2004. In dismissing the taxpayer's appeal, Little, J. of the T.C.C. agreed with the Minister's allegation that, because of clause 7 of the Agreement, the taxpayer was not under any binding legal obligation to make the support payments in dispute (2007 DTC 1544). The taxpayer appealed to the Federal Court of Appeal.

The taxpayer's appeal was allowed. Little, J. was wrong to rely on the opinion of the taxpayer's lawyer as to whether the Agreement was enforceable or binding on the taxpayer, since this was a question of law for Little, J. himself to determine. Little, J.'s interpretation of clause 7 of the Agreement was flawed. Considering the Agreement as a whole, clause 7 was only intended to prevent F from relying, in spousal support proceedings, on the fact that the taxpayer had agreed, allegedly because of his financial capacity, to pay F $2,000 per month until the happening of certain other events mentioned elsewhere in the Agreement. Clause 7, therefore, did not support Little, J.'s view that the taxpayer was not bound under the Agreement to pay F $2,000 per month. He was specifically required to do exactly that under clause 6 of the Agreement. Also, the Minister's alternative argument that F did not have discretion as to the use of the $2,000 monthly payments was not supported by the provisions of the Agreement. Little, J.'s judgment was therefore set aside and the Minister was ordered to reassess on the basis that the taxpayer was entitled to the deductions claimed.

Syrek, 2009 DTC 5063

Allowances for employment at special work site or remote location not taxable

During 2002 and 2003, the taxpayer was employed by a contractor, Yukon, to work on a contract project as a Concrete Forming Foreman. Yukon paid the taxpayer various allowances totalling $72,000 for 2002 and $77,154 for 2003. The taxpayer did not report these allowances as income, on the assumption that they represented non-taxable reimbursements for costs he incurred for the benefit of Yukon. The Minister included the $72,000 and $77,154 in the taxpayer's income for 2002 and 2003, respectively, and imposed penalties for gross negligence. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was allowed in part. An annual travel allowance for trade shows of $7,800 paid to the tax-

payer during 2002 and 2003 by Yukon was required to be included in his income for those years (with the exception of one $1,755 amount), since most of the trips taken by the taxpayer using this allowance were for pleasure rather than for business purposes. An annual board and lodging allowance of $39,000 paid by Yukon during 2002 and 2003 to the taxpayer fell within the remote location provisions of s. 6(6)(*a*) of the Act, and thus was not required to be included in his income for those years. An annual transportation allowance of $13,000 paid by Yukon to the taxpayer during 2002 and 2003 fell within the special work site rules in s. 6(6)(*b*) of the Act, and thus was not required to be included in his income for those years. The balance of the travel allowances paid by Yukon to the taxpayer ($12,200 for 2002 and $17,354 for 2003) did not constitute reasonable allowances for negotiating contracts under s. 6(1)(*b*)(v) of the Act and, hence, were not exempt from inclusion in his income for tax purposes. In light of the foregoing findings, the $72,000 and $77,154 included in the taxpayer's incomes for 2002 and 2003 should be reduced to $18,245 for 2002 and $25,154 for 2003. The penalties were deleted, since the income inclusions assessed by the Minister were reduced by some 70%. The Minister was ordered to reassess accordingly.

Agostini, 2009 DTC 1088

Move to start new work at same location was "eligible relocation"

In 2006, the taxpayer moved from her residence in Woodville, Ontario to Whitby, Ontario, which brought her more than 40 kilometres closer to her place of employment at a hospital in Oshawa, Ontario (the "Hospital"). In reassessing the taxpayer for 2006, the Minister denied the deduction of $18,823.44 in moving expenses claimed in respect of her move. The Minister's position was that the taxpayer's move was not to enable her to work at the Hospital, because she was already working there, albeit part-time. On her appeal to the Tax Court of Canada, the taxpayer's argument was that, after her move, she became employed at the Hospital full-time, which made her move an "eligible relocation" within the meaning of s. 248(1) of the Act.

The taxpayer's appeal was allowed. The taxpayer's move was work related. It involved an "eligible relocation", because the taxpayer's new job involved new full-time work under new circumstances on a different floor in the Hospital. The words "new work location" in the definition of "eligible relocation" should be read to mean "new work", and not necessarily "new location". The taxpayer was therefore entitled to the moving expense deduction claimed.

Gelinas, 2009 DTC 1091

Corporation and sole shareholder reassessed on unreported income

The individual taxpayer, W, was the sole shareholder and director of the corporate taxpayer, Vialink. Vialink carried on the business of telemarketing chat lines. Using the net worth method, the Minister added unreported amounts of $56,040.27, $82,373.56, and $239,309.97 to W's income for his 2000, 2001, and 2002 taxation years, respectively, and imposed penalties for gross negligence. In reassessing Vialink using a bank deposit analysis, the Minister added unreported business income of $187,192.00 and $7,768.00 to its 2001 and 2002 taxation years, respectively, and also imposed penalties for gross negligence. On their appeals to the Tax Court of Canada, the taxpayers argued that the large sums of money flowing through Vialink's bank account during the years in issue represented gifts and loans to W from family and friends, together with amounts forwarded from an acquaintance in England for potential investment in a restaurant/bar business in Canada.

The taxpayers' appeals were allowed in part. Careless record keeping, exacerbated by implausible testimony lacking credibility, along with a lack of adequate documentation, all led to the conclusion that the taxpayers were unable to meet the onus of disproving the accuracy of the Minister's reassessments. The Minister did, however, make some concessions respecting deductible expenses and shareholder appropriation adjustments. The Minister was therefore ordered to reassess in order to give effect to these concessions, and to adjust the penalties accordingly.

Vialink Inc. et al., 2009 DTC 1093

Notice: *Readers are urged to consult their professional advisors prior to acting on the basis of material in this newsletter.*

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