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Restrictive Covenants: Last of the Unholy Trinity

This article is being written two years after an article I wrote called "Kill Bill: Is C-10 on the Ropes?", a rant about the unholy triumvirate of (former) Bill C-10 proposals: the foreign investment entity (FIE), non-resident trust, and restrictive covenant rules. In keeping with the unholiness, Bill C-10, which died in September 2008, sprung back to life last month in the form of the *Income Tax Amendments Act*, 2010 – an altered state that omitted the FIE and non-resident trust proposals.

As most readers are aware, courtesy of the federal Budget, the FIE rules are now history, replaced by the pre-existing section 94.1 – mercifully brief and relatively simple rules which hearken back to a bygone era. The non-resident trust rules, also dealt with in the Budget, are still a work-in-process with yet another round of proposed legislation in the wings. A number of modifications may remedy some of the shortcomings. But the price will be even more complexity.

This brings me to the last of the Trinity, not dealt with in the Budget, but which does appear in the new legislation – the restrictive covenant proposals. These proposals have been in a more or less constant state of revision since they were first introduced in 2003. When the new legislation arrived on my desktop, I can't say I was surprised to see that the proposals survived – the government had pretty well told us they were coming. Too bad, though: unlike the somewhat esoteric non-resident trust proposals, the super-complex restrictive covenant proposals can potentially apply in any sale of a business.

Inside

Fully Taxable Treatment – The Base Line

Because of the many articles and papers on this subject, I do not intend to go into detail on the restrictive covenant proposals.[1] But to refresh your memory, the cornerstone of the proposals is subsection 56.4(2) – the rule that, by default, all amounts received or receivable in respect of a restrictive covenant are fully taxable. Since this is obviously an undesirable result, one would first look to the limited exceptions to this result in subsection 56.4(3) that may (but more often than not, don't) apply if an amount is allocated to a restrictive covenant: besides an exemption for covenants given by employees,[2] there is an asset sale exception (in respect of eligible capital), which in its simplicity assumes that the person granting the restrictive covenant (typically the shareholder) is carrying on the business (of course, this is typically the shareholder's corporation).[3] There is also a share[4] sale exception[5] for non-competition covenants[6] which precludes complex corporate structures (e.g., a Holdco with separate subs to limit liability) and imposes various other requirements.[7]

If the exceptions to subsection 56.4(2) do not apply, the main issue becomes the related proposal that allows the CRA to reallocate proceeds on a sale to restrictive covenants under proposed section 68, to the extent that the reallocated amount is "reasonable". The focus then shifts to some "relieving provisions" in respect of the section 68 reallocation which, if applicable, nullify this ability. Until the latest revisions to the proposals, apart from provisions directed toward covenants given by employees,[8] the section 68 relieving provisions for sales of businesses have related to non-competition covenants given in respect of the disposition of goodwill[9] (directly or by an eligible corporation[10]), and the disposition of other property, including shares.[11] Needless to say, these relieving provisions are fairly stringent, complex (maybe "hodgepodge" is a better description) and in many cases, will not be applicable,[12] leaving the vendor – shall we say – a sitting duck.[13]

So What's New?

The latest revisions add a new section 68 relieving provision, pertaining to succession planning. As explained in our book, *Tax and Family Business Succession Planning*, the pre-existing relieving provisions apply only to a disposition to an arm's-length person, so that in the succession planning context, these exceptions will generally not be applicable.[14] Therefore, the presence of a restrictive covenant in a family business succession planning agreement, e.g., to be given in connection with a buy-out of a family member's interest, appeared to be problematic, since the CRA would be able to: (a) reallocate proceeds to a restrictive covenant; and (b) impose full taxation on the reallocated amount.

Proposed subsection 56.4(8.1) potentially prevents a section 68 reallocation if a non-competition covenant is granted by a Canadian resident individual (the "vendor") to an "eligible person" – an individual related to the vendor who is 18 or older – in connection with a share sale of an eligible corporation (referred to as the "target corporation"), provided that no proceeds are received for granting the non-compete and several other requirements are met.[15] However, there seems to be at least one issue with the legislation: one of the requirements is that, if the shares of the target corporation are sold to a purchaser corporation, the vendor cannot (at any time after granting the non-compete) have an "interest" in either the target or purchaser corporation.[16] This appears to be problematic, for example, if there is a staged sale, or if, as a result of the transaction or otherwise, the corporation in question is indebted to the vendor.

Another section 68 relieving provision that has been widened relates to non-competition covenants when there has been a sale of goodwill by an eligible corporation.[17] The former requirement – a good example of the perversity of the proposals – was that a family member or other person not at arm's length with the vendor could not hold 10% or more of the shares of such a corporation. (To me, it's almost as if to say, if you split dividends or capital gains, the non-applicability of this relieving provision is your punishment.) This restriction has been dropped.

Where a non-resident gives a restrictive covenant, there is potentially non-resident withholding tax,[18] and in this context as well, it appears that section 68 could apply to reallocate a portion of the proceeds to the restrictive

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covenant. In view of the restrictions to taxable Canadian property in this year's federal Budget – so that non-real-estate-based share sales are generally no longer taxable in Canada – would the CRA attempt to collect tax by reallocating in this manner? Of course, the same temptation might have been present in respect of a treaty-protected sale under the pre-existing regime.[19] However, under the new regime, some structures could involve the holding of Canadian companies by non-resident entities in low-tax jurisdictions. If the CRA is offended by such a structure, will this be a way of collecting taxes through the "back door"? If so, should the purchaser be concerned that the CRA could try to collect tax for failure to withhold?[20] What about directors' liability?

What's the Point of This – uh – Stuff?

At the centre of the proposals is the rule that, by default, fully taxable treatment applies to non-competition or other restrictive covenants. Undoubtedly, this greatly complicates the provisions. So taking a giant step backwards, I ask a very basic question: Given that most of the instances in which the restrictive covenant proposals will apply pertain to a non-compete or other covenants given in connection with the sale of a business – which is essentially a capital transaction – what policy rationale is there for treating a restrictive covenant as fully taxable, rather than capital treatment applying?

I can't help wondering whether the answer may be to punish taxpayers. Punish them for their evil ways in treating non-competition covenants as tax-free, which led to all of this – uh – stuff. Or is it to punish tax advisers – to be saddled with all but incomprehensible legislation? But if that is your agenda, Sirs, it is not working. I point out that, since our corporate lawyers must dutifully seek our advice before putting a deal through, our future as tax drones is assured. So how about if we just treat restrictive covenants as capital – and call it a day?

– David Louis, tax partner, Minden Gross LLP, a member of MERITAS law firms worldwide. David's practice focuses on tax and estate planning for entrepreneurs and their corporations. dlouis@mindengross.com.

Notes:

1 For a concise discussion, see "Restrictive Covenants", Mark Woltersdorf, TAX TOPICS NO. 1875, February 14, 2008.

2 Proposed paragraph 56.4(3)(*a*).

3 Proposed paragraph 56.4(3)(*b*).

4 Or partnership interest.

5 Proposed paragraph 56.4(3)(*c*).

6 Of course, a non-competition covenant is only one type of restrictive covenant. Other restrictive covenants may include exclusivity, non-solicitation, and confidentiality agreements, for example.

7 For example, dispositions involving section 85 and subsection 97(2) rollovers, or deemed dividends on a redemption, etc., under subsection 84(3) are problematic.

8 Proposed subsection 56.4(6).

9 Proposed subsection 56.4(7).

10 Under the revised proposals, an "eligible corporation" is simply a taxable Canadian corporation of which the taxpayer holds shares directly or indirectly.

11 Proposed subsection 56.4(8). Unlike paragraphs 56.4(3)(*b*) and (*c*) and subsection 56.4(7), for subsection 56.4(8) to be applicable, an election is not required to be filed.

12 For example, all of the section 68 relieving provisions relate to non-competition as opposed to other types of restrictive covenants. Dispositions involving section 85 and subsection 97(2) rollovers, or (in the case of subsection 56.4(8)) deemed dividends on a redemption, etc., under subsection 84(3) are problematic. Finally, no proceeds may be allocated to the covenant.

13 Although the relieving rules in subsection 56.4(7) and (8) (in the case of a share sale) require that no portion of the proceeds in respect of restrictive covenant be received or receivable by a non-arm's length individual or by another taxpayer in which the non-arm's length individual holds an interest, where those relieving provisions are not applicable solely because this requirement is not met, then subsection 56.4(9) allows for a joint election (in the manner provided by subsection 56.4(14)), so that the part or all of such "allocable portion" of the consideration for the restrictive covenant can be treated as a goodwill amount/proceeds of disposition in the hands of the person granting the restrictive covenant. Where the election is made but the proceeds are actually received or receivable by a corporation, partnership or trust, it is deemed to be an agent of the taxpayer granting the restrictive covenant to the extent that the amount designated in the election is transferred to the taxpayer within 180 days from the date of receipt.

14 See "Restrictive Covenants", at ¶1107 of the book.

15 For example, dispositions involving section 85 and subsection 97(2) rollovers, or deemed dividends on a redemption, etc. under subsection 84(3) are problematic. In determining the proceeds of disposition of the shares under section 69, the shares are to be valued on the basis that the restrictive covenant is part of the share – i.e., the proceeds cannot be discounted based on the value of the restrictive covenant.

Similar requirement/elections as described in note 13 apply to any portion of the proceeds in respect of the restrictive covenant received or receivable by a non-arm's length individual or taxpayer in which the non-arm's length individual holds an interest. To the extent that the allocable portion is received or receivable by an eligible corporation of the vendor (i.e., a taxable Canadian corporation in which the vendor is a direct or indirect shareholder), an election may be filed in which the eligible corporation is deemed to be an agent for the vendor for the amount designated. In this case, however, the tax consequences of this election are more severe: it is required not only that the amount be transferred within 180 days of receipt, but that it is included in the vendor's income under subsection 56.4(2) – i.e., as fully taxable income. Is the advantage of this election *vis-à-vis* a section 68/subsection 56.4(2) reassessment that it avoids the tax cost of a distribution?

16 Proposed paragraph 56.4(8.1)(*c*).

17 I.e., under subsection 56.4(7).

18 Per proposed paragraph 212(1)(*i*). It is intended that withholding tax apply to payments from one non-resident to another in respect of Canadian restrictive covenants, per proposed 212(13)(*g*). (The provision deems the non-resident payor to be a resident of Canada in respect of an amount to which paragraph 212(1)(*i*) would apply (if the amount were paid or credited by a resident of Canada), and that amount affects or is intended to affect: (i) the acquisition or provision of property or services in Canada, (ii) the acquisition or provision of property or services outside Canada by a person resident in Canada, or (iii) the acquisition or provision outside Canada of a taxable Canadian property.) It appears that the proposal has been revised to overcome certain technical arguments to the effect that it is ineffective.

[19] However, depending on the wording of the particular treaty, it might be argued that an amount relating to a restrictive covenant is treaty-protected.

[20] Proposed paragraph 68(*c*) provides that "the part of the amount that can reasonably be regarded as being consideration for the restrictive covenant is deemed to be an amount received or receivable by the taxpayer . . .". Proposed paragraph 212(1)(*i*) provides for Part XIII tax on "an amount that would, if the non-resident person had been resident in Canada throughout the taxation year in which the amount was received or receivable, be required by . . . subsection 56.4(2) to be included in computing the non-resident person' s income for the taxation year".

It appears that relieving provisions, notably subsection 56.4(8) if applicable, may prevent an income inclusion under subsection 56.4(2) and consequently the application of paragraph 212(1)(*i*). Query, however, whether this would give a great deal of comfort to a purchaser. Perhaps an indemnity might be obtained.

The CRA Introduces Simplified Logbook for Motor Vehicle Expenses

In the 2008 federal Budget, the government announced that as a result of some lobbying by the Canadian Federation of Independent Business, it would consider a method to simplify the record keeping for purposes of motor vehicle expense claims. The proposal was to allow taxpayers to maintain a logbook for a sample period of time that is representative of the usage of the motor vehicle, in order to support motor vehicle expense deductions and taxable benefit calculations. Consultations were undertaken and on June 28, 2010, the Minister of National Revenue announced the introduction of such a logbook. The News Release and the explanation of the required documentation is reproduced below.

> The Honourable Keith Ashfield, Minister of National Revenue, Minister of the Atlantic Canada opportunities Agency and Minister for the Atlantic Gateway, is pleased to announce the introduction of a new simplified logbook for motor vehicle expense provisions as part of the government's overall strategy to assist small and medium sized businesses and Canada Revenue Agency's (CRA's) aim to ease the tax compliance burden of small business owners.
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> * * *
>
> In the 2008 Federal Budget, the Government of Canada, through recommendations by the CFIB, identified the requirement to keep a logbook as the most burdensome aspect of the motor vehicle tax provisions for its members. In response, the Canada Revenue Agency developed an alternative system for recording business travel with the aim to assist businesses in substantiating the business use of a motor vehicle that was used for business and personal reasons.
>
> * * *
>
> Businesses can choose to maintain a full logbook for one complete year to establish the business use of a vehicle in a base year. After one complete year of keeping a logbook (starting in 2009 or thereafter) to establish a base year, a three month sample logbook can be used to extrapolate business use for the entire year, providing the usage is within the same range (within 10%) of the results of the base year. Businesses will need to demonstrate that the use of the vehicle in the base year remains representative of its normal use. Thus, for both income tax and GST/HST purposes, the motor vehicle record keeping burden is being reduced.

Documenting the use of a vehicle

This document explains the ways in which a person who uses a vehicle in a business can keep track of business travel.

When a vehicle is used partially for business purposes and partially for other purposes, the expenses relating to its use must be apportioned. Only those expenses relating to the business travel or commercial activity are considered eligible for a business deduction and for input tax credits on GST/HST. The proration in such cases is done based on the distances driven. To support a deduction or claim, the person must know and be able to demonstrate the distance travelled for business purposes and commercial activities.

The *Income Tax Act* and the *Excise Tax Act* do not set out specific documentary requirements for recording the usage of a vehicle. The general rule is that the person must retain records that would enable an objective determination of the person's tax payable.

Full logbook

The best evidence to support the use of a vehicle is an accurate logbook of business travel maintained for the entire year, showing for each business trip, the destination, the reason for the trip and the distance covered.

Alternative records

The fact that a viable business exists is usually a strong indicator that a person incurred vehicle expenses, because it is extremely difficult to carry on a business without doing at least some driving. Claims for a very low amount of business use do not require extensive records to demonstrate business travel. As the percentage of business use and the related expense claims increase, more documentation, as discussed below, is expected to be available.

For many persons, the books and records they already retain as part of their normal business operations may be indicative of the presence of and the extent of business driving. An appointment diary indicating what addresses were visited and why, or a log of service calls might be sufficient. Purchase or sales invoices may indicate that items were picked up or delivered by the taxpayer. Examples of other evidence that may be taken into consideration may include:

- whether the person has another vehicle for personal travel,
- the type of vehicle,
- the nature of the business and the business travel likely required,
- who else drives the vehicle (e.g., family),
- how the vehicle is insured, and
- indications of other personal travel.

CRA auditors will generally consider the usage of a vehicle in the context of the entire operation of that particular business. A proposal to disallow a portion of a claim for vehicle expenses would only occur where the claimed travel seems out of proportion in that overall context and is not supported by sufficient evidence as described here. However, it should be noted that individuals will be responsible for providing sufficient evidence to demonstrate the accuracy of their claims for business distances driven throughout the year.

Logbook for a sample period

The CRA would be prepared to afford considerable weight to a logbook maintained for a sample period as evidence of a full year's usage of a vehicle if it meets the following criteria.

- The taxpayer has previously filled out and retained a logbook covering a full 12-month period that was typical for the business (the "base year"). The 12-month period is not required to be a calendar year.
- A logbook for a sample period of at least one continuous three-month period in each subsequent year has been maintained (the "sample year period").
- The distances travelled and the business use of the vehicle during the three-month sample period is within 10 percentage points of the corresponding figures for the same three-month period in the base year (the "base year period").
- The calculated annual business use of the vehicle in a subsequent year does not go up or down by more than 10 percentage points in comparison to the base year.

The business use of the vehicle in the subsequent year will be calculated by multiplying the business use as determined in the base year by the ratio of the sample period and base year period. The formula for this calculation is as follows:

(Sample year period % ÷ Base year period %) × Base year annual % = Calculated annual business use

Where the calculated annual business use in a later year goes up or down by more than 10%, the base year is not an appropriate indicator of annual usage in that later year. In such a case, the sample period logbook would only be reliable for the three-month period it had been maintained. For the remainder of the year, the business use of the vehicle would need to be determined based on an actual record of travel or alternative records, as discussed above. In these circumstances, the taxpayer should consider establishing a new base year by maintaining a logbook for a new 12-month period.

Example:

An individual has completed a logbook for a full 12-month period, which showed a business use percentage in each quarter of 52/46/39/67 and an annual business use of the vehicle as 49%. In a subsequent year, a logbook was maintained for a three-month sample period during April, May and June, which showed the business use as 51%. In the base year, the percentage of business use of the vehicle for the months April, May and June was 46%. The business use of the vehicle would be calculated as follows:

$(51\% \div 46\%) \times 49\% = 54\%$

In this case, the CRA would accept, in the absence of contradictory evidence, the calculated annual business use of the vehicle for the subsequent year as 54%. (I.e., the calculated annual business use is within 10% of the annual business use in the base year – it is not lower than 39% or higher than 59%.)

Even though records and supporting documents are only required to be kept for a period of six years from the end of the tax year to which they relate, the logbook for the full 12-month period must be kept for a period of six years from the end of the tax year for which it is last used to establish business use.

Year of acquisition of a vehicle

The business use of a vehicle in the year it is bought or leased can also have implications as to how the vehicle is defined and limitations on amounts that can be claimed for certain expenses. Individuals should take extra care to document its use in that year. Further information is provided on the CRA's website at http://www.cra-arc.gc.ca/tx/bsnss/tpcs/slprtnr/bsnssxpnss/mtr/typ-eng.html.

Prescribed Interest Rates – Third Quarter of 2010

The prescribed interest rates for the third quarter of 2010 were released on June 28, 2010. As proposed in the 2010 federal Budget, effective July 1, 2010, the interest rate on overpayments of tax by corporations is set at the average yield of three-month government treasury bills, rounded up to the nearest percentage point instead of that rate plus 2% as it has been for corporations and continues to be for non-corporate taxpayers. This change is reflected in an amendment to section 4301 of the Income Tax Regulations contained in Bill C-9, *Jobs and Economic Growth Act*.

- 1% to calculate a deemed interest taxable benefit on subsidized employee and shareholder loans;
- 1% on refunds of income tax overpayments paid to corporate taxpayers;
- 3% on refunds of income tax overpayments paid to non-corporate taxpayers; and
- 5% 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 July 1, 2010 to September 30, 2010.

Bill C-9, *Jobs and Economic Growth Act* Receives Royal Assent

Bill C-9, *Jobs and Economic Growth Act* received Royal Assent on July 12, 2010 and is now law as S.C. 2010, c. 12. This Bill (CCH SPECIAL REPORT 050H) contains some of the income tax measures from the 2010 federal Budget, including: amendments to the definition of "taxable Canadian property"; a change to the interest rate for tax refunds paid to corporations for tax overpayments; amendments regarding payments made to RESPs or RDSPs through provincial programs; disallowance of the medical expense tax credit for costs relating to cosmetic procedures; and extension of the mineral exploration tax credit for qualifying expenses incurred before 2012. The Senate has now adjourned for the summer and returns September 28, 2010. The House of Commons, which adjourned on June 17, 2010, is scheduled to return on September 20.

Draft Income Tax Legislation Released – Revised Technical Amendments

On July 16, 2010, the Department of Finance released draft legislation and explanatory notes to implement many of the technical and bijuralism amendments that were in Parts 2 and 3 of former Bill C-10, which ceased to exist when Parliament was dissolved on September 7, 2008. In the 2010 Budget document, the government had stated that it intended to proceed with the technical and bijuralism amendments. As described in News Release No. 2010-068, reproduced below, this revised package does not contain provisions relating to foreign investment entities or non-resident trusts, which were contained in Part 1 of former Bill C-10. The 2010 federal Budget indicated that the government will not be proceeding with the rules relating to foreign investment entities that had been proposed in former Bill C-10. CCH has prepared SPECIAL REPORT 052H, which contains the draft legislation and explanatory notes. This SPECIAL REPORT may be ordered by calling (416) 224-2248 (toll-free 1-800-268-4522), by faxing (416) 224-2243 (toll-free 1- 800-461-4131) or by e-mailing cservice@cch.ca.

> The Department of Finance today released draft legislative proposals to implement outstanding income tax technical measures.
>
> The proposals released today include measures previously included in technical tax legislation introduced in the 39th Parliament that will implement:
>
> - a large number of technical amendments that provide tax relief;
> - other technical amendments that are important to the integrity of the tax system; and
> - amendments to ensure that both the common law and civil law are properly referred to and reflected in the *Income Tax Act*.
>
> Draft legislative proposals released today include:
>
> - modifications to the provisions relating to restrictive covenants;
> - modifications to the provisions in section 143.3 of the *Income Tax Act* relating to non-monetary consideration;
> - updated amendments to reflect previously announced reductions in the general corporate income tax rate;
> - modifications to the provisions concerning the rate to be applied to investment income earned by cooperatives and credit unions; and
> - draft amendments to the *Income Tax Regulations*.

The draft legislative proposals do not include two aspects that had been part of technical tax legislation in the 39th Parliament:

- the provisions relating to foreign investment entities and non-resident trusts, in respect of which Budget 2010 proposed to consult on modified proposals; and
- the amendments related to the Canadian Film or Video Production Tax Credit.

The amendments to the Canadian Film or Video Production Tax Credit, as announced on November 14, 2003, will be reintroduced at a later date. However, the Government will not proceed with the proposed public policy test included in the aforementioned November 14, 2003 announcement.

Full explanatory notes are included with the legislative proposals. Interested parties are invited to provide comments on the draft legislative proposals by September 17, 2010. Comments may be sent to:

Tax Policy Branch
Department of Finance
140 O'Connor Street
Ottawa, Ontario
K1A 0G5

Cross-Border Nightmare[1]

I am involved on a file which is a textbook case on why knowledgeable tax advisers must be retained on cross-border investments.

Facts

The following is a simplified version of the facts. An individual resident in Canada personally owned U.S. real estate. One U.S. property (vacant land) was sold to a U.S. purchaser. The sale was structured as an instalment sale with a down payment of 10% of the price and the balance of the purchase price being payable on the fifth anniversary of the sale. The purchaser withheld and remitted to the Internal Revenue Service ("IRS") 10% of the purchase price under the *Foreign Investment in Real Property Tax Act* ("FIRPTA"). The individual subsequently died and bequeathed all of his assets to his spouse.

A Canadian accountant undertook to do the tax planning and the compliance in both Canada and in the United States. For a variety of reasons, it took him eight years to file the U.S. return reporting the sale of the land. For Canadian tax purposes, a taxpayer must report a minimum of 20% of the capital gain each year where there is an instalment sale. The accountant filed the Canadian returns reporting one fifth of the gain in each year but claiming a foreign tax credit for U.S. tax (which wasn't payable) in each year. He also filed the U.S. returns claiming a credit for the tax withheld under FIRPTA and reporting one fifth of the gain in each year although this was not in accordance with the U.S. rules. Canada didn't accept the foreign tax credit for the U.S. taxes and the United States didn't accept the credit for the tax withheld under FIRPTA. When the client died, the accountant reflected the transfer of assets to the spouse on a tax-deferred basis in the terminal return for Canadian tax and forgot to file for U.S. estate tax.

Problems

(1) Section 6511(a) of the *Internal Revenue Code* ("IRC") requires that a U.S. tax return be filed to claim a credit for FIRPTA withholding within three years of the filing date of the return, or within two years of the payment, whichever is later. No refund is generally available for a late-filed return. In this case, no U.S. tax was exigible for the year of sale because of the U.S. instalment sale rules. The IRS takes the position that section 6511 applies to refunds of FIRPTA payments (see IRS FSA 199951002 (August 27, 1999)). The client was denied a refund or credit in the United States for the U.S. tax withheld by the purchaser on the sale. U.S. lawyers are attempting to obtain an offer of compromise in order to effectively obtain a refund of the FIRPTA withholding and avoid double taxation.

(2) The CRA denied the U.S. foreign tax credits claimed on the Canadian tax returns because U.S. tax was not payable in those years. There was also a problem as the land sale may have been inventory in Canada and could have been a long-term capital gain for the United States or a sale of the trade or business assets.

(3) The mismatch of the reporting under the Canadian and U.S. instalment sale rules is a problem. Canada requires that more gain be reported in each year (minimum 20%) than was taxable in the United States. As a result, there is double taxation. There is no credit in Canada for the U.S. tax payable in subsequent years when no Canadian tax is exigible.

(4) The accountant also reported on the U.S. return the interest on the balance of sale as income effectively connected to a trade or business taxed at graduated rates rather than as passive income subject to 10% U.S. withholding tax. Attempts are being made to recharacterize these payments.

(5) By claiming the spousal rollover under subsection 70(6) of the ITA in the terminal Canadian tax return, the accountant foregoes the foreign tax credit for U.S. estate tax. He should have elected pursuant to subsection 70(6.2) of the ITA to deem the U.S. property to have been disposed of at fair market value so as to use the tax credit for U.S. estate tax and to bump the tax cost of the property to fair market value. There was some concern that the year was statute-barred. We filed amended returns with the alternative being an application to the competent authority under Article XXVI of the Treaty should the amended return not be accepted.

(6) The IRS required the client to pay all U.S. tax before any negotiation. This included all U.S. tax on the sale and on the interest income without the credit for the FIRPTA withholding and all U.S. estate tax. The IRS threatened to put the client on the Homeland Security List and deny her entry to the United States if all taxes were not paid.

Jack Bernstein, Aird & Berlis LLP, Toronto

Notes:

[1] The original article was first published in the May 2010 issue of *Canadian Tax Highlights* (Toronto: Canadian Tax Foundation).

Principal Residence

The CRA was asked (i) whether an interest expense incurred to acquire the upper unit of a duplex for rental purposes was deductible, (ii) whether paragraph 13(7)(*e*) (non-arm's length acquisition) would adjust the capital cost of the depreciable property if it was purchased from a sibling, and (iii) whether the sale of the upper unit in the duplex would qualify for the principal residence exemption.

Two sisters (Sister A and Sister B) purchased a duplex as tenants in common and each occupied one unit. Sister A occupied the lower unit and Sister B occupied the upper unit. Sister A purchased Sister B's interest in the upper unit and then rented the upper unit to a third party. Sister A borrowed funds to finance the purchase of the upper unit.

The CRA stated that interest is generally deductible on funds borrowed to purchase a rental property. In Interpretation Bulletin IT-533 "Interest Deductibility and Related Issues" (31 October 2003) the CRA discussed the criteria that must be met for interest deductibility. To the extent that Sister A used the borrowed funds to acquire the upper unit for the purpose of earning rental income in a *bona fide* rental operation, the interest paid on the borrowed funds would be deductible under paragraph 20(1)(*c*) of the Act (but see also subsection 9(3), which states that income from a property does not include any capital gain from the disposition of the property).

Generally, paragraph 13(7)(*e*) provides that where a transferor does not deal at arm's length with a taxpayer, the taxpayer's capital cost of depreciable property is equal to the total of the transferor's capital cost or cost of the capital property and half of the amount by which the transferor's proceeds of disposition exceed the capital cost or the cost to the transferor immediately before the transfer. Individuals related by blood are related and thus not at arm's length (see Interpretation Bulletin IT-419R2 "Meaning of Arm's-Length" (8 June 2004) for more information).

The principal residence exemption (see paragraph 40(2)(*b*) and section 54 eliminates or reduces the capital gain on the disposition of a taxpayer's principal residence (see also Interpretation Bulletin IT-120R6 "Principal Residence" (17 July 2003)). The CRA stated that where two individuals own a duplex as tenants in common and each ordinarily inhabits one unit in the duplex, each unit could be a principal residence for each person, respectively. However, where Sister A acquires the upper unit, rents the unit to a third party, and later disposes of the unit, the gain (if any) on the disposition would not qualify for the principal residence exemption under paragraph 40(2)(*b*) because the rental unit is not Sister A's principal residence as it was used to earn rental income and was not ordinarily inhabited and used by Sister A as her principal residence.

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