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SOME CRA MISSIVES

— David Louis, tax partner, Minden Gross LLP, a member of MERITAS law firms worldwide.

Since the new year, the CRA has released a number of "interesting" missives — so interesting that a full-scale article could be written on each of the following items. But I will hit only the highlights.

Partnerships

In my last article, I talked about the changes to joint ventures — particularly the fact that the CRA now requires income from joint ventures to be calculated based on the fiscal period of the particular taxpayer, as opposed to the fiscal periods of the joint venture ending in the particular year. This obviously puts pressure on tax reporting of corporate-owned real estate co-ownerships and the like. But, apparently, the CRA does not play favourites: it has beefed up the reporting for partnerships. The revised Schedule 50 requires disclosure of the adjusted cost base and the "at-risk amount" of each partner's interest in the partnership. Additionally, Schedule 9 requires disclosure of all persons affiliated with the partnerships. Details are contained, for example, in a PricewaterhouseCoopers tax memo dated March 3 (#2012-10). Fortunately, as stated in the memo, the CRA has since confirmed that it will not impose penalties on T5013 returns for 2011 fiscal periods as a result of incomplete adjusted cost base ("ACB") or at-risk information if Schedule 9 is prepared to the best knowledge and ability of the partnership and the preparer. The CRA has also announced that it will accept returns containing either the 2010 or 2011 version of Schedule 50 if the return is filed on the due date, and contains complete information on partner identification and the annual transactions between the partners and the partnership.

So, subject to these caveats, preparers are off the hook — for now. However, the 2011 *Guide for Partnership Information Returns* (T4068(E)) reads like a course in partnership taxation, with a half-dozen pages devoted to Schedule 50. Also, the CRA requirements beg the question of whether, for many partnerships, it is possible to prepare this information. For example, the ACB balance might depend on transactions between partners, deemed dispositions (for example, on the death of a partner), etc. Also, for long-standing partnerships, the information may almost literally be ancient history, requiring information to be called from storage, if in fact it is available and the documentation hasn't been lost or destroyed.

It's getting to the point where the complexity of tax compliance for partnerships and joint ventures could be a material impediment to the viability of these business structures. If the CRA had wanted the information, why didn't it tell us years ago, when the logistics of the calculations for long-standing partnerships were still reasonably feasible?

Having said this, I can see the CRA's new requirements being beneficial to many partners, particularly in professional partnerships; in many cases, the partnership interest's ACB will be in excess of its capital because of non-deductable items (e.g., 50% of most entertainment expenses), which effectively increase ACB but not partnership capital. I suspect that, when many partners terminate their interests in their respective partnerships, this latent capital loss is ignored due to the difficulties of doing the calculation. But over the course of a professional's career, these adjustments can really mount up. And the CRA's new requirements will, of course, make the calculation a cinch — not to mention that the capital loss may come in very handy.

Spousal Trusts

In the last few months, the CRA has released several missives pertaining to spousal trusts. One of these, CRA Document No. 2011-0430261E5 (December 28, 2011), caught my eye.

As many readers are aware, subsection 104(2) gives the CRA the power to lump multiple testamentary (and other) trusts together and treat them as a single trust. One of the main results is that, if there is a single trust, the ability to split income in low tax brackets for testamentary trusts will be restricted.

Over the years, the CRA has released several Technical Interpretations regarding this power. Likewise, my colleagues have written a number of articles on subsection 104(2), often focusing on the ability to multiply trusts and, thus, gain multiple access to lower tax brackets. The trouble is that, in this era of low-interest rates, the capital required to pull off these manoeuvres is limited to families that can afford summer homes on an island in Lake St. Joe's, and the like. Also, in many cases, complications will arise where family wealth is bottled up in corporations (e.g., drafting to facilitate post-mortem tax planning options).

Anyway, the thing that caught my eye in the Technical Interpretation relates to a seemingly typical testamentary spousal trust will: trust number 1 — spouse for life, remainder to child X; trust number 2 — spouse for life, remainder to child Y; etc. The CRA indicated that it would indeed apply subsection 104(2) to bust the would-be multiplication of low tax brackets. Unlike the often-canvassed situation where separate trusts are set up for particular children, the CRA noted that there is a common beneficiary — i.e., the surviving spouse — even though the spouse has only a life interest.[1] But note the would-be income-splitting advantages during the surviving spouse's lifetime.

Besides this, there have been a number of other intriguing Technical Interpretations relating to testamentary spousal trusts, including the availability of tax credits where a will provides for a spousal trust with a specific bequest to be made to charity upon the death of a spouse (CRA Document No. 2011-0428021E5 (December 14, 2011)), and whether income earned by a testamentary spousal trust after the death of the surviving spouse is taxable to the trust or to the residual beneficiary (STEP 2011, Q 4, 2011-041851C6).[2]

Pipelines

It has been awhile since I have written about this topic. As a reminder, a "pipeline" involves the estate of a decedent swapping shares of an Opco to a Holdco for debt in order to extract corporate-level assets equivalent to the cost base of the Opco shares — which is bumped up when the shares pass on death to another generation. The CRA might be tempted to say that this process strips the corporate assets at capital gains rates. As I observed in previous issues of *Tax Notes*, the procedure was called to attention in a 2009 APFF Round Table Question that canvassed the possible application of subsection 84(2) — deemed dividend treatment — to the repayment of the aforementioned debt.

The trouble is, the issues raised by this antiquated and misunderstood anti-avoidance provision were addressed in a succession of often conflicting articles and CRA Round Tables awaiting formal answers, as well as mainly francophone rulings. Alas, a comprehensive treatment on the topic would now be the subject of a full-scale paper.

However, a CRA missive recently occurred in the form of a written answer to Question 5 of the 2011 STEP conference (CRA Document No. 2011-0401861C6), involving a hypothetical cash corporation with no activities or business.

Not surprisingly, the CRA refused to confirm that the anti-avoidance provisions in subsection 84(2) would not apply. Some additional facts and circumstances that could warrant the application of subsection 84(2) could include the funds or property of the corporation being distributed to the estate in "a short time frame" following death, and that the nature of the underlying assets would be cash and the original corporation would have "no activities or business ('cash corporation')".

It was also noted that several favourable rulings have been issued on the matter (including one in English, CRA Document No. 2011-0403031R3). However, the CRA maintained that these situations, in contrast to the example in question, did not involve cash corporations (although perhaps the term differs from an actively managed investment portfolio). Furthermore, in each case, the taxpayers' proposed transactions contemplated, among other things, the continuation of the business for a period of at least a year, followed by a "progressive distribution" of the corporation's assets over an additional period of time. A similar draft answer given to a CRA Round Table question at the 2011 Canadian Tax Foundation annual conference states that the CRA continues to rule on subsection 84(2) on a "case-by-case basis" (and that the foregoing elements are part of the proposed transaction rather than "conditions").

My remarks will be particularly brief. First, although counter-arguments may be made (and there are plenty of examples of incongruities from the literal application of this provision), arguments can also be made in favour of the CRA's position on the potential application of subsection 84(2) in this context. As interpreted by a long line of cases stretching back well over half a century, the provision potentially applies where funds or property of a corporation have been distributed or otherwise appropriated *in any manner whatever* to or for the benefit of shareholders of any class on the *winding-up, discontinuance, or reorganization of its business*.[3]

But I stress that the above perquisites must be met. For example, I can see the CRA's objection to a cash corporation being stripped based on capital gains rates rather than those of dividends; however, the CRA should make its views on the application of the provision in this context more explicit (e.g., presumably that subsection 84(2) potentially applies because this is a cash corporation's business or because it is part of the winding-up or discontinuance of its former business).

Also, I wonder if the CRA-imposed impediments are really showstoppers. In many cases, the insistence in the out-and-out stripping of corporations by beneficiaries of a decedent (i.e., in a manner that is offside subsection 84(2)) may be due to greed, rather than reason. Must the clients be in such a rush to buy a house in Forest Hill?

Finally, I wish the Department of Finance would amend subsection 164(6) — the main alternative to the pipeline — to extend the time limit to three years to generate the capital loss "carryback" to the deceased taxpayer, rather than limiting it to the first year of the estate, as is done now. The trouble with this post-mortem procedure is its complications, coupled with the fact that it often takes months before a grieving family member would even think to consult a professional about the estate.

Rental Income and the Small Business Deduction

Another interesting missive is a Technical Interpretation dated February 14, 2012 (CRA Document No. 2011-0407051E5). The Technical Interpretation, which gives several hypothetical situations, relates to the issue of whether rental income is income from active business, or, more specifically, whether it is "pertaining to" or "incident to" a business. The situations are as follows:

(1) A construction company owns a building with a parking lot and receives rental income for the portion of the parking lot that is rented to a neighbouring company.

(2) A used car dealership receives rental income from the rental of a portion of its previous location. The car dealership moved to a new location but continues to use a portion of the old location for storage and intends to sell it when the market value increases.

(3) A small manufacturing corporation that moves to a larger location and receives rental income from the building where it was located for over 20 years.

(4) A used car dealership owns two lots that are side by side. One lot has a trailer and the other a building with four units. The car dealership uses a portion of both lots and receives rental income from the remainder of the building and lot from subcontractors.

(5) The sole shareholder of a holding company owns a property that it rents to the holding corporation, and which in turn is rented to an operating company. The two corporations are associated.

The CRA accepts situation (1) as active business income and points out that situation (5) will be governed by subsection 129(6), which generally deems investment income from an associated corporation to be active business income. However, the CRA, in its wisdom, deems situations (2) through (4) to be ineligible for the small business deduction.

Part of me is wondering "what did I think they were going to say?" Be that as it may, the CRA cites no authority for its positions. The letter concludes that this determination is always a question of fact: whether a corporation qualifies for the small business deduction can only be made "based on the complete review and the principal purpose of a corporation's business, which must be determined annually after all the facts relating to that business are considered".

Thanks to Joan Jung and Matthew Getzler, of Minden Gross.

Notes:

[1] See also CRA Document No. 9714835 (June 30, 1997), a similar situation in which the CRA appears to be non-committal. Also, CRA Document No. 9306245 (May 20, 1993) involved a situation where separate trusts were purported to be created for each of a testator's several children, but the wife of the testator was made a "co-beneficiary of all the trusts". The CRA stated that applicability of subsection 104(2) of the Act would be more likely than if each trust had a separate and distinct beneficiary.

[2] See the November issue of *Tax Hyperion* for further discussion on recent Technical Interpretations relating to spousal trusts.

[3] For a recent discussion of the jurisprudence, see "Estate Planning — Hot Topics", Oakey, 2011 Atlantic Provinces Tax Conference (Canadian Tax Foundation, unpublished at time of writing).

The deemed dividend is based on the amount or value of the funds or property distributed or appropriated, in excess of the amount, if any, by which the paid-up capital in respect of the shares (it seems to me: of the particular corporation) of that class is reduced on the distribution or appropriation.

PRESCRIBED INTEREST RATES — SECOND QUARTER OF 2012

The prescribed interest rates for the second quarter of 2012 were released by the Canada Revenue Agency on March 14, 2012. They are unchanged from the first quarter of 2012 and are noted below.

- 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 April 1, 2012 to June 30, 2012.

A listing of the prescribed interest rates for each quarter, dating back to 1994, is reproduced in ¶12,745 of the print, online, and DVD services of the *Canada Income Tax Guide*.

CROSS-JURISDICTIONAL TABLE OF CONCORDANCE ADDED

A new Federal/Provincial Income Tax Concordance Table has been added to the federal *Income Tax Act* collection. This new quick reference feature contains handy cross-jurisdictional references that link to legislative provisions in respect of tax rates, tax credits and benefits, and tax administration. This new reference table can be found on CCH Online and on DVD in the federal *Income Tax Act* under the heading "Tables of Concordance — Federal/Provincial Income Tax Concordance Table".

2012 FEDERAL BUDGET DATE — MARCH 29, 2012

The 2012 federal Budget was tabled on Thursday, March 29, 2012. The government's Budget documents have been posted on CCH's federal income tax News Tracker and GST News Tracker. CCH, in partnership with Fraser Milner Casgrain LLP, was in the lock-up that day with a team of tax experts to provide commentary on the tax provisions contained in the Budget. This commentary as well as the government's Budget plan has been published in CCH *Special Report* 064H. Additional orders may be placed by calling (416) 224-2248 (toll-free 1-800-268-4522), by faxing (416) 224-2243 (toll-free 1-800-461-4131), or by emailing cservice@cch.ca.

PARTNERSHIP INFORMATION RETURN

The Canada Revenue Agency has revised the returns, forms, and schedules that make up the partnership information return for 2011. The changes reflect the new requirements for filing a partnership information return starting for fiscal periods ending in 2011. As set out in T4068, Guide for the Partnership Information Return, four new forms have been added to the T5013, three previous forms are no longer in use, and several other forms have been changed. The 2011 version of T5013, Schedule 50 has been completely redesigned from the 2010 version. It is now called Partner's Ownership and Account Activity. Schedule 50 requires information on each partner's adjusted cost base ("ACB") of the partnership interest and the at-risk amount ("ARA"). On February 29, 2012, the CRA announced that it recognizes that preparers of the information return may have a difficult time supplying the information required in Schedule 50 and that a transition period is required. The CRA stated the following:

> To ease concerns about providing updated ACB and ARA information, we will accept returns filed by the due date if they contain either the 2010 or 2011 version of schedule 50 with complete information on partner identification and the annual transactions between partners and the partnerships.
>
> The CRA will not impose penalties on T5013 returns for 2011 fiscal periods as a result of incomplete ACB and ARA information on the schedule 50. We want to assure partnerships and tax preparers that penalties for incomplete returns are not intended to be applied on T5013 returns filed for 2011 fiscal periods that have been completed, to the best knowledge and abilities of the partnerships and preparers, by the filing deadline.

RECENT CASES

Taxpayer could not deduct travel expenses not directly related to the business

The corporate taxpayer's sole owner, M, travelled by private jet to provide gratuitous services to four corporations in which he owned shares. He claimed flight expenses related to those services in 2002 and 2003, on the basis that those expenses were incurred to garner future income from his shares of those companies. The taxpayer also claimed input tax credits ("ITCs") to recover GST paid for the supply of the flight services. The Tax Court of Canada allowed the taxpayer's deductions for flight expenses related to direct business activity and the related ITCs claimed, but disallowed the other deductions (2010 DTC 1351). The taxpayer appealed to the Federal Court of Appeal.

The taxpayer's appeal was dismissed with costs. The connection between the travel expenses and the taxpayer's shares in the corporations, as possible sources of income, was not sufficiently direct to be deductible. Furthermore, ITCs could not be claimed by the taxpayer, as they were not incurred for business purposes. Lastly, the Tax Court judge did not make a palpable and overriding error warranting the appeal court's intervention.

Lyncorp Manufacturing Ltd.

2012 DTC 5032

Taxpayer entitled to clergy residence deduction

The taxpayer deducted $10,000 in each of 2006, 2007, and 2008 for a clergy residence. She performed various functions within the Toronto International Celebration Church. The Minister disallowed the deductions, on the basis that the taxpayer was not a member of the clergy and did not minister to a congregation.

The taxpayer's appeal was allowed. The Court found the taxpayer was a "clergy." She was a spiritual leader in the church, recognized by the congregation and the senior pastor. The Court also found that the taxpayer ministered to the congregation. She was fulfilling the ministerial role in the manner requested by the congregation and by the senior pastor. Ministering to the congregation at the church was an integral part of the taxpayer's employment responsibilities and expectations.

Tidd

2012 DTC 1060

Capital gains accruing in trust were taxable in hands of beneficiaries

The taxpayer's grandmother owned a property at the time of her death in 1967. In her will, she left the property in trust for the benefit of the taxpayer's mother for the term of her life, and upon her death, the property was to be transferred to the taxpayer and his siblings once the youngest of them had reached the age of 21. The taxpayer's mother passed away in 2007, and since the youngest of the siblings was 21, the property was transferred to the grandchildren at that time. No capital disposition was ever reported by the trust. In 1994, the trust filed an election to defer the 21-year deemed disposition rule until 1999. The Minister disallowed the taxpayer's deduction of a capital loss, and included a capital gain in the taxpayer's income

The taxpayer's appeal was dismissed. The Court found that capital gains had been accruing in the trust since 1999, and that there was rollover of the accrued capital gain to the beneficiaries. A trust is obliged to roll over to the beneficiaries the capital gains accrued on a capital property by deeming the beneficiaries to have acquired the asset at a cost approximately equal to the trust's adjusted cost base. A trust may elect not to have the rollover provision apply if it is resident in Canada, but a prescribed form must be filed with the trust's income tax return in the year of the distribution. In this case, the trust did not file the prescribed form with its 2007 income tax return when the property was passed to the taxpayer and his siblings.

Green

2012 DTC 1061

Non-residents not required to file notice of capital distributions from Quebec succession

The taxpayers, who were non-residents of Canada, were two of the three beneficiaries of the residue under their mother's will. After her death in 2006, the mother's succession made five capital distributions to each of her children, including the taxpayers. The Minister assessed penalties and interest against the taxpayers for three of the distributions, on the basis that they had failed to provide notice of a disposition of Canadian taxable property. On the taxpayers' appeal to the Tax Court of Canada, the Crown submitted that the taxpayers had disposed of capital interests in a trust.

The taxpayers' appeals were allowed. The Court found that a Quebec succession is not a trust. Consequently, there was no disposition of "taxable Canadian property" and no obligation on the part of the taxpayers to file a notice of disposition. The purpose of the applicable provision was to simplify the drafting, not to equate estates with trusts.

Lipson

2012 DTC 1064

Amount paid to taxpayers for non-competition covenant constituted part of taxpayers' proceeds of disposition of corporation's shares

Chateau Dollard Inc. owned and operated a seniors' residence, and its shares (the "Shares") were owned equally by the three taxpayers. They agreed to sell the assets of Chateau Dollard Inc. to a numbered corporation ("4178092") but later terminated this agreement and entered into a new one agreeing to sell 4178092 the Shares for the same consideration ($13,750,000). They paid $1,050,000 to 4178092 for the right to convert the original agreement into the new one involving the sale of the Shares (the "Share Agreement"). This payment was effected by the taxpayers endorsing back to 4178092's solicitors cheques they initially received from 4178092. The purchase price for the Shares also included $4,678,000 paid to the taxpayers for a non-competition covenant. The Minister reassessed the taxpayers for capital gains arising out of their sale of the Shares during 2003. On their appeal to the Tax Court of Canada, the taxpayers argued that: (a) in computing the proceeds of disposition of the Shares, the $1,050,000 should be deducted from the $13,750,000, since the sole purpose of that $1,050,000 was to enable 4178092 to improve its borrowing capacity to permit it to carry out the purchase transaction; and (b) the $4,678,000 should not be included in the proceeds of disposition of the Shares, because it was an amount agreed upon by the parties in a separate arm's length transaction not related to the sale price of the Shares.

The taxpayer's appeals were dismissed. Nowhere in the documentary evidence provided to the Court was mention made of the fact that the $1,050,000 formed part of the adjustments to the $13,750,000 sale price of the Shares. In addition, the $1,050,000 was really paid by 4178092 to the taxpayers, and was then paid back to it as part of their obligation to compensate it for the loss of its tax advantages flowing from the sale of the Shares, as opposed to the sale of assets. This arrangement, however, was separate and distinct from the Share Agreement. Therefore, the $1,050,000 could not be applied to reduce the $13,750,000 sale price of the Shares. Nor could it be deducted by the taxpayers in computing either their income or their capital gain from the sale of the Shares, because it was not laid out by them to earn income, or to alter the sale price of the Shares. Although the parties had specifically allocated $4,678,000 to the non-competition covenant in the Share Agreement, the Minister's expert assigned a value of between $0 and $125,000 to that covenant. He also assigned a value of $13,202,500 to the Shares. Accordingly, the value of the non-competition covenant could not be considered as additional consideration for the Shares in excess of the $13,750,000 ascribed to them in the Share Agreement. The Minister, therefore, was justified in treating the $4,678,000 as part of the $13,750,000 proceeds of disposition of the Shares under subparagraph 40(1)(*a*)(i). The Minister's reassessments were affirmed accordingly.

Wagner

2012 DTC 1065

Mental incapacity does not form basis to alter limitation periods

The taxpayer claimed a donation tax credit of $30,000 for his participation in the Universal Donation Program in 2005, which consisted of $6,000 in cash and $24,000 in kind. The Canada Revenue Agency reassessed the taxpayer on July 31, 2008, and reduced his charitable donation to nil, on the basis that there was no gift. In applying for an extension of time to file a notice of objection, the taxpayer argued that he did not receive the notice of reassessment and that, alternatively, he suffered from age-related dementia.

The taxpayer's application was dismissed. The taxpayer failed to file his notice of objection within the required one-year-and-90-day limit, and additionally, mental incapacity would not alter the time limits provided in the legislation.

Jablonski

2012 DTC 1066

Decision denying relief from interest and penalties based on financial hardship was reasonable

The taxpayer applied to the Minister for a waiver of $42,125.58 in penalties and $19,236 in interest accruing for 2005, 2006, and 2007 on the basis of financial hardship. The evidence the taxpayer submitted to the CRA indicated that in the year ending January 31, 2004, it made over $900,000 in profit; in the year ending January 31, 2005, over $72,000 in profit; and in the year ending January 31, 2008, over $235,000 in profit; and that it expected to make in the order of $700,000 in profit in the year ending January 31, 2007. The request was denied and this decision was confirmed upon review. The taxpayer applied to the Federal Court for judicial review of that decision, submitting that too little, if any, weight was given to the taxpayer's precarious cash flow situation.

The taxpayer's application was dismissed. The Court found that the Minister's decision was reasonable. The report to the decision maker outlined in considerable detail all aspects of the taxpayer's financial situation, including its cash flow and past history about penalties and interest. The decision at issue stated that the record had been carefully reviewed, including the submissions made on behalf of the taxpayer. The taxpayer's cash flow situation was a matter of weight and judgment to be afforded by the CRA.

Inline Fiberglass Ltd.

2012 DTC 5026

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