Tax Notes

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SOME MORE MISSIVES

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

As years go by, I see more and more of what looked like "stock" estate planning methodology that does not prove to be the panacea it was thought to be.

A case in point: recent developments pertaining to so-called "single-purpose corporations" relating to U.S. vacation properties and the like. Once upon a time, having a single-purpose corporation was looked on as a relatively simple way to avoid U.S. estate tax; I'm old enough to remember the days when these corporations were used rather routinely. But complications ensued. The changes to the Canada–U.S. Tax Treaty in 1995 put pressure on the applicability of the strategy. Eventually, the administrative policy pertaining to single-purpose corporations was discontinued (details are contained in *Income Tax Technical News* No. 31R2, May 16, 2006).

However, for structures in place at the end of 1994, grandfathering was allowed until the earlier of the disposition of the U.S. real estate by the single-purpose corporation and a disposition of the shares of the single-purpose corporation other than a transfer of such shares to the shareholder's spouse or common-law partner as a result of the death of the shareholder. (Special rules were also available for properties under construction or renovation at the end of 2004.) At the time, most people checked whether the clients were eligible for grandfathering, and moved on. In fact, at the 2006 STEP conference, the CRA indicated that it had received "very few questions" concerning the position set out in ITTN No. 31R2.[1]

However, in recent months the situation has changed dramatically. If you were reading carefully, you saw that grandfathering would apply to "dispositions" of shares, other than those mentioned. In fact, the CRA is using the word "disposition" in the technical way. In Document No. 2011-0426971E5 (February 16, 2012), the CRA is of the view that grandfathering status is lost under the deemed disposition of single-purpose shares that takes place upon emigration of the shareholder from Canada (that is, apart from the usual results of the deemed disposition itself[2]). Several months earlier, the CRA expressed the view that the transfer of a corporation's shares as a result of a divorce or marriage breakdown would also destroy the grandfathering (Document No. 2010-0386871E5, July 7, 2010). Early on, the CRA confirmed that grandfathering relief would continue to apply to the transfer of a single-purpose corporation's shares to a post-1971 spousal or common-law partner trust as a consequence of death. However, in Document No. 2011-0393401E5 (August 24, 2011), the CRA was of the view that a transfer to an *alter ego* trust would be offside. (As would a situation where the corporation redeems all the shares owned by the individual who had contributed the funds to acquire the property, leaving the children of the individual as the shareholders — see Document Nos. 2004-0106241E5, December 20, 2004, and 2006-0185561C6, September 11, 2006.)

When one adds up the recent restrictions (i.e., divorce, emigration, and possibly sophisticated estate planning), one is left to wonder how useful grandfathered single-purpose company status actually is.

As a reminder, the issue with non-grandfathered corporate-owned vacation properties and the like is whether a shareholder benefit applies — i.e., pursuant to subsection 15(1) of the *Income Tax Act* (the "Act"). The applicable policy is expressed in paragraph 11 of IT-432R2. In many cases, the antidote relies on fair market value rent for the use of the property, subject to the caveat that fair market value rent may not "always be appropriate for measuring the benefits, particularly when it does not provide for a reasonable return on the value or cost of the property"— e.g., for luxury homes, particularly where comparable rent doesn't exist. Also, if the single-purpose rules may become problematic, consider converting to a more acceptable structure while the value of U.S. real estate is still depressed.

Eligible Dividends

The next two topics can be described by that famous saying, "You can't always get what you want". However, unlike in the song, I question whether the governments' actions are consistent with the "get what you need" part.

Particularly in respect of closely held private corporations, the existing eligible dividend rules have had (at least) two warts. The first is that you must designate an entire dividend. The larger problem is often that, in the CRA's view at least, to be eligible for the tax break, payment of the dividend requires a contemporaneous notification in writing to the recipients. To this end, various strategies and boilerplate have been unsuccessfully proposed to the CRA to meet this requirement.

The federal Budget contains two proposals in this vein. The first is the ability to designate a portion of the dividend as an eligible dividend. Apart from the fact that this applies only for dividends paid after March 28, 2012, I don't have any particular problem with this proposal. However, rather than remove the contemporaneous notification requirement, the government proposes to permit the CRA (again, in respect of dividends paid after March 28, 2012) to accept an eligible dividend designation filed up to three years after the day on which the designation was required to be made, if it would be "just and equitable" to permit such a late designation. The Budget papers don't specify what would be considered just and equitable in the circumstances, other than considering "affected shareholders".[3]

While some firms treated this announcement as welcome news, in view of the increased scrutiny for private corporations (especially when they are held by "wealthy" individuals), many accountants may be reluctant to have such an application on the record, as it may, in some minds, tip the CRA off as to sloppy compliance. I suppose that the late designation could be applied for if the CRA is already challenging the proper designation of the dividend. But particularly in these circumstances my question becomes even clearer: why does the government require this paperwork, as opposed to dropping the contemporaneous notification requirement — especially since, in most provinces, the differentiation between a non-eligible and an eligible dividend is a few points?

Joint Ventures

Continuing with the "can't always get what you want" theme, Document No. 2012-0432111E5 (March 13, 2012) contains somewhat welcome developments for the new joint venture policy.

As I have indicated in previous articles, the new policy is that, effective for taxation years ending after March 22, 2011, taxpayers must report their joint venture income based on the joint venturer's year end — that is, deferred joint venture income will no longer be acceptable. However, for additional stub-period income, transitional relief similar to that given in the partnership rules will potentially apply, so that a deferral of the extra income will be offered. But unlike partnerships, which use an estimated formula (that is, they estimate current stub-period income based on the previous year's partnership income, subject to adjustments), joint venturers must report actual joint venture income based on their particular year ends.

The CRA's latest policy is that, if financial data is not available at the time of filing the joint venture participant's return, the CRA will generally accept, for the purposes of the stub income reporting, estimated amounts to be corrected to actual amounts, and amend the transitional relief, as long as the joint venture participant requests that the CRA amend the relevant return on a "timely basis". The CRA notes that in order for an election for transitional relief to be accepted, the amount of deferred income being brought into income, as well as the amount of transitional relief being sought, must be specified in the election. (The CRA also recommends that the capital cost allowance be computed separately for the transitional period.)

Obviously, this does not alleviate the requirement to compute joint venture income based on the joint venturer's year end, rather than use the estimated method as with partnerships. However, at least this task can be deferred to a more convenient time, provided that the return is amended on a "timely basis". In summary, you can't always get what you want — but time is on your side.

Two Other Missives

I would like to briefly mention two other recent Technicals which I found interesting. Although it does not feature particularly revealing new views on the CRA's part, Document No. 2012-0435101E5 (March 27, 2012) illustrates the interaction between subsection 129(6) and the definition of "small business corporation" ("SBC") in subsection 248(1). In the Technical itself, two-thirds of the fair market value of assets of Propertyco (with no employees) is rented to a related and associated corporation, Opco, and used in Opco's active business (so that the rent paid to Propertyco is deduction therefrom), and one-third of the fair market value of the Propertyco assets are rented at arm's length.

Is Propertyco an SBC (e.g., for the capital gains exemption)? The CRA considers subsection 129(6), which deems the rentals to Opco (i.e., on two-thirds of Propertyco assets) to be income from an active business because they were deductible in computing Opco's active-business income. But the CRA points out that subsection 129(6) applies only for the purposes of subsection 129(4) (i.e., investment income status) and section 125 (the small business deduction). It does not apply for the SBC definition in subsection 248(1), so vis-à-vis Propertyco's SBC status, subsection 129(6) would appear to be a red herring (even though affected payments are deemed by subsection 129(6) itself to be income from an active business carried on by Propertyco).

However, an SBC is defined in subsection 248(1) as a Canadian-controlled private corporation where all or substantially all of the fair market value of the corporation's assets is used principally in an active business carried on primarily in Canada by a particular corporation or a corporation "related" to it. Sounds promising. Trouble is, since only two-thirds of the fair market value of Propertyco's assets is attributable to such use (i.e., by a related corporation), Propertyco will not be an SBC, presumably under the CRA's usual 90%-of-value benchmark for SBC status to apply.

Document No. 2011-0423141E5 (March 21, 2012) involves a situation where the settlor is the sole beneficiary of a trust, having transferred the sum of $100. The trust subsequently took a loan in the amount of approximately $1 million for the acquisition of a rental property. Even though the rental property is to be distributed to the sole beneficiary (the settlor), the CRA is of the opinion that subsection 107(4.1) applies to the distribution of the rental property, so that a rollout is not available, even though it is to the settlor — who is typically eligible for an exemption from subsection 107(4.1). The implicit problem appears to be that the particular property to be distributed was not received by the settlor.

Thanks to Joan Jung and Michael Goldberg of Minden Gross LLP.

Notes:

[1] The CRA took the occasion to express the conditions that previously applied to single-purpose corporations:

(1) The corporation must be a Canadian corporation within the meaning of subsection 89(1) of the Act.

(2) The corporation's only objective is the holding of a residential real property in the United States for the personal use or enjoyment of the shareholder.

(3) The shares of the corporation are held by an individual or an individual and persons (other than a corporation) related to the individual.

(4) The only transactions of the corporation relate to its objective of holding property in the United States for the personal use or enjoyment of the shareholder.

(5) The shareholder is charged with all the operating expenses of the property by the corporation, with the result that the corporation shows no profit or loss with respect to the property on any of its income tax returns.

(6) The corporation acquired the property with funds provided solely by the shareholder and not by virtue of his or her holdings or that of a related person in any other corporation.

(7) The property must be acquired by the corporation on a fully taxable basis, that is, without the use of any of the rollover provisions of the Act.

See Document No. 2006-0185561C6, September 11, 2006.

[2] Presumably, the result would be withholding on the subsection 15(1) benefit under subsection 214(3).

[3] However, per the Explanatory Notes to the Ways and Means Motion in respect of the March 23 federal Budget (April 23), another factor is the extent to which the corporation actually had income taxed at the general corporate income tax rate when the dividend was paid. To me, this suggests a policy of largesse. But we will have to wait and see.

NOTICE OF WAYS AND MEANS MOTION TABLED

On April 23, 2012, the Minister of Finance tabled a Notice of Ways and Means Motion to amend the *Income Tax Act*, which implements a few of the provisions from the 2012 Budget. CCH Canadian Limited has prepared *Special Report 065H*, which contains the Notice of Ways and Means Motion 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 emailing cservice@cch.ca.

The proposals from the 2012 Budget that are reflected in the Notice of Ways and Means Motion include the following items:

- a temporary measure to allow certain family members to qualify as registered disability savings plan holders for an adult individual who is not able to enter into a contract (portion of resolution 1);
- extension of the mineral exploration tax credit for flow-through investors (resolution 2);
- split and late eligible dividend elections (resolution 3);
- taxation of the Governor General's salary (resolution 15);
- donations to foreign charities and political activities by charities (resolutions 42 and 43); and
- changes relating to tax shelters, including tax shelter identification numbers and increased penalties for failure of promoters to file information returns (resolutions 44 to 47).

The Notice of Ways and Means Motion expands the list of eligible expenses under the medical expense tax credit (Regulation 5700). It also provides the Canada Revenue Agency with authority to issue a demand to file a return by means of an online notice or by regular mail.

RECENT CASES

Taxpayers receiving amounts under Ponzi scheme; taxpayers not entitled to rectification of records to show amounts as capital and not income

Ontario Superior Court of Justice, January 23, 2012

From 1998 to 2004, the taxpayers and their corporations were victims of a Ponzi scheme, in which amounts they received were reported to them as income, but were allegedly, in reality, a return of capital. As a result, the taxpayers unnecessarily paid significant amounts of income tax. The Canada Revenue Agency and the Ontario Ministry of Finance both refused to reassess. In their view, in a Ponzi scheme the investors do not receive a return of capital, but instead receive funds from the contribution of new investors into the scheme, which is a source of income for tax purposes. The taxpayers applied to the Ontario Superior Court to have their corporations' records rectified to show the amounts received from the Ponzi scheme as a return of capital.

The applications were dismissed. When these corporate records were prepared, they accurately expressed the intention that the amounts received from the Ponzi scheme should be characterized as income. Rectification, therefore, was not available. It was appropriate, however, for a declaration to be made that those Ponzi scheme amounts received should be characterized not as income, but as a return of capital, without prejudice as to how, as a matter of law, they should be treated for tax purposes. That treatment was a matter for the tax authorities to determine, subject to judicial review by the Federal Court with respect to the *Income Tax Act* and by the Ontario Superior Court with respect to corporate tax under the Ontario *Corporations Tax Act*.

Orman v. Marnat Inc., 2012 DTC 5052

Amalgamated credit union could not ignore capital cost allowance deducted by predecessors

Federal Court of Appeal, November 21, 2011

The taxpayer credit union was the result of an amalgamation of two other credit unions. Simultaneously with the amalgamation, the predecessors entered into an agreement to sell some real estate identified as surplus to a newly incorporated company. The shares in the new company were transferred to the taxpayer as part of the amalgamation. The taxpayer deducted capital cost allowances ("CCAs") without taking into account CCAs previously deducted by the

predecessors. The Minister assessed the taxpayer on the basis that the predecessors' undepreciated capital cost flowed through to the taxpayer, and accordingly disallowed part of the CCAs claimed. The Tax Court of Canada held that the provision applicable to amalgamations did not apply because not all of the property of the predecessors became the property of the taxpayer by virtue of the merger. It held that the common law principles applied, and dismissed the taxpayer's appeal accordingly (except for one year that was statute-barred) (2010 DTC 1399). The taxpayer appealed to the Federal Court of Appeal.

The taxpayer's appeal was dismissed. The Court found that the amalgamation rules applied. The fact that the beneficial interest in the surplus properties was vested in the taxpayer's wholly owned subsidiary as of the moment of amalgamation did not mean that the property of the predecessors did not become property of the taxpayer. The transactions related to the merger merely changed the form of the ownership of the surplus real estate. Further, the transactions were part of a composite transaction, each component of which was intimately related to the merger. The surplus real estate thus became the property of the taxpayer "by virtue of the merger". Even if the amalgamation rules did not apply, the trial judge was correct in applying the common law principles relating to "flow through" derived from the "continuation" model of merger. The statutory provisions were not so exhaustive that they impliedly excluded common law principles. The interpretative presumption against redundancy did not apply, for essentially the same reasons. Accordingly, the trial judge was correct in concluding that, even if the amalgamation rules were not applicable, the common law principles would attribute the predecessors' undepreciated capital cost to the taxpayer.

Envision Credit Union v. The Queen, 2012 DTC 5055

Taxpayer's disclosure was not voluntary — Disentitled to Voluntary Disclosure Program

Federal Court of Appeal, February 15, 2012

The taxpayer realized, but failed to report, a gain (the "Gain") on the sale of condominium units in a residential project (the "Project") being developed by a corporation (the "Corporation") of which he was the president. In a second-level decision, the Minister refused the taxpayer Voluntary Disclosures Program ("VDP") relief with respect to the interest and penalties relating to the Gain, on the grounds that: (a) as a result of a previous telephone conversation with the Canada Revenue Agency ("CRA"), the taxpayer knew that the Minister was looking for information concerning unnamed persons who had purchased units in the Project; and (b) the Minister had sought an *ex parte* court order authorizing a formal requirement for this information from the Corporation, which constituted "enforcement action" within the meaning of the VDP Guidelines and was sufficient to disentitle the taxpayer to VDP treatment. In the Minister's view, therefore, the taxpayer's disclosure was not voluntary. The Federal Court dismissed the taxpayer's application for judicial review of the Minister's second-level decision (2010 DTC 5161), concluding, in essence, that the Minister had acted reasonably. The taxpayer appealed to the Federal Court of Appeal.

The taxpayer's appeal was dismissed. The Minister acted reasonably in deciding that the taxpayer knew from his telephone conversation with the CRA that the latter was planning enforcement action. On this basis alone, therefore, the taxpayer's disclosure was not voluntary.

Livaditis v. CRA, 2012 DTC 5059

Taxpayer did not gamble in sufficiently commercial manner to deduct losses

Federal Court of Appeal, January 26, 2012

The taxpayer was very active in gambling activities, including horse races, slots, casino games, and lotteries. In 2002 and 2003, he deducted losses and associated expenses of $40,933 and $56,000, respectively, against his winnings for those years. The Minister disallowed the deductions because the taxpayer's gambling activities did not constitute a business. The decision was upheld by the Tax Court of Canada, and the taxpayer appealed to the Federal Court of Appeal.

The taxpayer's appeal was dismissed. Although the taxpayer kept books and records of his gambling activities, he did not conduct himself in a sufficiently commercial manner. Accordingly, the Tax Court was correct and did not make a palpable and overriding error in its judgment.

Tarascio v. The Queen, 2012 DTC 5046

Tax Court had no authority to grant relief for conduct of CRA during audit and objection stages

Tax Court of Canada, February 14, 2012

The taxpayer appealed to the Tax Court of Canada from the Minister's assessments for 2004 to 2010 relating to excess contributions to, and withdrawals from, registered retirement savings plans. As both the taxpayer and the Crown made a number of concessions, the remaining issue was the taxpayer's submission that there should be a remedy for the conduct of the Canada Revenue Agency (the "CRA") during the audit and objection stages, which led to such a protracted and bitter dispute.

The taxpayer's appeal was allowed in part. The Court quashed the appeal with respect to assessments for which an extension of time was earlier denied, and with respect to assessments for which no notice of objection was filed. The appeal, where there were no assessments to be appealed, was also quashed. With respect to the remaining issues, the Court gave effect to some concessions made by the Crown. With respect to the taxpayer's submission that there should be a remedy for the conduct of the CRA during the audit and objection stages, the Court found that the Tax Court was not the proper forum for the relief that was sought. The Tax Court of Canada has no authority to grant relief for conduct of the CRA during the audit and objection stages. It also has no authority to waive tax, interest, or penalties on grounds of fairness.

Bruce v. The Queen, 2012 DTC 1089

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