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SOMMER OF LOVE?

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

In the last few months, a number of court decisions have put taxpayers on a high; for some examples, see "Taxpayer Victories: Coincidence or Trend?" in the June 2012 issue of *Tax Notes*. In mid-July, the *Sommerer* appeal confirmed that a sale at fair market value to a trust did not trigger the so-called reversionary trust rules, per subsection 75(2) of the *Income Tax Act* (the "Act") (see last month's *Tax Notes*). On August 1, the love-in continued, with the release of the Supreme Court of Canada's long-awaited verdict on farming losses, *Craig* (2012 DTC 5115). It overrode the Supreme Court's own verdict in the *Moldowan* case, which had required that, to obtain unrestricted tax losses, other sources of income had to be subordinate to the farming source of income. The top court held instead that, per section 31 of the Act, a taxpayer's income will be "a combination of farming and some other source of income"— and thus restricted farm losses do not apply — if both sources are significant endeavours for the taxpayer, but farming need not be the predominant one. In this case, the taxpayer's horse racing operation was a business, not a sideline, and it was a significant endeavour, so that restricted farm loss rules were inapplicable.

But elsewhere in Ottawa, it was not incense and peppermint. On August 14, 2012, the Department of Finance released draft legislation pertaining to several key proposals in the March federal Budget. If you are getting a sense of *déjà vu*, much of the same federal Budget was the subject of Bill C-38, which was passed in late June. But we are talking about some of the Budget's harder stuff here, such as in the international taxation area.

Magical Mystery Tour — Foreign Affiliate Debt Dumping

Particularly in view of their surprising breadth, I found the provisions relating to the controversial "foreign affiliate debt dumping" proposals particularly interesting. These are designed to deter Canadian subsidiaries of foreign-based multinational groups from making investments in foreign affiliate non-resident corporations in situations where these investments can result in the "inappropriate" erosion of the Canadian tax base. (Notably, dividends from foreign affiliates can be tax-free, with Canadian interest deductions available on debt incurred to make such investments.)

In general terms, the new rules, which (subject to grandfathering provisions) apply to transactions occurring after March 28, 2012, result in deemed dividends subject to non-resident withholding tax with respect to the value of investments in foreign affiliates, or reductions of paid-up capital of shares relating to such investments. These proposals are particularly controversial because of the wide variety of situations to which the rules potentially apply: to corporations resident in Canada ("CRICs") where the subject corporation, i.e., the investee, is (or becomes) a foreign affiliate[1] of the CRIC, and the CRIC is (or becomes) controlled by a non-resident corporation. Investments are very broadly defined, including the acquisition of shares or contribution of capital (now including "benefits" conferred by the CRIC), transactions where the subject corporation becomes indebted to the CRIC or related company, and acquisitions of options in respect of shares or debt. In fact, the revised proposals would be expanded further by the August 14, 2012 draft legislation to cover shares of another corporation resident in Canada that in turn derives more than 50% of the fair market value of its assets (subject to certain adjustments) from underlying shares of foreign affiliates, as well as the extension of maturity/redemption dates of debts/shares owned by the CRIC.

Purple Haze — Strategic Business Expansions

A key exception may apply in the context of a "strategic business expansion", according to stated criteria. Tax practitioners had already criticized these criteria as being uncertain in application, particularly in view of the broad swath of the proposal. It is unlikely that the criteria brought forth in the August 14, 2012 legislation will be perceived to be an overall improvement: the CRIC must demonstrate that *all* of the required conditions are met. Notably, the investment must remain *more closely connected* with the business activities carried on in Canada by a CRIC than to other non-residents of the group. Officers of the CRIC must exercise principal decision-making authority in respect of making the investment and a majority of those officers must be resident and work principally in Canada at the investment time. Similar expectations in respect of ongoing activities must be met, including in respect of the majority of ongoing executive compensation and performance evaluation of the CRIC's Canadian-based executives *vis-à-vis* the subject corporation.[2]

Apart from the strategic business expansion exemption, under the August 14, 2012 draft legislation, the proposals would be restricted in two other ways. First, they would not apply to foreign affiliates acquired by virtue of certain corporate reorganizations (but exceptions apply to the indebtedness assumed by the CRIC). Second, the proposals would not apply to investments in the form of foreign affiliate indebtedness to a CRIC incurred after March 28, 2012, if an election was made under new section 17.1, relating to so-called pertinent loan indebtedness ("PLI"), provided the CRIC includes in income an interest factor at the prescribed rate plus 4% (i.e., currently 5%) during the period the PLI is outstanding (or the rate applicable to debt obligation to fund the PLI, if higher).

A corresponding amendment would be made to subsection 15(2) permitting loans to a CRIC's foreign parent (or a foreign sister company, for example) without triggering the deemed dividend and withholding tax that can otherwise arise. These elections would be made on a borrower-by-borrower basis, not a loan-by-loan basis. But note the minimum rate on loans that is exigible annually, and compare that with the applicable withholding rate.

I suspect that advisers to multinationals will be less than pleased with the proposals, particularly with demonstrating the requirements for the strategic business expansion exemption.[3] This task will be difficult enough in the case of large multinationals, let alone smaller foreign-owned businesses. Interestingly, however, the draft legislation now includes new rules that may allow the reduction of a CRIC's paid-up capital in its shares to avoid the consequences of the deemed dividend. The conditions for making such an election vary, e.g., depending on whether there is more than one class of shares outstanding; in addition, all shares of the CRIC not owned by the foreign parent must be owned by persons dealing at arm's length with the CRIC.[4] The election can have other tax implications (e.g., thin capitalization limits, which, if exceeded, may trigger withholding tax under other proposals).

Thus, the anti-dumping proposals will presumably take their place as convoluted international provisions, with varying tax impact. By the way, the time frame for providing comments on the draft legislation is less than a month after their release — September 13, 2012. By now, international tax practitioners must be hard at work preparing submissions, which will probably lead to even more convolutions in the already-complex proposals.

Although the August 14, 2012 draft legislation was particularly interesting, shortly before this, the government released other rather notable documents. Actually, the date of the CRA's release on tax shelters (July 30, 2012) may be at least as interesting as the actual content of the release itself, which echoed about a dozen similar releases over the years. These CRA releases have tended to come in the fall and are often focused on charitable donation schemes, so this more general release about the perils of tax shelters was somewhat out of the norm.

Shortly afterward, other releases were focused on consultations regarding the impact of contingency fees on the scientific research and experimental development ("SR&ED") tax incentive program. Ostensibly, the consultations seek input on several issues, such as why firms hire tax preparers on a contingency fee basis, why these tax preparers charge contingency fees, the impacts of this practice on the effectiveness of the SR&ED program, etc. One suspects, however, that the consultations are more about process than answers to such questions, which are rather obvious. As readers may remember, proposed section 237.3 would enact a reportable transaction regime, applicable to tax avoidance that is entered into after 2010 (or that is part of a series of transactions that began before 2011 and is completed after 2010). Contingency fees are one of three hallmarks of a reportable transaction (to be reportable, a transaction must contain two out of three such hallmarks). Anyone remember Altamont?

Notes:

[1] Either immediately after the investment is made, or as a result of the series that include making the investment.

[2] The strategic business expansion exemption and some of the corporate reorganization exemptions do not apply to investments in preferred shares and the like, except in wholly owned situations.

[3] Although one might envision the "demonstration" process taking place before a tribunal or similar body, rather than ultimately taking place in court pursuant to reassessment, no such procedure is specifically mentioned in the proposals. Because the issue is largely dependent on applicable facts, it is uncertain whether the CRA will consider granting a ruling on the issues.

[4] For example, the election will not be available where a holding company is interposed.

DRAFT LEGISLATION RELEASED FOR 2012 BUDGET PROPOSALS

On August 14, 2012, the Department of Finance released draft income tax legislation and explanatory notes to implement most of the remaining 2012 Budget proposals. CCH has prepared *Special Report* No. 066H, 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 emailing cservice@cch.ca.

Resolution 16, Life Insurance Policy Exemption Test, is not included in the release. The 2012 Budget document indicated that the government would consult with stakeholders over a period of months and that amendments arising from the consultations would apply to life insurance policies issued after 2013.

The remaining Budget proposals are described in News Release No. 2012-089, reproduced below. Any comments by interested parties are to be submitted by September 13, 2012.

> The Department of Finance today released for consultation draft legislative proposals that would implement a range of important tax measures from Economic Action Plan 2012 — A Plan for Jobs, Growth and Long-Term Prosperity.
>
> The draft legislative proposals include the following measures:

Personal Income Tax

- Improving Registered Disability Savings Plans (RDSPs) following the review of the RDSP program in 2011 [Budget Resolution 1 — the remaining proposals other than the portion allowing certain family members to be RDSP plan holders that was included in Bill C-38].
- Including an employer's contributions to a group sickness or accident insurance plan in an employee's income to the extent that the contributions are not in respect of wage-loss replacement benefits payable on a periodic basis [Budget Resolutions 4 and 5].
- Amending the rules applicable to retirement compensation arrangements to prevent certain schemes designed to inappropriately reduce tax liabilities [Budget Resolutions 6 to 11].
- Amending the rules applicable to Employees Profit Sharing Plans to discourage excessive contributions for employees with a close tie to their employer [Budget Resolutions 12 to 14].

Corporate Income Tax

- Expanding the eligibility for the accelerated capital cost allowance for clean energy generation equipment to include a broader range of bioenergy equipment [Other measures — Class 43.2].
- Phasing out the Corporate Mineral Exploration and Development Tax Credit [Budget Resolution 17].
- Phasing out the Atlantic Investment Tax Credit for activities related to the oil & gas and mining sectors [Budget Resolution 18].
- Providing that qualified property for the purposes of the Atlantic Investment Tax Credit will include certain electricity generation equipment and clean energy generation equipment used primarily in an eligible activity [Budget Resolution 19].
- Reducing the general Scientific Research and Experimental Development (SR&ED) investment tax credit rate to 15 per cent from 20 per cent [Budget Resolutions 20 and 21].
- Reducing the prescribed proxy amount, which taxpayers use to claim SR&ED overhead expenditures, from 65 per cent to 55 per cent of the salaries and wages of employees who are engaged in SR&ED activities [Budget Resolutions 20 and 21].
- Removing the profit element from arm's length third-party contracts for the purpose of the calculation of SR&ED tax credits [Budget Resolutions 20 and 21].
- Removing capital from the base of eligible expenditures for the purpose of the calculation of SR&ED tax incentives [Budget Resolutions 20 and 21].
- Preventing the avoidance of corporate income tax through the use of partnerships to convert income gains into capital gains [Budget Resolutions 22 to 26].

International Taxation

- Ensuring that transfer pricing secondary adjustments will be treated as dividends for Part XIII withholding tax purposes [Budget Resolution 28].
- Improving the integrity and fairness of the thin capitalization rules by [Budget Resolutions 29 to 32]:
  - reducing the debt-to-equity ratio from 2-to-1 to 1.5-to-1;
  - extending the scope of the thin capitalization rules to debts of partnerships of which a Canadian-resident corporation is a member;
  - treating disallowed interest expense under the thin capitalization rules as dividends for Part XIII withholding tax purposes; and
  - preventing double taxation in certain circumstances where a Canadian resident corporation borrows money from its controlled foreign affiliate.
- Restricting the ability of foreign-based multinational corporations to transfer, or "dump", foreign affiliates into their Canadian subsidiaries, while preserving the ability of these subsidiaries to undertake legitimate expansions of their Canadian businesses [Budget Resolutions 33 to 40].
- Phasing out the Overseas Employment Tax Credit [Budget Resolution 41].

The measures listed above apply as indicated in Budget 2012, generally on March 29, 2012. In a few cases, modifications to the measures have been made that will apply as of today's date. References to "Announcement Date" in the draft legislative proposals are to be read as references to today's date. Explanatory notes are included with the draft legislative proposals.

Interested parties are invited to provide comments on the draft legislative proposals by September 13, 2012. Please send your comments by email to ConsultationB2012tax-fiscalite@fin.gc.ca or by post to:

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SUPREME COURT OF CANADA DECISION IN *THE QUEEN V. CRAIG*

On August 1, 2012, the Supreme Court of Canada released its unanimous decision in *The Queen v. Craig*. The case concerned restricted farm losses. The taxpayer, a lawyer, also bought, sold, and raced horses. The Minister restricted the taxpayer's farm losses to the formula amount in subsection 31(1) of the *Income Tax Act*. Citing the Federal Court of Appeal decision in *Gunn* (2006 DTC 6544), the Tax Court of Canada allowed the taxpayer's appeal (2010 DTC 1032) and the Federal Court of Appeal upheld the decision (2011 DTC 5047). The Supreme Court dismissed the Crown's appeal and overruled its decision in *Moldowan* (77 DTC 5213).

EXISTING RETIREMENT COMPENSATION ARRANGEMENTS UNDER ATTACK

— David C. Nathanson, Q.C., Davis LLP

There was an elaborate description of the effect on retirement compensation arrangements ("RCAs") in the 2012 federal Budget. There are, however, countless RCAs that are currently under attack by the Canada Revenue Agency ("CRA"), which, for various reasons, the CRA considers not to be RCAs but salary deferral arrangements ("SDAs").

The main reason for the CRA's position is that these putative RCAs have used the amounts contributed to them and, in some cases, borrowed money to lend, directly or indirectly, to the contributing employer on favourable terms.

While it has not done so in its reassessment proposal letters to taxpayers affected, the CRA has signified a willingness to "settle" such cases by withdrawing the reassessment proposal if the loan is repaid to the RCA and the proceeds of the loan are invested by the RCA on more conventional terms. Many taxpayers have accepted this proposal rather than having the RCA beneficiary reassessed on the basis of inclusion of the full amount in his or her income of the amount contributed to the RCA and fighting the CRA on principle inasmuch as they simply do not see the fight as being worth the candle.

However, there may be many situations in which it is simply not possible for the contributing employer to repay the loan to the RCA because of financial constraints. In such situations, the RCA beneficiary will be compelled to fight.

What must the RCA beneficiary fight?

First, there is the substantive question of whether the putative RCA is truly an RCA or an SDA.

Second, even if the putative RCA is truly an SDA, there is the procedural question of whether the CRA is statute-barred from reassessing the RCA beneficiary.

As to the first question, the statutory definition of an RCA expressly excludes an SDA. An SDA is defined in subsection 248(1) of the *Income Tax Act* (the "Act") to mean, in respect of a taxpayer, "a plan or arrangement . . . under which any person has a right in a taxation year to receive an amount after the year where it is reasonable to consider that one of the main purposes for the creation or existence of the right is to postpone tax payable under this Act by the taxpayer in respect of an amount that is, or is on account or in lieu of, salary or wages of the taxpayer for services rendered by the taxpayer in the year or a preceding taxation year (including such a right that is subject to one or more conditions unless there is a substantial risk that any one of those conditions will not be satisfied) . . .".

There is a whole host of reasons on which the CRA focuses to treat an arrangement set up as an RCA to be an SDA, one of which is the "loan back", which the CRA does not like.

In the 2012 Budget, the Department of Finance said this:

> The Canada Revenue Agency has identified a number of arrangements that seek to take advantage of various features of the RCA rules in order to obtain unintended tax benefits. For example, some arrangements involve the deduction of large contributions that are indirectly returned to the contributors through a series of steps ending with the purported RCA having little or no assets but still being able to claim the refundable tax using the impaired asset exception. Other arrangements use insurance products to allocate costs to the arrangement for benefits that arise outside the arrangement.
>
> The Government is challenging these tax-motivated arrangements, which are not consistent with the policy intent of the RCA rules. Since these challenges are both time-consuming and costly, the Government is acting now to introduce specific legislative measures to prevent the use of similar schemes in future.

Despite the government's legislative initiative to make loan backs "prohibited investments" under the Budget, arrangements entered into prior to the Budget are still exposed because of subsection 45(2) of the *Interpretation Act*, which reads as follows:

> The amendment of an enactment shall not be deemed to be or to involve a declaration that the law under that enactment was or was considered by Parliament or other body or person by whom the enactment was enacted to have been different from the law as it is under the enactment as amended.

The second question posed above is really the anterior, and more important, question.

If the putative RCA is really an SDA, then, by virtue of subsection 6(11) of the Act, "[w]here at the end of a taxation year any person has a right under [an SDA] in respect of a taxpayer to receive a deferred amount, an amount equal to the deferred amount shall be deemed, for the purposes only of paragraph [6](1)(*a*), to have been received by the taxpayer as a benefit in the year, to the extent that the amount was not otherwise included in computing the taxpayer's income for the year or any preceding taxation year". And a "deferred amount" at the end of a taxation year under an SDA in respect of a taxpayer means, by virtue of subsection 248(1) of the Act,

> *(a)* in the case of a trust governed by the arrangement, any amount that a person has a right under the arrangement at the end of the year to receive after the end of the year where the amount has been received, is receivable or may at any time become receivable by the trust as, on account or in lieu of salary or wages of the taxpayer for services rendered in the year or a preceding taxation year, and
>
> *(b)* in any other case, any amount that a person has a right under the arrangement at the end of the year to receive after the end of the year.

For the purposes of this statutory definition, a right under the arrangement shall include a right that is subject to one or more conditions unless there is a substantial risk that any one of those conditions will not be satisfied.

In many instances, the beneficiary of the putative RCA is deemed to have received the deferred amount by virtue of the contribution made by the employer to the putative RCA in a year long prior to the end of the "normal reassessment period" for that year. Paragraph 6(1)(*a*) of the Act requires the inclusion of the deferred amount in computing the income of the taxpayer for a taxation year as income from an office or employment. The deferred amount cannot be included in computing the taxpayer's income for any year subsequent to the year in which the right to receive it accrued because it has been "otherwise included in computing the taxpayer's income for . . . [a] preceding taxation year", as contemplated by subsection 6(11) of the Act.

Just as a taxpayer to whom subsection 6(11) of the Act applies has no right to pick and choose which year the deferred amount is brought into his or her income, so too does the CRA not have the right to pick and choose. The deferred amount is ascertained, and subjected to tax, only once: in the year the right is received. Subsequent accruals to the deferred amount are taxed separately by virtue of subsection 6(12) of the Act, which subjects to tax in each year the incremental increase in income accumulated on the deferred amount in that year. Subsection 6(12) of the Act reads as follows:

> Where at the end of a taxation year any person has a right under [an SDA] (other than a trust governed by [an SDA]) in respect of a taxpayer to receive a deferred amount, an amount equal to any interest or other additional amount that accrued to, or for the benefit of, that person to the end of the year in respect of the deferred amount shall be deemed at the end of the year, for the purposes only of subsection [6](11), to be a deferred amount that the person has a right to receive under the arrangement.

Thus, subsequent accruals to the deferred amount are taxed separately by virtue of subsection 6(12) of the Act, which subjects to tax in each year the incremental increase in income accumulated on the deferred amount in that year.

Therefore, the only amount that could be taxed in the year in which the right to receive the deferred amount was received or in any subsequent year will be the amount that "accrued to, or for the benefit of" the taxpayer on the deferred amount, i.e., the amount accrued on the original contribution in that particular year.

The operation of these provisions is summarized neatly in the 2003 Conference Report paper entitled "Executive Arrangements: Innovations and Issues" by Anne E. Montgomery, who points out that if a plan is characterized as an SDA, "the participant will be taxed in the year in which the right to the deferred amount arises [citing subsection 6(11) of the Act] and as income accumulates under the plan [citing subsection 6(12) of the Act], rather than when benefits are subsequently paid under the arrangement".

The CRA itself has stated in paragraph 12 of IT-529, entitled "Flexible Employee Benefit Programs" and dated February 20, 1998, that "[a]mounts deferred under [an SDA] are included in the employee's income in the year they are earned under paragraph 6(1)(*a*) by virtue of subsection 6(11)" and that "[a] deferred amount means an amount at the end of the year that the employee has a right to receive in the future".

It is trite law that a taxpayer's tax liability is created by his or her taxable income under the Act and not by the way in which he or she reports his or her income or by the way in which the CRA assesses or reassesses. Therefore, if the putative RCA is an SDA and a deferred amount arose in the year in which the contribution was made by the employer, then in most cases it would have been made in a year that is now long statute-barred.

The CRA, on the other hand, takes the position that it is free to reassess the deferred amount for the earliest year that is not statute-barred on the basis that, inasmuch as the deferred amount was not reported or assessed in such a year or in any preceding year, it qualifies as not being "otherwise included in computing the taxpayer's income for the year or any preceding year," within the meaning of subsection 6(11) of the Act. This is an exceedingly aggressive, not to say fatuous, position to take. We shall see in due course whether the CRA is correct or, as is generally thought, decidedly wrong.

The CRA has also stated that it will hold "in abeyance" the refundable tax paid under Part XI.3 of the Act, whether the RCA is indeed such or is instead an SDA. If the arrangement is an SDA, then the tax was withheld on account of tax payable under Part XI.3, and if there was no such tax payable because the arrangement was an SDA, then there was an overpayment of such tax, which must be refunded. It seems rather risky, then, for the CRA to take the position that it is taking because it may end up with no tax at all as a result of its reassessment of the beneficiary in a statute-barred year, and it may have to refund tax withheld on account of tax payable under Part XI.3. On the other hand, if the CRA recognizes the RCA as an RCA, then it will ultimately receive tax on amounts payable by the RCA when distributions are made to the beneficiary.

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