Tax Notes

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INCOME TAX AMENDMENTS

Bill C-45, Jobs and Growth Act, 2012

On October 18, 2012, Bill C-45, the *Jobs and Growth Act, 2012*, received first reading in the House of Commons. This Bill contains the income tax measures that were in the Notice of Ways and Means Motion tabled on October 15, 2012 (CCH *Special Report* No. 067H). Bill C-45 also contains a number of non-tax amendments, including those affecting environmental assessment, fisheries, shipping, and cross-border travel.

Technical Amendments and Other Measures

On October 24, 2012, the Minister of Finance tabled a Notice of Ways and Means Motion to implement a large number of income tax amendments and a few GST/HST technical amendments (CCH *Special Report* No. 068H). The Notice of Ways and Means Motion is divided into seven parts. Part 1 contains amendments relating to non-resident trusts and offshore investment property. This replaces Part 1 of the draft legislation released on August 27, 2010. Parts 2 and 3 contain amendments relating to foreign affiliates which replace the draft legislation released on August 27, 2010 and the draft legislation released on August 19, 2011 concerning foreign affiliates. Part 4 contains the amendments relating to bijuralism, which replaces Part 2 of the draft legislation released on July 16, 2010. Part 5 contains numerous amendments including those proposed in the 2010 Budget concerning reporting tax avoidance transactions, foreign tax credit generators, loss trading re SIFT conversions, and regulations amending the specified leasing rules, which were included in Part 3 of the August 27, 2010 draft legislation; technical amendments that were in Part I of the draft legislation released on July 16, 2012; and further technical amendments that were released on November 5, 2010 and on October 31, 2011. Part 5 also includes amendments relating to real estate investment trust rules that were released on December 16, 2010. Part 6 contains a few amendments to the *Excise Tax Act* that were announced on October 31, 2011. Part 7 contains coordinating amendments.

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FOCUS ON CURRENT CASES

This is a regular monthly feature examining recent cases of special interest, coordinated by *John C. Yuan* and *Christopher L.T. Falk* of McCarthy Tétrault LLP. The contributors to this feature are from McCarthy Tétrault LLP, Montreal, Toronto, Calgary, and Vancouver.

A Change in Use Begins with a Change in Intention

***Robert Peluso v. The Queen*, 2012 DTC 1166 (Tax Court of Canada)**

In this case, the Tax Court decided several appeals on the issue of whether land had been converted from inventory to capital property. The key consideration was whether a positive act was taken to change the use of the land from its initial acquisition as inventory to a type of property the disposition of which may result in a capital gain such as an investment or a capital asset of a business. In this case, the judge found that no change of use took place.

The Clifton Group Inc. generally earned income through the acquisition and management of commercial properties held as long-term investments, such as shopping centres. Other legal entities, such as the Meander Limited Partnership ("Meander") and JR Investments Limited Partnership ("JR"), the limited partnerships in this case, owned the property and paid management fees to the Clifton Group for its services. There was no dispute that the land at issue was acquired as inventory.

The first parcels of land at issue were acquired with the intention of putting in services and selling off lots to builders. The project was expected to be accomplished in several phases; however, numerous challenges presented themselves and development ceased following phase 1. Without a clear idea of how to proceed, an unsolicited offer to purchase the land was accepted on December 17, 2004. Subsequently, it was agreed that the purchaser would acquire all the Meander lands in phases: phase 3 in May 2005 and phase 4 in August 2006 (the completion of phase 2 was delayed until 2008 because of litigation). The Meander 2004 financial statements showed income from the sales of the phase 1 land. The Meander 2005 and 2006 financial statements showed distinct treatment for the phase 1 lots and for the sale of land that was destined for other phases. The notes to the 2006 financial statements indicated that the land development had been abandoned in 2005 and the remainder of the land was sold in bulk.

JR was involved in projects whereby the Clifton Group had been developing land to increase the number of residents near one of its shopping centres. JR sold most of the land as serviced lots and reported the revenue on income account. However, the four parcels of land at issue were sold unserviced and reported as giving rise to capital gains. The Minister reassessed to treat the gains as business income. The Tax Court upheld the reassessment and applied the same principles in respect of the Meander and JR lands in reaching its decision.

In both analyses, the Tax Court recalled the principles outlined in *Edmund Peachey Ltd. v. The Queen* (79 DTC 5064) requiring that for a change in use to take place, a clear and unequivocal positive act must be taken to implement the change. The Tax Court did not find any evidence demonstrating that a conversion of the land took place. Instead, the Tax Court decided that there had been a bulk sale of land which, without a conversion, remained inventory giving rise to income upon disposition. The Tax Court clarified that although there was a clear decision to change the plan and stop development, there was no evidence demonstrating a change in use. Had there been a stated intention to change the use of the land, the Tax Court would have considered the stated intention and the surrounding circumstances to determine the existence of a change of use. However, circumstances such as selling the land unserviced based on unsolicited offers do not, on their own, constitute a change in use.

It is worth noting that the Tax Court accepted the taxpayer's uncontested argument that vacant land could change uses from inventory to capital property. Justice Jorré did not need to pursue this question, as his decision was based on other reasons, but he noted that this finding was consistent with the minority and not the majority decision of the Supreme Court of Canada in *Friesen* (95 DTC 5551). The 3-2 majority held that the *Income Tax Act* contemplates two broad categories of property, which cannot change from one year to another. Interpretation Bulletin IT-218R (September 16, 1986) provides that where real estate is vacant land, any gain on its sale is business income and not a capital gain.

As a final point, one might consider what type of clear and unequivocal positive act a taxpayer could have taken in these circumstances to demonstrate the change in use of the land. A change in use from inventory to capital property may be particularly tricky because it may mean ceasing to develop land and beginning to merely hold it as an investment. IT-218R addresses the conversion of real estate from inventory to capital property and, while it excludes vacant land, it depicts how such a conversion may be undertaken. IT-218R provides that real estate may be converted by establishing that the original intention has been abandoned, by capitalizing the cost of the real estate, and by making use of the real estate as a capital asset that is indicative of investing rather than trading, for example, by renting it or using it to house the taxpayer's business. While these steps are consistent with the Tax Court's findings in *Peluso*, questions remain in regard to whether such a conversion may take place in respect of vacant land. That said, it

is clear from the authorities that evidence of both the taxpayer's change in intention and resulting actions will be required to prove there has been a change in use for tax purposes.

— *Lindsay Hollinger*

No Penalty for Failure To Withhold Source Deductions on Dividend Turned Wages

***Maxi Maid Services Ltd.*, 2012 DTC 1174 (Tax Court of Canada)**

The issue in *Maxi Maid* was whether the taxpayer corporation was liable for a penalty for failure to withhold and remit source deductions on an amount that the corporation initially disbursed as a dividend and recharacterized as salary in a subsequent year. The Tax Court held that the penalty did not apply.

During the 2008 tax year, Maxi Maid deviated from its normal practice of paying biweekly wages to its sole shareholder and director to making biweekly payments to him in the form of dividends. In 2008, these dividend draws were composed of amounts between $1,800 to $2,000, totalling approximately $40,000 for the year. In the following April, the sole shareholder met with the corporation's accountant during the course of filing his personal income tax return to obtain documentation to report the dividend income. The accountant advised the shareholder that Maxi Maid was not able to pay dividends in 2008 and that the company would be required to recharacterize the "dividend" draws paid in the prior year as salary and make adjusting entries in the company's books. The taxpayer prepared the necessary T4 slip reflecting $50,000 salary in 2008 and calculated the required source deductions on the $50,000 wage, which amounted to $12,773. The source deductions were remitted to the Canada Revenue Agency in May 2009.

Upon receiving Maxi Maid's T4 Summary showing $50,000 in salary paid in 2008, the Minister assessed a late filing penalty pursuant to subsection 227(9) of the *Income Tax Act* (the "Act"). Subsection 227(9) imposes a penalty when a person withholds an amount pursuant to the Act but does not remit the amount "as and when required" by the Act. Presumably, the Minister assessed a penalty pursuant to subsection 227(9) on the theory that Maxi Maid withheld and remitted the correct amount in May 2009 but that the remittance was late because the corresponding wages were paid in 2008. However, in the Tax Court's view, since no amount was withheld in 2008 when Maxi Maid paid the "dividend" amounts, a penalty under subsection 227(9) could not apply in the circumstances. The Minister's failure to assess a penalty under the provision in the Act that covered the failure to withhold — subsection 227(8) — was sufficient for the Tax Court to allow the taxpayer's appeal and vacate the assessment of the penalty.

The Tax Court recognized that the Minister would in all likelihood turn around and issue an assessment for a penalty on the basis of the same facts under subsection 227(8) and, to reduce the "waste of time, effort and resources" that would be associated with the parties disputing a fresh assessment imposing a subsection 227(8) penalty, the Court decided to provide its views on whether a penalty assessment under subsection 227(8) would be upheld on the same facts.

The taxpayer's position was that, since the amounts being drawn were not characterized as salary in 2008, there was no remittance required at that time, i.e., during 2008. The remittance was not required until the dividend payments were subsequently recharacterized as salary in April 2009 and was promptly remitted in May 2009. In other words, the withholding was remitted at the time it was due. The Minister's position was that the biweekly payments issued by Maxi Maid were always salary payments and that this conclusion was supported by the fact that in the years prior and subsequent to the 2008 taxation year, payments issued by Maxi Maid to its sole shareholder were issued by way of salary.

The Tax Court began its review of the facts by noting that the Minister bears the onus on proving the assessment of the penalty under subsection 227(8) or (9).

First, the Tax Court found that the Minister was unable to meet the onus of proving that an amount was withheld by Maxi Maid in 2008; as noted earlier, the Tax Court allowed the taxpayer's appeal of the penalty assessment that was under appeal.

Second, as part of the Tax Court's analysis of whether a subsection 227(8) penalty could have been upheld on these facts, the Tax Court determined that the Minister did not demonstrate on a balance of probabilities that Maxi Maid paid salary during 2008. Although the taxpayer did not produce any of the company's book or records, the Tax Court

was satisfied that the evidence by the company supported a conclusion that the subject payments were distributed as dividends and that this evidence was uncontradicted by the Minister. However, this determination was not sufficient to dispose of the subsection 227(8) question, as the Court went on to consider whether the adjustments made in 2009 to the 2008 journal entries had the effect of changing the characterization of the payments from dividends to salary with retroactive effect back to the dates the payments were made. The Tax Court declined to come to a conclusion on the temporal impact of the changes reflected in the journal entries. Rather, the Tax Court found that, even if the journal entries had retroactive effect, subsection 227(8) provides for a due diligence defence that applied in the circumstances. The Tax Court found that, at the relevant time, there was no intention on the part of Maxi Maid to distribute money to the sole shareholder and director by way of salary. Accordingly, Maxi Maid could not then be faulted for failing to withhold source deductions, as the company was acting reasonably and in line with commercial reality (and common practice for small businesses) to wait until year end to determine how the owner/manager will be paid.

The *Maxi Maid* case is notable because it confirms that a due diligence defence may be available if the Minister imposes a penalty for the failure to withhold and/or remit payroll source deductions from salary and wages in a small private company context where an amount that the company originally paid as a dividend to its owner/shareholder is later recharacterized as salary/wages.

— *Jeremy Pleasant*

MANDATORY ELECTRONIC FILING FOR TAX PREPARERS — QUESTIONS AND ANSWERS

As described in *Tax Notes* No. 593, dated June 2012, the *Income Tax Act* was amended to require tax preparers who file more that 10 returns to file them electronically. This requirement is for 2012 tax returns filed after 2012 (subsection 150.1(2.3) of the *Income Tax Act*). The Canada Revenue Agency has released some questions and answers regarding this change which are reproduced below.

Q1. I am a tax preparer; how will this affect me?

A1. If you are an individual, a corporation or a partnership, and you accept payment to prepare more than 10 T1 General income tax and benefit returns or more than 10 T2 corporation income tax returns per year, you must file those returns electronically. An employee who prepares returns as part of their work duties is not a tax preparer.

Q2. Are there any exceptions to the new legislation?

A2. The following returns do not need to be filed electronically:

- returns for tax years before 2012;
- T1 General income tax and benefit returns filed after November 30;
- excluded T1 returns; and
- T2 returns with restrictions.

Other exceptions apply if you are a tax preparer who:

- applied to use EFILE, but was not accepted; or
- had EFILE privileges suspended or revoked.

Q3. How do I file electronically?

A3. If you prepare and file more than 10 T1 General income tax and benefit returns, you will be required to file them electronically through the Canada Revenue Agency (CRA) EFILE system. EFILE is an automated service that permits approved tax preparers to file current year income tax and benefit returns online.

If you prepare and file more than 10 T2 corporation income tax returns, you will be required to file them electronically through the available service in Represent a Client or through Corporation Internet Filing.

Q4. I have never filed electronically. How do I start?

A4. As a tax preparer, you will need to register with the CRA in order to be allowed to file T1 General income tax and benefit returns electronically. This must be done at least 30 days before the service is required.

For more information on how to register for T1 General returns, go to EFILE — New Registration.

For more information on how to register for T2 corporation returns or how to file corporation returns electronically, go to Corporation Internet Filing.

Q5. I currently file my clients' returns electronically. Do I need to re-register?

A5. If you currently file your clients' returns electronically with an EFILE number, you need to renew your EFILE eligibility every year. As such, you will be contacted to renew your registration every year in late October.

Q6. I use in-house software to file returns for my clients, but I don't use EFILE. What do I do?

A6. Your software package will need to be certified by the CRA before you can use it to file electronically. To find out more about certification:

For T1 General returns: EFILE — Software

For T2 corporation returns: Corporation Internet Filing

Q7. Are there penalties if I do not comply with the new legislation?

A7. If you are required to file electronically but do not comply, you may be charged a penalty of $25 for each T1 General return that is paper-filed and $100 for each T2 corporation return that is paper-filed.

Q8. Where can I get help to file returns electronically?

A8. For T1 General returns, contact your EFILE Helpdesk.

For T2 corporation returns, contact our Corporation Internet Filing Helpdesk.

INVESTMENT TAX CREDIT — LEASING PROPERTIES

The Canada Revenue Agency (the "CRA") was asked to consider whether a taxpayer can claim an investment tax credit ("ITC") under s. 127(5) of the *Income Tax Act* (the "Act") on tangible property that is subject to a joint election made in prescribed form pursuant to s. 16.1 of the Act.

Section 16.1 was originally introduced in 1989 to permit a lessee in certain situations to treat a lease as a purchase of the leased property and to treat the rental payment not as rent but as a blended payment of principal and interest on a loan if the lessor and lessee so jointly elect under the provisions of the Act. In 1998, the provisions were amended to attack the use of leasing arrangements as a means of arranging after-tax financing. The amendments responded to a growing concern that non-tax-paying entities were trading their capital cost allowance deductions to lessors for reduced lease payments. The overall effect of such arrangements would be a reduction in tax revenues. Consequently, the Department of Finance introduced legislation restricting capital cost allowances for lessors in certain situations.

As noted above, s. 16.1 of the Act sets out an elective scheme of rules which apply to treat a lease as a loan. The election must be made by both the lessee and the lessor in prescribed form with their returns of income for their taxation years that include the year in which the lease commenced. The election is available only with respect to leased tangible property, other than prescribed property, that would otherwise have been depreciable property. The property must be leased from a person resident in Canada or a person who carries on business in Canada through a permanent establishment in Canada, provided that the property is used in connection with that establishment and the income from that business is taxable in Canada. As well, the lease must be for a term of more than one year. The exclusion of short-term leases is a concession which recognizes that short-term leases are not normally used as a means of after-tax financing.

As also noted above, if the election is filed, s. 16.1(1)(*a*), (*b*), and (*c*) deem the lessee to have acquired the property at its fair market value and to have borrowed an equivalent amount from the lessor for the purpose of acquiring the property. The reference to the purpose for the borrowing is relevant since it assists in establishing the deductibility of interest on the deemed loan. Under s. 16.1(1)(*d*), interest will be deemed to accrue on the principal amount of the

deemed loan at the prescribed rate in effect at the earlier of the time the lease agreement is entered into and the time the lease commences.

Subsection 127(5) of the Act provides for the deduction of a taxpayer's investment tax credit earned on certain property acquisitions and expenditures. Subsection 127(9) of the Act provides the rates at which qualified property acquisitions and qualified expenditures earn investment tax credits in a particular year and defines what property and expenditures are eligible for the credit. To be "qualified property" pursuant to s. 127(9), the property must be new property which has not been used or acquired for use or lease for any purpose prior to its acquisition. To qualify for the credit, the prescribed building or equipment must be used primarily in one of a broad range of activities.

In CRA Document No. 2011-0417811E5, "Investment Tax Credit and 16.1(1)" (October 6, 2011), the CRA stated that "where a lessor acquires a depreciable property that has never been used or leased by any person before the time it is leased to a particular lessee and the lessor and lessee have made a valid election in respect of that property pursuant to s. 16.1(1) of the Act, the fact that s. 16.1(1)(*b*) of the Act deems the lessee to have acquired the particular property from the lessor for its fair market value, would not, in and of itself, mean that the second requirement described above could never be met by the particular lessee." The CRA now advises that the earlier statement was an "inadvertent" extension of its position expressed in paragraph 72 of IT-151R5 (Consolidated) in respect of scientific research and experimental development expenditures. In the CRA's view, that extension is not in accordance with the law or the CRA's understanding of tax policy. CRA Document No. 2011-0417811E5 has, therefore, been revoked.

Accordingly, property that is otherwise qualified property for the purposes of s. 127(9) would not qualify if a s. 16.1 election has been made in respect of that property.

See also CRA Document No. 2004-0109381E5 "Prepaid Lease and Election Under 16.1" (February 22, 2005).

— *External Technical Interpretation, Capital Transactions Section, May 14, 2012, Document No. 2012-0440531E5*

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For CCH Canadian Limited

Susan Peart, C.A., LL.M.
(416) 224-2224, ext. 6434
email: Susan.Peart@wolterskluwer.com

Natasha Menon, Content Product Manager
Tax, Accounting and Financial Planning
(416) 224-2224, ext. 6360
email: Natasha.Menon@wolterskluwer.com

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CCH Canadian Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
416 224 2248 · 1 800 268 4522 tel
416 224 2243 · 1 800 461 4131 fax
www.cch.ca

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