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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.

An Agent's Fees for Negotiating an Employment Contract for a Professional Athlete Are Non-Deductible

***Caruso v. The Queen*, 2012 DTC 1200 (Tax Court of Canada, Informal Procedure)**

The Tax Court of Canada in *Caruso* was asked to consider whether a professional athlete is entitled to deduct the fees paid to an agent to negotiate a player contract with a professional sports team.

Michael Caruso is a professional hockey player. In 2006, he engaged an agent to represent, advise, counsel, and assist him in conducting negotiations towards an employment contract.

Caruso entered into a three-year contract with the Florida Panthers hockey team in 2008. Pursuant to the terms of the agency agreement, Caruso paid his agent a fee of $2,927.64, which represented a percentage of the taxpayer's signing bonus instalment and minimum salary for the 2008-09 minor league season.

In his tax return for the 2008 taxation year, Caruso deducted the fees paid to his agent in computing his income from employment on the basis that these fees were legal expenses incurred to establish a right to salary or wages and are deductible under paragraph 8(1)(*b*) of the *Income Tax Act* (the "Act"). Following an assessment of Caruso's 2008 tax return, the Minister disallowed the deduction. Caruso appealed the Minister's assessment position to the Tax Court of Canada.

The primary issue before the Tax Court was whether the payment of a fee for services provided by an agent during contract negotiations is deductible pursuant to paragraph 8(1)(*b*) in determining Caruso's income from employment in 2008. Pursuant to subsection 8(2) of the Act, an amount paid by the taxpayer will only be deductible in computing income from employment if there is a specific provision of the Act that permits such a deduction to be made. Paragraph 8(1)(*b*) allows a taxpayer to deduct an amount paid by the taxpayer for legal expenses incurred to collect or establish a right to salary or wages owed to the taxpayer by the employer or a former employer in computing the taxpayer's income from employment.

Justice Webb of the Tax Court dismissed Caruso's appeal and held that the agency fees paid by the taxpayer were not deductible because there was no indication that Caruso's agent was authorized to practice law, even if the guarantor of the agency agreement was a lawyer licensed to practice law in Ontario.

The Tax Court also questioned whether the services provided by Caruso's agent could be regarded as legal services even if provided by a lawyer but then went on to conclude that even if the assistance provided by Caruso's agent could be considered legal services for purposes of paragraph 8(1)(*b*), the services were not provided to collect salary or wages owed by a taxpayer or to establish a right to salary or wages. A right to salary or wages will exist when an employment contract is signed. This will occur after services to support negotiations have already been delivered by Caruso's agent.

One of the taxpayer's arguments was that the agent fee should be deductible under the proposed amendments to paragraph 8(1)(*b*). The proposed amendments to paragraph 8(1)(*b*) will allow a deduction for legal expenses incurred by a taxpayer to collect or establish a right to collect an amount that, if received, would be included in computing the taxpayer's employment income. This amendment will expand the application of paragraph 8(1)(*b*) to an amount that is not owed directly by an employer but does not change the character of the type of legal services that would meet the requirements for deductibility. Consequently, the Tax Court had no difficulty in concluding that the amended version of paragraph 8(1)(*b*) would not allow the deduction even if the amended provision was in force.

Consistent with the Canada Revenue Agency's published position in IT-168R3, "Athletes and Players Employed by Football, Hockey, and Similar Clubs," May 13, 1991, in relation to professional athletes, *Caruso* demonstrates that services rendered during employment contract negotiations do not establish a right to salary or wages. A taxpayer's right to salary or wages arises after an employment agreement is signed, which is generally the product of the services provided during negotiations.

— *Sherena Hussain, Student-at-Law*

Revival or Taxes

***S. Cunard & Company Limited v. Canada (Attorney General),* 2012 DTC 5122 (Federal Court of Canada)**

In this decision, the Federal Court decided that the Minister's refusal to accept a late-filed election under section 85 of the *Income Tax Act* (the "Act") in respect of a transfer of property was not unreasonable. The election must be made jointly by the transferee corporation and the transferor in prescribed form. In this case, the transferee corporation had been voluntarily dissolved before making the election and the Minister required the transferee corporation to be revived before a late-filed election would be accepted. However, New Brunswick corporate law would not allow the transferee corporation to be revived in the circumstances.

In 2004, S. Cunard & Company ("SC") entered into a purchase and sale agreement with 612482 NB Limited ("NBL"). SC transferred a 20% interest in Irving Oil, LLC in exchange for 100,000 preferred shares of NBL. The agreement provided that the transaction was to be completed on a rollover basis under subsection 85(1) of the Act, but the required election form was not filed before NBL was voluntarily dissolved pursuant to New Brunswick law.

In 2009, the Canada Revenue Agency (the "CRA") proposed a reassessment of SC because the section 85 election had not been filed. SC wrote a letter to the Minister requesting that a late-filed election be accepted pursuant to subsection 85(7.1) of the Act and filed the late election with the penalty required by paragraph 85(7.1)(*d*). SC's counsel had initially advised that steps were being taken to revive NBL for purposes of making the election, and the Minister's delegate advised that the CRA would accept the late election as long as SC could establish that NBL had the legal capacity to execute the election. Unfortunately, it was later determined that, under New Brunswick law, a corporation that has been voluntarily dissolved cannot be revived. SC then made an application to the Federal Court of Canada for judicial review of the Minister's refusal to accept the late-filed election.

In determining the appropriate standard of review, the Federal Court decided that the decision of whether to accept a late-filed election under subsection 85(7.1) of the Act is discretionary and deals with provincial and federal corporate legislation of which the CRA is familiar. Therefore, the Court found that the standard was reasonableness. The Court then went on to find that it was clear from subsection 85(1) and the relevant election form that both the transferor and transferee must make the election, which would require an authorized officer to sign on behalf of NBL. The Court also observed that it was well established in the jurisprudence that a person cannot bind a dissolved corporation unless it is revived. Accordingly, the Court found that the decision of the Minister's delegate was reasonable.

As the Federal Court was applying the reasonableness (rather than a "correctness") standard of review, the Court was not required to address an argument that SC put forward. SC suggested that the Minister had the discretion under the Act to accept a late-filed election executed by the authorized representative of a dissolved corporation in the same way that the Minister accepts a final tax return for a dissolved corporation signed by an authorized representative. This position is reinforced by the fact that subsection 85(6) of the Act provides that the deadline for filing the election is the same as the final tax return where a corporation elects and dissolves in the same year. For tax practitioners and taxpayers alike, it would have been helpful if the Court had addressed this conflict to provide direction for future cases.

That said, the practical take-away from this decision is that persons involved with the tax affairs of a corporation that is going to be dissolved should ensure that the corporation has made elections, received refunds, obtained certificates, and completed any necessary paperwork requiring the signature of an authorized officer prior to dissolution. Although the corporate law regimes in many Canadian jurisdictions have provisions that allow for corporations to be revived to address errors in this regard, as this case illustrates, the ability to revive a dissolved corporation under applicable corporate law is not always available.

— *Lindsay Hollinger*

Appellate Court Upholds Ruling on Alberta GAAR

***Husky Energy Inc v. The Queen*, 2012 DTC 5132 (Court of Appeal of Alberta) and *Canada Safeway Limited v. The Queen*, 2012 DTC 5133 (Court of Appeal of Alberta)**

The companion cases of *Husky Energy* and *Canada Safeway* considered whether the general anti-avoidance rule ("GAAR") in the *Alberta Corporate Tax Act* ("ACTA") was breached when taxpayers reorganized and refinanced to take advantage of Ontario's tax regime. At the relevant time, the Ontario *Corporations Tax Act* ("OCTA") did not tax corporations on interest income if they were incorporated outside Canada and resident in Ontario. In both cases, a corporation resident in Alberta paid interest to a corporation resident in Ontario and deducted the interest payments from income. The Ontario-resident corporation received the interest payments, but did not include them in computing taxable income for Ontario purposes, and declared dividends to its parent corporation, which corporation included the dividends in income but then claimed a dividend deduction. The Alberta Minister of Finance reassessed the respective taxpayers pursuant to GAAR to include interest in income of the Alberta corporation and to deny the intercorporate dividend deduction under subsection 112(1) of the *Income Tax Act* (the "Act") and the interest deduction under paragraph 20(1)(*c*) of the Act.

Briefly, the facts in *Husky Energy* were as follows: In 2003, the Husky group of companies was involved in three separate financings referred to as CFS I, CFS II, and CFS III. CFS I involved a corporation referred to as Operations incorporating two subsidiaries, being Central (incorporated in the British Virgin Islands and resident in Ontario) and West (resident in British Columbia). Three related corporations collectively referred to as the Subsidiaries then borrowed from a bank to repay a $722 million debt to Operations, Operations invested the $722 million in Central, Central loaned the $722 million to West, and West loaned the $722 million to the Subsidiaries. As a result, the Subsidiaries paid interest to West, West paid interest to Central, and Central paid dividends to Operations when declared by the directors of Central. Pursuant to the ACTA, the Subsidiaries claimed an interest deduction for interest paid to West, Operations included the dividends from Central in income and then claimed a dividend deduction, and Central reported the interest income but such interest income was non-taxable for Ontario purposes pursuant to the OCTA. West included the interest received and deducted the interest paid pursuant to the Act and the B.C. *Income Tax Act.* CFS II and CFS III, which were the same kinds of transactions, were undertaken by Husky Energy and various other related parties. The tax consequences and reporting in CFS II and CFS III were essentially the same as in CFS I. The Minister reassessed the Husky companies in all three refinancings such that the dividend deduction pursuant to subsection 112(1) and the interest deduction pursuant to paragraph 20(1)(*c*) were disallowed, and the interest that Operations would have included in income pursuant to paragraph 12(1)(*c*) had the refinancing not occurred was included in income.

The facts in *Canada Safeway* were similar to the facts in *Husky Energy*. In 2001, CSHL was incorporated and held common shares in the capital of Canada Safeway. The aggregate of $600 million in dividends was distributed from Canada Safeway to CSHL, and Canada Safeway borrowed an aggregate of $600 million from CSHL on the same days that those dividends were declared and distributed. The money borrowed by Canada Safeway created a legal obligation to pay interest and allowed Canada Safeway to claim an interest expense. Canada Safeway used the borrowed money to repay commercial paper it had used for the purposes of earning business income. CSHL acquired shares in a corporation referred to as SOFC (incorporated in the British Virgin Islands and resident in Ontario) and assigned Canada Safeway's debt to SOFC in consideration for the shares, such that SOFC became the beneficial owner of the debt of Canada Safeway and interest on such debt became payable by Canada Safeway to SOFC. SOFC included the interest in income under paragraph 20(1)(*c*), but the interest was not taxable for Ontario purposes pursuant to the OCTA. After SOFC received interest payments from Canada Safeway, SOFC paid dividends to CSHL when declared by the directors of SOFC, which dividends were included in income and deducted under subsection 112(1). The Minister reassessed Canada Safeway to deny the interest deduction under paragraph 20(1)(*c*) for interest paid to SOFC; alternatively, CSHL was to be reassessed to include in its income the interest paid by Canada Safeway to SOFC, as if Canada Safeway's debt had not been assigned to SOFC.

Both taxpayers appealed to the Court of Queen's Bench and the appeals were allowed. In both cases, the Court concluded that the taxpayers did not abuse paragraph 20(1)(*c*) because the borrowed money was for the purpose of earning income, the deduction under subsection 112(1) was not abusive because the purpose of subsection 112(1) is to avoid multiple levels of tax and not to ensure that the income that resulted in the dividend is taxed at least once, and refinancing to take advantage of another province's tax regime was not abusive. The Minister appealed to the Court of Appeal of Alberta.

At the Court of Appeal of Alberta, the Minister based the appeal of both cases on the application of GAAR by the trial judge. In *Husky Energy,* it was the Minister's position that the trial judge failed to determine whether there was a tax benefit and avoidance transaction in regard to CFS I, failed to properly apply the GAAR analysis, and failed to identify the correct purpose of paragraph 20(1)(*c*) and subsection 112(1). In *Canada Safeway,* the Minister's main ground of appeal was that the trial judge applied the wrong legal test in determining whether there was abusive tax avoidance. In both cases, Hunt JA for the Court found that the proper standard of review was the palpable and overriding error standard. For the purposes of the appeals, the Act and the ACTA are identical.

In *Husky Energy,* Hunt JA stated that the trial judge did not apply the first two steps of the GAAR analysis (whether there was a tax benefit and avoidance transaction) to CFS I and as such, Hunt JA went through the analysis and determined that there was a tax benefit under paragraph 20(1)(*c*) and subsection 112(1) and that the series of transactions constituted tax avoidance under subsection 245(3). With respect to whether the purpose of paragraph 20(1)(*c*) was frustrated, the Minister's main argument was that the refinancings did not increase the Husky group of companies' consolidated capital or profits, that the refinancings did not have any commercial objective, and that paragraph 20(1)(*c*) was abused because the interest was not taxed in Ontario notwithstanding that a deduction was claimed in Alberta. Hunt JA found that the Minister's approach was problematic because paragraph 20(1)(*c*) was drafted to deal with the circumstances of the borrower, while the Minister focused on the circumstances of the lender. Hunt JA noted that the abuse of paragraph 20(1)(*c*) cannot be established on the tax treatment of a related company in another province. With respect to subsection 112(1), the Minister's position was that because no Ontario tax was payable on the underlying income from which the dividend was paid (the interest payments), there was no possibility of double taxation and therefore subsection 112(1) was frustrated because its purpose is to prevent double taxation of an intercorporate dividend which should be deductible only if there is provincial taxation on the stream of income resulting in the dividend. Hunt JA rejected that argument for several reasons, including that there is no indication in subsection 112(1) that amounts should be deductible only if the underlying stream of income was taxed. Hunt JA noted that Alberta was free to, but did not, alter the language of the ACTA counterpart to section 112 to except the intercorporate dividend deduction if the underlying source of income was not taxed. In addition, there are enumerated exceptions in the other subsections of section 112 which limit the deduction in subsection 112(1), and Parliament presumably would have made an exception based on the tax treatment of the underlying income stream if such exception was intended.

Hunt JA's analysis in *Canada Safeway* was very similar to his analysis in *Husky Energy*. The Minister's main argument was that the trial judge did not correctly apply the legal test for abuse and therefore wrongly concluded that there was no abusive tax avoidance. In respect of paragraph 20(1)(*c*), the Minister's position was that the trial judge misapplied the purpose of paragraph 20(1)(*c*), being to create an incentive and encourage the accumulation of capital to produce income, to the facts of *Canada Safeway*. Hunt JA rejected the Minister's arguments, including the Minister's submission that Canada Safeway did not "need" to borrow $600 million, on the basis that a taxpayer is free to replace retained earnings with borrowed money without frustrating paragraph 20(1)(*c*). With respect to subsection 112(1), the Minister's position was that the trial judge misstated the purposes of, and therefore misapplied, subsection 112(1). Similar to the Minister's argument in *Husky Energy,* the Minister submitted that it is abusive to claim the dividend deduction, because there is no double taxation since no Ontario tax was payable on the underlying income. As a result, there could be no double taxation and claiming the dividend deduction frustrates the purpose of subsection 112(1). The Court rejected this argument for the same reasons the argument was rejected in *Husky Energy*, including that there is no indication in subsection 112(1) that amounts should be deductible only if the underlying stream of income was taxed and that Parliament did not intend to permit the deduction of intercorporate dividends only if the underlying income was taxed.

In both cases, the Minister also asked the Court to determine whether taking advantage of the lack of alignment between federal and provincial legislation could be abusive tax avoidance. In *obiter,* Hunt JA noted the constitutional reality is that each level of government has taxation authority and provinces are free to fully adopt the federal system, but Alberta and Ontario have not done so. Hunt JA noted that each case of alleged abuse must be assessed in the context of Supreme Court of Canada law.

The appeals in *Husky Energy* and *Canada Safeway* were dismissed. These decisions are significant because they indicate that a taxpayer may be able to structure its affairs to benefit from tax-planning opportunities in other provinces. However, the Minister has sought leave in both cases to appeal to the Supreme Court of Canada.

— *Bernice P. Wong*

Taxpayer's Appeals Dismissed, But Why?

***SRI Homes Inc.* v. *The Queen*, 2012 DTC 5135 (Federal Court of Appeal)**

Inadequate or insufficient reasons for a judicial decision can form the basis for a successful appeal. In this case, the insubstantial reasons for judgment given by the Tax Court of Canada (the "TCC") were sufficient for the taxpayer's appeal to the Federal Court of Appeal (the "FCA") to succeed.

This case involved a taxpayer that had appealed an assessment by which the Minister had denied the taxpayer a non-capital loss in the amount of $411,830 for its taxation year ending April 30, 2001, which appeal was dismissed by the TCC. Simply put, the facts were that the taxpayer had transferred shareholder loans receivable to another corporation for $411,830 below their total face value and claimed a business loss with respect to the said transfer. Therefore, the issue in this case was essentially to determine whether the $411,830 was deductible by the taxpayer.

The trial judge, in his reasons for judgment, began by setting out certain uncontested facts and certain assertions made by the Minister, and paraphrasing some of the assumptions pleaded in the Crown's reply to the amended notice of appeal of the taxpayer. In the second part of the reasons for judgment, the Court quoted verbatim the issues as framed by the Crown in its reply. In the next segment of the reasons, the Court began by very briefly quoting the taxpayer's counsel's closing arguments and more extensively the Minister's counsel's closing arguments. Finally, the Court concluded by stating, in its closing paragraphs, that it agreed with the reasoning outlined by the Minister's counsel in his argument and that the appeals were therefore dismissed, with costs.

The taxpayer appealed to the FCA on the ground that the lack of reasons constituted an error of law and sufficient basis for appeal. The FCA begin its analysis by describing the "functional approach" as outlined by the Supreme Court of Canada in *Sheppard* ([2002] 1 SCR 869) and *R.E.M.* ([2008] 3 SCR 3). In *R.E.M.*, the Court stated that the functional approach requires:

> [. . .] reasons sufficient to perform the functions reasons serve — to inform the parties of the basis of the verdict, to provide public accountability and permit meaningful appeal. The functional approach does not require more than will accomplish these objectives.

By applying the functional analysis, the FCA determined that, in the circumstances of this case, the trial judge's reasons did not serve their proper function for four reasons. First, the reasons failed to account for the competing theories put before the Court. The trial judge accepted, without explanation, the Minister's framing of issues and ignored the issues that were raised by the taxpayer. Second, the reasons of the Minister that the trial judge "agreed" with were internally inconsistent. The six reasons advanced by the Crown relied on different characterizations of the transaction, and it was unclear which the trial judge had chosen. Third, the trial judge failed to make reference to any of the *viva voce* evidence adduced by the taxpayer in the three-day trial, so that there was no basis for an appellate court to know which evidence had been rejected by the trial judge. Fourth, the trial judge rejected an argument that the taxpayer had not made before him, suggesting that the judge may not have understood the issues that were presented to him. In other words, the FCA ruled that the trial judge's reasons were inadequate because the judge did not actually explain why he embraced the Crown's position so completely; as a result, the FCA could not ascertain whether the initial decision was correct in law. The FCA concluded that the trial judge failed to satisfy the taxpayer's right to procedural fairness, and remitted the matter back to the TCC for redetermination by a different judge.

The *SRI* case is interesting because it confirms that the requirements of the functional approach apply in tax cases. This approach requires informing the parties involved of the basis of the decision, and allowing an appellate court to be able to properly evaluate the evidence and the conclusion that was ultimately drawn from that evidence.

— *Sophie Larochelle*

INTEREST DEDUCTIBILITY

The CRA was asked whether interest on funds borrowed from a financial institution by a shareholder and used to acquire preferred shares of a corporation was deductible under s. 20(1)(*c*) by the shareholder where there was a subsequent return of capital from the corporation to the shareholder.

An individual is a shareholder of Aco. The individual borrows money from a financial institution, which he then uses to acquire Aco preferred shares that have a fixed dividend rate. Subsequently, Aco makes a distribution of capital to the shareholder. The individual uses the returned capital funds for a variety of personal, non-income-producing purposes.

Subparagraph 20(1)(*c*)(i) permits the deduction of an amount paid or payable in the year pursuant to a legal obligation to pay interest on borrowed money used for the purpose of earning income from a business or property. Generally, interest is deductible where the direct use of the funds was to earn income. However, the original use of the funds is not determinative. Rather, the current use of the funds is the relevant use, and a taxpayer must establish a link between the money that was borrowed and its current use.

In Interpretation Bulletin IT-533, "Interest Deductibility and Related Issues" (October 31, 2003), the CRA addressed borrowing for investments and stated that where an investment (i.e., preferred shares) carries a stated interest or dividend rate, the "purpose of earning income test" will be met absent a sham or window dressing or similar vitiating circumstance (see paragraph 31 of IT-533). Accordingly, interest on money borrowed to acquire preferred shares with a stated dividend rate will be deductible.

The CRA noted that whether interest on borrowed funds continues to be deductible after a corporation returns capital to the taxpayer would depend on whether the funds continue to be traceable to an eligible use. This is a question of fact.

The CRA stated that, in the present case, the income-earning purpose of the borrowed money would no longer be met. The capital is returned to the shareholder, and the borrowed money is no longer used in the corporation's business. Interest on the loan would not be deductible because the current use of the funds is personal rather than income earning.

See also CRA Document No. 2012-0436411E5 "Accumulated Profits — Section 20(1)(*c*)" (August 10, 2012), CRA Document No. 2009-0307951E5 "Restructuring of Borrowings" (March 31, 2009), CRA Document No. 2006-0216781E5 "Interest Deductibility" (September 7, 2007), and CRA Document No. 2004-0103721E5 "Borrowing To Pay Dividends" (January 21, 2005).

— External Technical Interpretation, Financial Industries Division, August 15, 2012, Document No. 2012-0446741E5

CAPITAL LOSSES

The CRA was asked whether a taxpayer was able to claim a foreign exchange loss on the redemption of shares it held in a subsidiary.

Parentco owned shares of Subco, which was a U.S.-based controlled foreign affiliate of Parentco. Subco redeemed the shares held by Parentco. Subco and Parentco remained affiliated after the redemption. Due to a fluctuation in the exchange rate between the Canadian dollar and the U.S. dollar, Parentco recorded a foreign exchange loss and, for Canadian tax purposes, a taxable capital loss on the disposition. Subsequently, an additional capital restructuring of Subco resulted in Parentco owning all of the shares of Subco.

Under ss. 39 and 54, a capital gain or loss is a gain or loss on the disposition of capital property. Under s. 38(*a*), one-half of any capital gain is taxable, and under s. 38(*b*), one-half of any capital loss is the taxpayer's allowable capital loss. Under s. 3, capital gains and losses are netted against each other in the computation of a taxpayer's taxable income. Under s. 39(2), where as a result of the fluctuation of the value of the currency of a country other than Canada the taxpayer has made a gain or sustained a loss, the amount of the gain or loss is deemed to be a capital gain or capital loss, respectively. (We note that the $200 *de minimis* exception applies only to individuals; see ss. 39(2)(*a*)(iii) and 39(2)(*b*)(iii).)

In respect of the calculation of the gain or loss, s. 40(1)(*a*) generally states that a taxpayer's capital gain is the amount by which the proceeds of disposition exceed the taxpayer's adjusted cost base in the property. Similarly, under s. 40(1)(*b*), a taxpayer's capital loss is generally the amount by which the taxpayer's adjusted cost base in the property exceeds the proceeds of disposition. Additionally, under s. 40(3.6), where a taxpayer disposes of shares of an affiliated corporation to that corporation, and after the disposition the corporations are still affiliated, (i) the taxpayer's loss on the disposition is deemed to be nil, and (ii) the amount of that loss (as otherwise determined under the Act) is added to the adjusted cost base of the remaining shares.

The CRA stated that, in the present case, Parentco is deemed under s. 84(9) to have disposed of the Subco shares to Subco at the time Subco redeemed the shares. Since Parentco and Subco were affiliated after the disposition, s. 40(3.6) would deem the loss on the disposition to be nil. Since Parentco's loss is nil, Parentco cannot be considered to have sustained a loss at the time Subco redeemed the shares, and neither s. 39(1) nor (2) would apply to the disposition. However, Parentco would be entitled to increase the adjusted cost base of any other Subco shares that it held after the disposition. If Parentco held no other Subco shares after the disposition (i.e., before the subsequent reorganization), then s. 40(3.6) would not operate to apply the amount of the loss to the adjusted cost base of any remaining shares. Further, s. 40(3.6) would not operate to increase the adjusted cost base of shares subsequently acquired by Parentco.

See also CRA Document No. 2003-0035135 "Stop-Loss Rules" (September 18, 2003), CRA Document No. 2002-0151025 "Subsection 40(3.6)" (January 16, 2003), CRA Document No. 2002-0161447 "40(3.6)" (November 14, 2002), and CRA Document No. 2000-0062505 "Affiliated Persons — Stop Loss Rules" (March 6, 2001).

— External Technical Interpretation, International Division, April 23, 2012, Document No. 2012-0436921I7

ATTRIBUTION RULES — TRANSFER TO CORPORATION

The CRA was asked how to calculate the amount attributed to X in the following situation:

- X is a Canadian-resident individual holding as capital property all participating common shares in Opco, a taxable Canadian corporation that is not a small business corporation.
- X would exchange those shares for Opco preferred shares (freeze shares) that would be non-participating, have a redemption value equal to the $1 million fair market value of the exchanged shares, and have a priority dividend at a rate equal to a prescribed rate calculated on the redemption value. The exchange would be made under s. 51(1) of the *Income Tax Act* (the "Act") (and be deemed to be a transfer under s. 74.4 as per s. 51(1)(*c*) of the Act in French; see s. 51(1)(*e*) of the English version) or under s. 85(1) as an internal rollover transaction. This transfer would allow "designated persons" (as this expression is defined in s. 74.5(5) of the Act, including spouses or minor children) to subscribe through a trust to Opco common shares for a $100 nominal value.
- The purpose of the transfer is to reduce X's income to benefit designated persons and give them access to Opco's excess dividends and capital appreciation. Those persons would be "specified shareholders" since they would hold more than 10% of a class of Opco shares (see the definition in s. 248(1) of the Act, as modified by s. 74.4(2)(*a*)).
- X would use the rollover provisions in s. 85(1) of the Act to transfer his freeze shares to Newco in exchange for Newco common shares. X would be Newco's sole shareholder.
- Newco would receive income from other sources and the value of its common shares would increase with time. For example, their value would increase to $1.5 million while the value of the freeze shares (Opco preferred shares) would remain at $1 million.
- Opco would gradually redeem its preferred shares held by Newco and pay dividends on preferred shares held by Newco before paying dividends on common shares held by the designated persons. Newco does not plan to redeem its common shares held by X but could pay dividends on those shares.
- Assume that the purpose test described in s. 74.4(2) of the Act would be met at the time of the exchange of the Opco common shares for Opco preferred shares (freeze shares).

More specifically, the CRA was asked to answer the following questions:

(1) Would X have to include an amount in his income under s. 74.4(2) of the Act following the transfer of his Opco common shares to Newco?

(2) Would the calculation of this amount be based on the fair market value of Newco common shares or Opco preferred shares?

(3) Would the redemption of Opco preferred shares reduce the "outstanding amount" (see s. 74.4(3) of the Act) on which the above income inclusion is based?

(4) Would the dividends paid on Newco common shares held by X reduce the above income inclusion?

(5) Would the dividends paid on Opco preferred shares held by Newco reduce the above income inclusion?

(6) Would the answers to the above questions be different if all or substantially all the annual profits of Opco were used to pay dividends on Opco preferred shares?

(7) Could the general anti-avoidance rule apply to this situation?

The CRA offered the following comments:

(1) Assuming that the purpose test described in s. 74.4(2) of the Act would be met when X exchanged his Opco common shares for Opco preferred shares, an amount would have to be included in X's income.

(2) To calculate the amount included in X's income under s. 74.4(2) of the Act, the taxpayer would have to calculate an amount A under s. 74.4(2)(*d*) (i.e., interest calculated at the prescribed rate on the "outstanding amount" of the transferred property; see the definition of "outstanding amount" in s. 74.4(3)) and then subtract from the amount A an amount B (i.e., dividends calculated under s. 74.4(2)(*f*)). Given the above assumptions, amount A could not be reduced by amounts under s. 74.4(2)(*e*) or (*g*). The only dividends qualifying for the reduction under s. 74.4(2)(*f*) would be the taxable dividends received by X on the Opco preferred shares received as consideration for the transfer or the Newco common shares substituted for such shares, provided they are both excluded considerations at the time the dividends are received. Regarding the outstanding amount of the transferred property, it should be set at $1 million (which is the value at the time of the transfer by X of his Opco common shares) and this value would be used to calculate the amount of interest calculated at the prescribed rate by virtue of s. 74.4(2)(*d*) of the Act.

(3) See (2) above.

(4) The taxable dividends paid to X on Newco common shares would reduce the income inclusion.

(5) The taxable dividends received by Newco in respect of the Opco preferred shares would not be covered in s. 74.4(2)(*f*) of the Act and would not therefore reduce the amount that is calculated under s. 74.4(2)(*d*).

(6) The above answers would be the same even if all or substantially all the annual profits of Opco were used to pay dividends on the Opco preferred shares held by Newco.

(7) Based on the assumptions made by the taxpayer, the attribution rules of s. 74.4(2) of the Act would be applicable and the general anti-avoidance rule would therefore not apply.

— *External Technical Interpretation, Reorganizations Division, July 31, 2012, Document No. 2012-0449871E5 (CRA document is in French only)*

INDEXING FACTOR FOR 2013

The CRA has posted its Guide T4127-JAN, *Payroll Deductions Formulas for Computer Programs — 96th Edition — Effective January 1, 2013*. The guide contains the formulas needed by payroll professionals to calculate federal, provincial (except Quebec), and territorial income taxes and CPP and EI deductions effective January 1, 2013. As a result, it contains the indexing factor for 2013 tax brackets and personal amounts.

The federal indexing factor for 2013 is 2%; therefore, to calculate the indexed income thresholds and personal amounts for 2013, the 2012 amounts should be multiplied by 1.02. The guide states that for 2013, the federal indexing factor of 2% also applies to New Brunswick, Northwest Territories, Nunavut, Saskatchewan, and Yukon. The indexing factors for the other provinces are as follows: Alberta, 1.8%; British Columbia, 1.5%; Newfoundland and Labrador, 2.6%; and Ontario, 1.8%. There is no indexing applied to Manitoba, Nova Scotia, or Prince Edward Island.

It is expected that as usual, later this year the CRA will release a Fact Sheet that lists all of the indexed amounts for next year. In the meantime, the personal income tax bracket thresholds and some of the personal amounts for 2013 that are noted in the T4127-JAN are shown below.

	2013 ($)	**2012 ($)**
Tax Bracket Thresholds		
Taxable income above which the 22% bracket begins	43,561	42,707
Taxable income above which the 26% bracket begins	87,123	85,414
Taxable income above which the 29% bracket begins	135,054	132,406
Selected Personal Amounts		
Basic personal amount	11,038	10,822
Spouse or common-law partner amount (maximum)	11,038	10,822

Amount for an eligible dependant (maximum)	11,038	10,822
Age amount	6,854	6,720
Amount for children under age 18 (maximum per child)	2,234	2,191
Canada employment amount (maximum)	1,117	1,095
Infirm dependant amount (maximum per dependant)	6,530	6,402
Caregiver amount	4,490	4,402
Disability amount	7,697	7,546

MONEY PURCHASE LIMITS AND RRSP LIMITS

The Canada Revenue Agency has released the money purchase limit for 2013, which corresponds to the RRSP limit for 2014. As set out in the definition of "RRSP dollar limit" in subsection 146(1), the RRSP dollar limit is the amount of the money purchase limit for the preceding year. The "money purchase limit" is defined in subsection 147.1(1). As described there, the money purchase limit is adjusted by the increase in the average wage for the year. For 2012 and 2013, the money purchase limits are $23,820 and $24,270, respectively. As a result, the RRSP limits for 2013 and 2014 are $23,820 and $24,270, respectively. The RRSP limit for 2012 is $22,970, which is the money purchase limit for 2011.

2013 EMPLOYMENT INSURANCE PREMIUMS

The CRA has released the figures for the 2013 Employment Insurance premiums. The 2013 maximum insurable earnings is $47,400 (up from $45,900 in 2012). The premium rate is 1.88% (up from 1.83% in 2012) for a maximum annual premium of $891.12. The employer rate is 1.4 times the employee rate. The 2013 premium rate for Quebec is 1.52% (up from 1.47% in 2012), for a maximum annual premium of $720.48.

CANADA PENSION PLAN MAXIMUM PENSIONABLE EARNINGS FOR 2013

On November 1, 2012, the Canada Revenue Agency announced that for 2013, the maximum pensionable earnings on which Canada Pension Plan contributions are made will be $51,100, increased from $50,100 in 2012. The basic exemption remains at $3,500 for 2013. The employee and employer contribution rates for 2013 remain at 4.95%, and the self-employed contribution rate remains at 9.9%. In 2013, the maximum employer and employee CPP contributions will be $2,356.20 (up from $2,306.70 in 2012), and the maximum self-employed contribution will be $4,712.40 (up from $4,613.40 in 2012).

NEGOTIATION OF AN INFORMATION EXCHANGE AGREEMENT WITH THE UNITED STATES

On November 8, 2012, the Department of Finance announced that Canada and the United States have entered into negotiations to improve cross-border tax compliance by means of enhanced information exchange under the *Canada–United States Income Tax Convention*. This would include the exchange of information with respect to the U.S. *Foreign Account Tax Compliance Act* ("FATCA"). FATCA "attempts to ensure tax compliance of U.S. persons who may have offshore accounts by requiring foreign financial institutions to enter into compliance agreements with the U.S. government and report U.S. accountholders". The notice from the Department of Finance indicates that the government "is actively seeking a solution to issues" raised by the FATCA provisions and has received submissions from individuals and organizations in this regard. Additional input from interested parties can be sent to the Department of Finance, 17th Floor, East Tower, 140 O'Connor Street, Ottawa, Canada, K1A 0G5. For further information, contact Kevin Shoom, Business Income Tax Division, (613) 992-2980.

CRA ALERT CONCERNING ELECTRONIC SALES SUPPRESSION SOFTWARE

On November 7, 2012, the Canada Revenue Agency (the "CRA") released an alert to businesses not to use sales suppression software, also referred to as Zappers. The alert notes that the CRA is increasing its efforts in identifying those who develop, sell, or use such software and that businesses that use Zappers are not only subject to interest and penalties on unpaid tax for the unreported income but could also face criminal prosecution.

SR&ED GUIDE AND FORM

The CRA has released new versions of Form T661, SR&ED Expenditures; Guide T4088, Guide to Form T661 SR&ED Expenditures Claim; and Form T1146, Agreement to Transfer Qualified Expenditures Incurred in Respect of SR&ED Contracts Between Persons Not Dealing at Arm's Length. Guide T4088 notes the following:

What's New?

The March 2012 federal budget proposed several changes to the Scientific Research and Experimental Development (SR&ED) Program. We have revised the guide to reflect the changes made to the SR&ED claim form (Form T661) to accommodate the legislative changes coming into effect starting January 1, 2013.

Changes to Form T661

We have introduced a new line (529) in Part 4 to reduce by 20% the expenditures for arm's length SR&ED contracts and third-party payments incurred after December 31, 2012, from the payer's qualified SR&ED expenditure pool.

We have changed the description for line 820 to accommodate the 5% reduction in the prescribed proxy amount (PPA) for the number of 2013 calendar days in the tax year.

This revised version of Form T661 (revision code 1201) is effective as of its publication date (October 31, 2012). We encourage you to start using the new form immediately.

You can submit the T661(11) version of the form until December 31, 2012. Starting January 1, 2013, we will accept only the T661(12) version of the form for all tax years.

Changes to the Guide to Form T661

We have revised the guide to reflect the changes to Form T661. We have included an example at line 529 for clarity. We have introduced a new formula at line 820 to calculate the PPA.

TAX NOTES

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Notice: *Readers are urged to consult their professional advisers prior to acting on the basis of material in this newsletter.*

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