Tax Notes

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FEDERAL GOVERNMENT INTRODUCES *ECONOMIC ACTION PLAN 2014, NO. 2* AGAIN

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On October 20, 2014 the federal government tabled another Notice of Ways and Means Motion ("NWMM") to implement the tax measures in *Economic Action Plan 2014, No. 2* (part 2 of the 2014 federal Budget) plus other amendments, changes, and tax relief measures. It has been an interesting October, as this is the third NWMM so far. It was thought that the October 10, 2014 NWMM proposals were the "official release" of the second Budget Bill of 2014, but the October 20, 2014 NWMM proved otherwise. This NWMM is a comprehensive piece of legislation that incorporates all of the following:

- all of the October 10, 2014 NWMM proposals on *Economic Action Plan 2014, No. 2* (Wolters Kluwer *Special Report* No. 082H);
- the October 9, 2014 NWMM proposal to increase the children's fitness tax credit to $1,000;
- the addition of section 75 to amend subsection 251.2(1) of the *Income Tax Act*; and
- a new measure that amends the loss restriction event rules for investment trusts in some situations.

In addition to the 2014 Budget items, the October 20, 2014 NWMM includes the following key measures and amendments:

- the Canadian film or video production tax credit (April 8, 2014 proposals — Wolters Kluwer *Special Report* No. 080H);
- the taxation of Australian trusts and international shipping corporations (July 12, 2013 proposals — Wolters Kluwer *Special Report* No. 072H);
- the extension of the section 118.62 credit to interest paid on a Canadian apprentice loan;
- modernizing the life insurance policy exemption test;
- ensuring Pooled Registered Pension Plans are subject to similar GST/HST rules as Registered Pension Plans;
- amending the definition of "non-qualifying country" in the foreign affiliate rules to exclude jurisdictions where the *Convention on Mutual Administrative Assistance in Tax Matters* is in force, and also to avoid unintended tax consequences for the British Virgin Islands as it has a tax information exchange agreement with Canada; and
- better use of partnerships in foreign affiliate rules and amendment of foreign affiliate dumping rules.

The October 10 and 20 NWMMs were not accompanied by Department of Finance explanatory notes. Practitioners awaiting government commentary can in the interim consult previously released publications of draft legislation including the August 29, 2014 Wolters Kluwer *Special Report* No. 081H (especially the Department of Finance explanatory notes), Wolters Kluwer *Special Report* No. 082H to gain a good grasp of the proposed NWMM measures that now constitute Bill C-43, and Wolters Kluwer *Special Report* No. 083H (including explanatory notes). Copies 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.

KEY DIFFERENCES BETWEEN THE OCTOBER 20, 2014 VERSION OF THE 2014 BUDGET LEGISLATION AND PREVIOUS VERSIONS

Differences between Various Versions of the Legislation

Changes to the Definition of "Specified Right"

One difference between various legislative wordings is that Clause 6 of the NWMM (both the October 10 and 20 versions) contains a definition of "specified right" that is substantially rewritten from the version found in Clause 4 of the August 29, 2014 draft legislation. Relevant to the subsection 18(4) "thin capitalization" discussion of disallowed interest deductions and the subsection 18(6) and proposed subsection 18(6.1) anti-avoidance rules, concerns that an intermediary's security interest or specified right in a property could potentially trigger the new "back-to-back loan" anti-avoidance rules were expressed by the Tax Executives Institute, Inc. in its September 26, 2014 comments to the Department of Finance. Somewhat addressing those concerns, the definition of "specified right" in the October 10 and 20 NWMMs is clearer and more specific, since additional statutory language not present in the original August draft legislation has been added.

Changes Related to Graduated Rate Taxation of Trusts

Differing legislative wording also occurs in the measures amending section 122 of the *Income Tax Act* (the "ITA"), in measures that form part of the changes to graduated rate taxation of trusts (i.e., only graduated rate estates and qualified disability trusts are to retain graduated rate taxation). Specifically, proposed paragraph 122(1)(*c*) is intended to provide for a recovery of tax in a scenario where a trust elected in an earlier taxation year to be a qualified disability trust ("QDT") but did not make a distribution from taxable income to an appropriate "electing beneficiary". While proposed paragraph 122(1)(*c*) in Clause 26 of the August 29, 2014 draft legislation provided an "A-B" formula to establish the amount that trust would have to pay, both subparagraphs (i) and (ii) in that formula have been further amended in Clause 38 of the NWMM (the clause's numbering is the same for both the October 10 and 20 versions). Whether or not changes between the draft legislation and the NWMM's wording should be regarded as merely a clarification of the government's original intent, what remains is that:

- ITA paragraph 122(1)(*c*)'s component A(i) now specifically refers to the rate of tax payable by the trust for each taxation year referred to in the description of component B; and
- ITA paragraph 122(1)(*c*)'s component A(ii) now specifically refers to a trust's payment or distribution made out of taxable income for a year referred to in component B.

As the interplay between electing beneficiaries and QDTs was the subject of much comment when the August 29, 2014 draft legislation was released, even clarifying changes to the formula's wording should be noted by practitioners.

It should also be noted that the potentially vague August 29 wording "reasonably be considered" remains unchanged; i.e., subclause 122(1)(*c*)(ii)(A)(II) from the October 10 and 20 NWMMs refers to trust situations in which "the payment or distribution can *reasonably be considered* to be made out of that taxable income" (emphasis added).

Changes to the Proposed Definition of "Qualified Disability Trusts"

Another difference between the August 29 draft legislation and the October 10 and 20 NWMMs pertains to the proposed definition of a QDT in subsection 122(3) of the ITA. In component 4(c) of its submission to the Minister of Finance (dated September 25, 2014), the Society of Trust and Estate Practitioners ("STEP Canada") requested deletion of the subparagraph (*a*)(i) requirement that a QDT be "created by will", positing that the requirement was overly restrictive and would have made certain types of insurance trusts automatically ineligible to be QDTs. This STEP Canada concern is somewhat addressed by the NWMM's new subparagraph (*a*)(i) wording for the QDT definition, which instead requires that the trust be "at the end of the trust year, a testamentary trust that arose on and as a consequence of a particular individual's death".

At the same time, however, the October NWMM wording in paragraph (*b*) of the QDT definition now requires that the trust be one in which each of the trust's beneficiaries was "named as a beneficiary by the particular individual in the instrument under which the trust was created". Since the August 29, 2014 wording of paragraph (*b*) of the QDT definition originally required that the trust's beneficiaries be "named in the will as a beneficiary under the trust", due care should also be taken in understanding the consequences of this other difference in NWMM wording.

Changes to Foreign Merger Transactions

A final example for this article comes from the topic of foreign merger transactions, specifically NWMM clause 19, which adds proposed ITA subsection 87(8.3). First proposed in Clause 3 of the July 12, 2013 draft legislation, subsection 87(8.3) is an anti-avoidance rule pertaining to tax-deferred rollovers, and was designed to block foreign merger transactions that are inconsistent with the existing subsection 85.1(4) anti-avoidance rule. Presumably, Clause 19 represents another instance where the government chose to use a specifically designed anti-avoidance rule instead of relying on the general anti-avoidance rule regime. What is important to note, in the context of legislative differences, is that the NWMM text differs from earlier wording in that paragraph 87(8.3)(*c*) now provides explicit exclusion (i.e., the anti-avoidance rule will not apply) to scenarios where a taxpayer has a paragraph 95(2)(*m*) "qualifying interest" in the recipient foreign affiliate.

OCTOBER 30, 2014 NOTICE OF WAYS AND MEANS MOTION

As a possible precursor to an election, the federal government released a Notice of Ways and Means Motion (included in Wolters Kluwer *Special Report* No. 083H) to improve tax incentives for families with children under the age of 18. Highlights of the new or improved tax incentives are as follows:

- The Family Tax Cut is a new non-refundable tax credit for 2014 and subsequent years. The credit is up to $2,000 for couples with children under 18. Essentially, for federal tax purposes, the credit allows couples to split/transfer up to $50,000 of income to the spouse with the lower marginal tax rate.
- For 2015, there is a $1,000 increase in the maximum limits for the Child Care Expense Deduction in all age categories.
- For 2015, the non-refundable child tax credit ($2,255 in 2014) for children under 18 is phased out and replaced by enhancements to the Universal Child Care Benefit ("UCCB"). For 2015 the enhanced UCCB rates are:

  (1) $160 per month for children under the age of 6; and

  (2) $60 per month for children aged 6 to 17.

  Similar to the current UCCB, the benefit is income tested and is an income inclusion for the lower income spouse.
- As previously reported on October 9, 2014, the Children's Fitness Tax Credit is increased to $1,000 for 2014, and will become a refundable credit in 2015.

SMALL BUSINESS DEDUCTION

In the situation described, a taxpayer carries on a professional services business through a Canadian-controlled private corporation. The business is carried on in office space that the corporation rents. Currently, the corporation is renting more space than is needed for the business and has subleased the excess space to other tenants that provide complementary services to the professional business. The corporation provides the tenants with reception and billing services as well as supplies and equipment. The Canada Revenue Agency ("CRA") was asked if the corporation can claim the small business deduction ("SBD") on the rental income that it receives. Because the SBD described in subsection 125(1) of the *Income Tax Act* (the "Act") is based on income earned from an active business, the CRA referred to the definitions of "active business carried on by a corporation" and "income of the corporation for the year from an active business" in subsection 125(7) of the Act. If the corporation's rental income pertains to or is incidental to the corporation's professional services business it will qualify for the SBD. However, if the rental activities do not pertain to or are not incidental to the active business then the rental income will be income from property and not eligible for the SBD. The CRA also noted that if the rental activities are considered to be a separate business of the corporation rather than interdependent with the professional services, the rental income would likely be from a specified investment business and not eligible for the SBD.

— *External Technical Interpretation, Business and Employment Division, August 11, 2014, Document No. 2014-0540041E5*

INTERACTION BETWEEN SUBSECTION 55(2) AND PART IV TAX

The situation reviewed by the Canada Revenue Agency ("CRA") involved two connected corporations subject to the application of subsection 55(2) of the *Income Tax Act* (the "Act") in respect of cross redemptions and resulting cross dividends. The CRA was asked if the corporations could use only their refundable dividend tax on hand ("RDTOH") immediately before receiving the dividends to calculate their dividend refunds or Part IV tax. More specifically, the CRA was asked to confirm that Part IV tax resulting from the application of subsection 55(2) would not be considered to apply that subsection to other dividends paid or received by the corporations in the course of the same series of transactions.

The CRA confirmed that sections 129 and 186 of the Act do not allow the use of only certain amounts to calculate the RDTOH, dividend refunds, and Part IV tax. All relevant amounts for a particular complete taxation year would be considered to make those calculations. The fact that the RDTOH would be calculated at the end of each corporation's taxation year and that there would be cross redemptions and cross dividends would result in circular calculations. From a tax policy viewpoint, the CRA would never permit the circular calculations to result in a total refund of the RDTOH of each corporation. The CRA referred to the case *943963 Ontario Inc. v. The Queen*, 99 DTC 802 (TCC), which deals with a dividend received from a connected corporation and subject to Part IV tax due to the application of paragraph 186(1)(*b*) of the Act. All parties agreed that there was an amount of Part IV tax payable by the beneficiary of the dividend even if a portion of the deemed dividend received by the corporation under subsection 84(3) of the Act was deemed under paragraph 55(2)(*a*) of the Act not to be a dividend received. In other words, the portion of the dividend considered to be a capital gain under subsection 55(2) of the Act does not affect the "eligible dividend" amount taken into account to calculate the Part IV tax payable. The application of subsection 55(2) of the Act in that case did not trigger any circular calculation.

— *External Technical Interpretation, Reorganizations Division, June 27, 2014, Document No. 2013-0498191E5*

PROPOSED REGULATORY TEXT: CFVP TAX CREDIT

On October 4, 2014, proposed amendments to subsections 1106(1), (10), and (11) of the *Income Tax Regulations* were published in the *Canada Gazette*. The proposed amendments relate to the Canadian film or video production ("CFVP") tax credit, important to Canadian-controlled production corporations as it is equal to 25% of eligible labour costs for films that have high Canadian content. Addressed are the definitions of "copyright owner" and "excluded production", clarification as to a right to share in the revenues of a film or video production, and harmonization of provisions to reflect bijuralism. Interested persons may address comments (which must cite the *Canada Gazette*, Part I and the publication date of the notice) regarding these proposed amendments to Venetia Putureanu, Tax Legislation Division, Department of Finance, 90 Elgin Street, Ottawa, Ontario, K1A 0H9. Please note that this is the updated mailing address; readers are similarly advised that the updated contact telephone number is (613) 369-3664.

CRA RELEASES PUBLICATIONS ON TAXPAYER RIGHTS AND SERVICES

On October 17, 2014, the Canada Revenue Agency ("CRA") released two publications pertaining to taxpayers' rights and services when interacting with the CRA:

- **RC17(E) Rev. 14, "Taxpayer Bill of Rights Guide"** — This Guide deals with the set of 16 rights that confirm the CRA's commitment to serve with professionalism, courtesy, and fairness. The Guide also includes details regarding the CRA's five "Commitments to Small Business" that were designed to simplify, reduce, and improve CRA communications with that sector.
- **RC4420(E) Rev. 14, "Information on CRA — Service Complaints"** — This booklet is related to specific points in the Taxpayer Bill of Rights, and outlines the way taxpayers can lodge both formal and informal complaints regarding CRA services. The booklet also summarizes the relevant forms and information related to tax objections, authorizing representatives, and contacting the CRA.

Both publications also contain information about available online services, as well as the contact information for the CRA's Taxpayer Services Directorate.

EFILE PARTICIPATION RENEWALS

On October 20, 2014, the Canada Revenue Agency ("CRA") opened its renewal window for participants in its online electronic filing program ("EFILE"). While renewal is important for users to maintain EFILE access in 2015, present participants who do not renew their accounts will still be able to use their current passwords until January 16, 2015 to:

- submit SEND requests;
- transmit 1013 forms;
- file T2 returns; and
- file 2012 and 2013 T1 returns.

Users can make an online request to renew their electronic filing participation by using their current EFILE number and password to log in to http://www.efile.cra.gc.ca/, clicking on "Renewal", and following the CRA instructions provided.

RECENT CASES

Corporate taxpayer's loss on disposition of two shareholders' loans constituted non-capital losses

The corporate taxpayer was in the business of manufacturing and selling manufactured homes. In anticipation of the sale of its shares to a third party, the taxpayer disposed of a number of its assets to a related company, including two shareholders' loans in subsidiary corporations (the "Loans") on which it realized losses. The Minister determined that the taxpayer's non-capital losses for 2001 did not include the losses on the disposition of the Loans (the "Losses"). The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was allowed. The Court needed to determine the fair market value of the Loans at the time of their non-arm's length disposition and whether the Losses were on income or capital account. The fair market value of the Loans was no higher than what the taxpayer had claimed and the Minister was unable to prove otherwise, so the Losses amounted to $411,830. Although the taxpayer was in the business of lending money, the Loans were not part of that business. However, the Loans were made for the purpose of earning income from the taxpayer's home manufacturing business, so its non-capital losses for 2001 should be increased by the amount of the Losses. The Minister was ordered to reassess accordingly.

SRI Homes Inc. v. The Queen, 2014 DTC 1185

Profits on sale of real property by real estate investment company were capital gain and not business income

The main issue before the Court was whether the corporate taxpayer correctly reported its sale of two real properties as capital gains. The Minister reassessed the taxpayer and characterized those gains as business income, but the taxpayer argued that it purchased the properties as investments in order to produce rental income. The taxpayer maintained two types of business: (1) to develop and sell condominium units; and (2) to acquire and hold long-term investments.

The taxpayer's appeal was allowed with costs. The taxpayer demonstrated that its course of conduct with regard to the rental-income-earning properties was consistent with an investment purpose that was distinct from the real estate trading activities. Moreover, the accounting records clearly drew a line between trading and long-term investments.

Belcourt Properties Inc., 2014 DTC 1182

Corporate taxpayers operated a "personal services business" and thus were not entitled to the small business deduction

The taxpayer, T, and his spouse, N, owned the shares of the corporate taxpayers, 1165632 Ontario Limited and 1286047 Ontario Limited. T sold his unincorporated building supplies business to a corporate third party, Dryco, but continued to manage that business under contracts entered into by Dryco and the corporate taxpayers. In assessing the taxpayers for 2009 and 2010, the Minister disallowed their small business deduction claims on the ground that they were each operating a "personal services business" as defined in subsection 125(7) of the *Income Tax Act*. The taxpayers appealed to the Tax Court of Canada.

The taxpayers' appeals were dismissed. Subsection 125(7) defines a "personal services business" to be a business of providing services being carried on by a corporate taxpayer through an employee who could be reasonably regarded as an officer or employee of the person or partnership for whom the services are being provided, but for the existence of the corporate taxpayer. The issue, therefore, was whether T would have been an employee of Dryco during 2009 and 2010 if he, and not the corporate taxpayers, had entered into the management contracts with Dryco. Determining the existence of an employer-employee relationship requires an analysis of certain factors associated with that relationship (i.e., control, tools, opportunity for profit, and risk of loss. See *Wiebe Door Services Ltd. v. MNR*, 87 DTC 5025 (FCA)). Applying these factors to T's relationship with Dryco, the conclusion was that T would have been an employee of Dryco during 2009 and 2010 if Dryco's business management contracts had not been with the corporate taxpayers but with T directly. As a result, the taxpayers were operating a "personal services business" as the Minister had contended. The Minister's assessments were affirmed accordingly.

1165632 Ontario Limited et al. v. The Queen, 2014 DTC 1184

Director liability assessments dismissed as directors had validly resigned from company

The taxpayers, D and S, were reassessed for $500,000 of unremitted tax withholdings including penalties and interest of 1056922 Ontario Limited, a corporation whose affairs and business were managed and operated by their husbands. The amounts were for the 2000 to 2005 tax years. The taxpayers argued that they had resigned more than two years before the director liability assessments and, alternatively, they were directors in name only and relieved of liability by the due diligence defence.

The taxpayers' appeals were allowed. While the taxpayers' husbands could have been pursued as directors or as *de facto* directors, the Minister instead chose to pursue the taxpayers, who were the *de jure* directors. The taxpayers had validly resigned from the corporation more than two years before the assessments. Even if the resignations were not effective, it was reasonable for S to do nothing in respect of the corporation's withholding requirements as it was reasonable for her to believe that they had resigned as directors and did not have the authority to remit. This was not the case for the other taxpayer, D, who did not exercise the degree of care, diligence, and skill to prevent the failure.

Gariepy v. The Queen, 2014 DTC 1188

Taxpayers were operating tree farm in a partnership and qualified for farming capital gains exemption

The taxpayers, who were husband and wife, bought 50.16 acres of land in 2003 for $100,000. The land was to be used in a tree farm operation that was expected to produce revenue beginning in 2008. After purchasing the land, they worked together to remove dead trees and plant new trees, and bought equipment to be used on the land. A portion of the land was rented to a local farmer to be used for hay production. After significant gravel deposits were discovered on the land in 2007, the taxpayers received unsolicited and persistent offers to buy the land. They sold the land in 2008 for $1.6 million and claimed the farming capital gains exemption ("FCGE") in 2008 and 2009. The Minister denied the FCGE claim arguing the taxpayers did not meet the eligibility requirements.

The appeal was allowed. Eligibility for an FCGE depends on who owns the land and whether it is used in a farming business. It must be owned for at least 24 months prior to its disposition, which was not in issue here. Also, during any 24-month period, more than 50% of the fair market value of the partnership property must be used principally in the course of carrying on a farming business, and all or substantially all of the fair market value of the partnership property must be attributable to property used in the farming business. The respondent argued that the taxpayers were operating the farm as individuals, while the taxpayers argued they were *de facto* partners. The eligibility criteria for the FCGE for individuals is more restrictive. The taxpayers were credible witnesses. While they alternated between arguing the land was held personally or in a partnership, they ultimately claimed it was owned by them personally and operated by them in partnership. The evidence showed that the taxpayers were carrying on the tree farm business as partners in a *de facto* partnership and both were fully engaged on a regular basis in the business. They bought the land to supplement their pension income and were carrying on the tree farming business with a view to making a profit. Only the land used in the tree farm business was qualified farm property, while the acreage rented out did not qualify. The taxpayers were entitled to an FCGE on 25.91 acres of the 50.16 acres they owned.

Otteson, 2014 DTC 1173

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