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Tax Notes

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CCPC PASSIVE INVESTMENT INCOME SAGA COMES TO AN END

- –*Joseph Frankovic, Adjunct Professor, Osgoode Hall Law School, Course Director and Tax Lecturer, York University, Associated with Wolters Kluwer Canada*

BACKGROUND

On July 18, 2017, the Department of Finance ("the Department") released proposals to amend the income tax treatment of certain businesses and in particular Canadian-controlled private corporations ("CCPCs").[1] The proposals included methods of eliminating the tax deferral advantage that occurs when a CCPC uses its after-tax business income to invest in passive investments that are not used concurrently, or at all, in its business (the "CCPC deferral advantage"). The main thrust of the proposals was to eliminate the refund of corporate tax on investment income earned by a CCPC upon the payment of dividends out of its refundable dividend tax on hand ("RDTOH").

On October 18, 2017, the Department retreated significantly on the passive investment issue, and announced that a minimum threshold would be exempt from the proposals.[2] The Department indicated that the threshold would be $50,000 of investment income per year, or, as the Department noted, the equivalent to $1 million in invested assets based on a nominal 5% rate of return (the "$50,000 income exemption"). In other words, the CCPC deferral advantage would continue to apply to up to $1 million of after-tax business income (or a different amount, with a different rate of return). The Department also indicated that prior investments retained by CCPCs, including the income earned from such investments, would be grandfathered and not subject to the RDTOH repeal.

In its February 27, 2018 Federal Budget (the "Budget"), the Department confirmed that it was following through with a $50,000 income exemption. As a result, many CCPCs will continue to enjoy the CCPC deferral advantage. The Department retreated on its initial proposal to eliminate the RDTOH refundable tax and replaced it with a rule that will grind down the small business limit for CCPCs that exceed the $50,000 investment income limit. This Budget proposal is discussed below ("First Budget Proposal"). This proposal along with related CCPC passive investment income measures are currently found in Bill C-74, *Budget Implementation Act, 2018, No. 1* ("Bill C-74").

THE CCPC DEFERRAL ADVANTAGE

The CCPC deferral advantage is a direct result of the small business deduction ("SBD"), which reduces the income tax rate on up to $500,000 of active business income earned by a CCPC to around 13%, depending on the province. In contrast, an unincorporated individual carrying on a business in the highest tax bracket pays 50% tax or more on business income. As a result, a shareholder of the CCPC who is in a 50% tax bracket, or would be but for the fact that the business income is earned in the CCPC, enjoys a significant tax deferral since the income is subject to the 13% tax rate rather than the 50% tax rate. A deferral advantage also exists for business income subject to the general corporate tax rate, but the advantage is less pronounced because the general corporate tax rate can be double the SBD rate or more.

Why is the CCPC deferral advantage significant? The answer lies in a well-known principle dealing with the deferral of the taxation of income (the "deferral principle"). The deferral principle holds that the deferral

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of the taxation of income is the equivalent of not allowing a deferral, but instead exempting from tax the income earned by investing the income.[3] In other words, allowing a tax deferral is the same as allowing an exemption from tax for investment income.

Example

A taxpayer has $200,000 of before-tax business income in year 1. The taxpayer is in a 50% tax bracket. The taxpayer can earn a 5% annual return on investments.

No deferral case: At the end of year 1, the taxpayer invests the after-tax business income of $100,000. By the end of year 2, the amount grows by 5% to $105,000, and net of 50% tax on the investment income, she is left with $102,500 after tax. If the investment income had been tax-exempt, she would have netted $105,000.

Deferral case: At the end of year 1, the taxpayer invests the entire $200,000 amount of business income (it was tax-deferred and not subject to tax in year 1). By the end of year 2, the amount grows by 5% to $210,000, and net of 50% tax on the entire $210,000 amount, she is left with $105,000 after tax.

Conclusion: Deferral is the same as no deferral with tax-exempt investment income. Note that this is the case even though the investment income was nominally subject to 50% tax in the deferral case in year 2.[4]

Turning back to the CCPC issue, consider the income earned by a CCPC when it invests business income that is eligible for the SBD. Owing to the SBD, the first $500,000 of the active business income ("SBD income") is subject to a tax rate that is typically much lower than the shareholder's tax rate. For example, if a shareholder is in a 50% tax bracket and the CCPC tax rate on SBD income is 13%, only 26% of that income is not tax-deferred. That is, 50% of 26% of the SBD income equals the 13% CCPC tax. The remaining 74% of the SBD income is tax-deferred. Applying the deferral principal, most of the investment income earned on the SBD income is effectively exempt from tax.[5] Not surprisingly, CCPCs have been marketed and used as tax-deferred retirement savings vehicles in addition to or in lieu of registered retirement savings plans ("RRSPs") and tax-free savings accounts ("TFSAs").[6]

JULY 18, 2017 PROPOSALS: DUMP THE RDTOH

Under the July 18, 2017 proposals, the Department of Finance presented various options to eliminate the CCPC deferral advantage. The main proposals involved the repeal of the RDTOH and therefore of the refundable portion of the corporate tax on investment income.[7]

Some critics argued that the repeal of the RDTOH would lead to tax rates on CCPC investment income well in excess of individual shareholder marginal tax rates—as high as 73%, depending on the province. (A common refrain asked "Is a 73% tax rate fair?") The validity of that argument turned on whether nominal tax rates or effective tax rates are the correct barometer of taxes paid. On this point, most tax policy experts agree that effective tax rates matter more than nominal tax rates, simply because the former take into account the effect of tax preferences such as deferrals, exemptions, and accelerated deductions, whereas the latter do not.[8]

Owing to the proposed repeal of the refundable corporate tax, the July 18, 2017, measures would have increased nominal tax rates when CCPC investment income was paid out as dividends. However, the increase in the nominal tax rate would have rendered the effective tax rate on the income equal to or close to the shareholder's marginal rate of tax. If structured properly, the proposals would have seen owners of CCPCs face the same tax treatment accorded to self-employed persons who carry on business without a CCPC, who are subject to their personal marginal tax rates both on the business income and the income earned by investing the business income.[9] In other words, with a shareholder in a 50% tax bracket, the

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shareholder would have been subject to an effective tax rate of 50% (or slightly more without perfect tax integration), and not 73%. Officials at the Department attempted to make this point, as did other tax policy experts.[10] In the end, the more vocal 73% crowd won the day,[11] and the proposed RDTOH repeal was jettisoned in the Budget. Presumably, the Department had been convinced that the RDTOH proposal would have added complexity to the existing CCPC rules,[12] and therefore replaced it with a more modest proposal.

On a related point, since the July 18, 2017, measures would have removed the CCPC deferral advantage in respect of investments in other businesses (for example, shares in small business corporations), an advantage would have flipped over to non-CCPC corporations. That is, the latter also enjoy a deferral advantage, although it is less significant than the current CCPC deferral advantage. Still, CCPCs and their shareholders would have continued to enjoy tax preferences that most non-CCPCs do not.[13] If the issue was problematic, the Department could have carved out an exception for CCPCs in respect of their investments in certain businesses. Such an exception was in fact subsequently introduced and retained in the Budget measures, as described in the text below (the “venture capital exception”). To come full circle, since the venture capital exception preserves the CCPC deferral advantage, CCPCs continue to enjoy an advantage relative to non-CCPCs and other taxpayers in respect of venture capital investments, and in particular, investments in “active assets”.

2018 BUDGET: FIRST PROPOSAL (CURRENTLY IN BILL C-74)

In the Budget, the Department retreated on its July 18, 2017, proposal to eliminate the RDTOH and the corporate tax refund for passive investment income. The Budget proposed an alternative approach to the deal with the CCPC deferral advantage. Under the Budget proposal, the maximum business income limit of a CCPC for a taxation year eligible for the SBD (“small business limit”) will be reduced, generally where its passive investment income exceeds $50,000. In particular, the small business limit of the CCPC for a taxation year ending in a calendar year will be reduced on a straight-line basis, with a $5 grind-down in the limit for every $1 in excess of $50,000 of the “adjusted aggregate investment income” (described below) of the CCPC and any corporations associated with the CCPC for their taxation years ending in the preceding calendar year (draft paragraph 125(5.1)(b)).

For example, if the adjusted aggregate investment income is $100,000, the small business limit will be reduced from $500,000 to $250,000. In such a case, a CCPC earning more than $250,000 of active business income will remain eligible for the SBD on the first $250,000, while the excess will be subject to the general corporate tax rate. If the adjusted aggregate investment income is $150,000 or more, the small business limit will be reduced to zero.

The Budget proposal preserves the $50,000 income exemption. Assuming a 5% annual return, a CCPC will be able to invest a total of $1 million of after-tax SBD income that will continue to benefit from the CCPC deferral advantage without a reduction in its small business limit. Obviously, the total after-tax SBD income that will continue to benefit will depend on the annual return—for example, a 2.5% annual return would reflect $2 million of after-tax SBD income rather than $1 million.[14] The $50,000 income exception is annual rather than cumulative, with no carryforward for a shortfall in any particular year. The exception applies regardless of whether the income is invested back into the business or used otherwise.

As can be appreciated, if a CCPC exceeds the $50,000 investment income threshold, its SBD income will be converted (in the 5:1 ratio noted above) into regular business income that is subject to the general corporate tax rate. On average, and depending on the province, SBD income is subject to a tax rate of around 13%, whereas other business income is subject to the general corporate tax rate of around 27%. If all or most of the business income is distributed annually as dividends or salary, the grind-down of the small business deduction should not be significant because there will be no deferral or a limited deferral of the business income. However, to the extent that the business income is re-invested in the business (or as a further passive investment), the grind-down will increase effective tax rates because of the lower amount of tax deferral for general corporate business income relative to SBD income. In such case, the significance of the grind-down will increase with the length of the period of deferral. Given the appropriate assumptions, basic

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tax arithmetic should allow a tax advisor to determine whether exceeding the $50,000 investment income threshold makes sense from a tax perspective. The practical problem, of course, will lie in the accuracy of the assumptions.

The Budget proposal will apply in conjunction with existing measures that reduce the small business limit where the total taxable capital employed in Canada of a CCPC and corporations associated with the CCPC exceeds $10 million (current subsection 125(5.1)). The reduction in the small business limit will be the greater of the reduction computed under the Budget proposal and that computed under the taxable capital reduction measures.

For the purposes of the proposal, the "adjusted aggregate investment income" (subsection 125(7)) of a CCPC will be computed in the same manner as the "aggregate investment income" currently used for refundable tax purposes (subsection 129(4)), with the following adjustments:

- taxable capital gains and allowable capital losses from the dispositions of "active assets" will be excluded;
- net capital losses carried over from other taxation years will be excluded;
- dividends from non-connected corporations will be included; and
- taxable amounts in respect of a life insurance policy will be included, to the extent they are not otherwise included in aggregate investment income.

The "active assets" of a CCPC at a particular time (draft definition in subsection 125(7)) will include property that is used principally in an active business carried on primarily in Canada by the CCPC or by a related CCPC. It will also include a share of another CCPC that is "connected" with the CCPC where the share would be a "qualified small business corporation share"[15] at the particular time if it were owned by an individual. Among other things, this entails a 24-month holding period of the shares, where at the particular time all or substantially all of the fair market value of the assets of the other CCPC are attributable to assets that are used principally in an active business carried on primarily in Canada or shares or debt in other corporations that meet similar criteria.[16] There is no monetary limit to the active asset exception, meaning that an unlimited number of such investments can benefit from the CCPC deferral advantage without reducing the CCPC's small business limit.

The active asset exemption as it applies to capital gains on shares in other CCPCs presumably reflects the Department's announcement on October 18, 2017,[17] that it will ensure that "incentives are in place so that Canada's venture capital and angel investors can continue to invest in the next generation of Canadian innovation." The Department provides no explanation as to why such incentives are required (perhaps it views that point as a given), or why non-CCPC investors are not provided with parallel incentives. The CCPC deferral advantage clearly provides a leg-up for CCPCs with SBD income relative to other investors. In short, if the Department believes that further tax incentives[18] are required for investments in "Canadian innovation", it is curious that the active asset exception targets a small minority of potential investors with no similar incentive for the majority of potential investors. Of course, a similar incentive for other investors would come at a high price in terms of lost tax revenues.

Adjusted aggregate investment income will not include investment income that is incidental to or pertains to an active business.[19] Adjusted aggregate investment income will include income earned on CCPC investments accumulated before the Budget proposals, and not just on investments made afterwards. In other words, the grandfathering proposals in the Department's October 18, 2017, announcement discussed earlier (see *Background*) do not apply for the purposes of this proposal.[20] However, they do apply in terms of the RDTOH and the refundable tax paid out of that account, as provided in the second Budget proposal discussed below.

One potentially unfair part of this Budget proposal relates to the fact that adjusted aggregate investment income over $50,000 per year will reduce the CCPC small business limit, whether the investment income was earned out of after-tax SBD income or otherwise. Income earned by investing after-tax business income that was subject to the general corporate tax rate will reduce the small business limit, even though the deferral advantage in respect of this type of income is less advantageous than that with respect to SBD

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income. More significantly, investment income earned by a CCPC by investing a shareholder's after-tax income that was contributed to the CCPC (e.g., paid-up capital) will reduce the small business limit even if the shareholder is in the top tax bracket. From a policy perspective, the latter type of investment income should not be subject to the new proposal, simply because the amount invested was already subject to top marginal tax rates, meaning that there was no tax deferral. If the Department were to remedy the situation, the solution would likely involve at least another investment income or refundable tax account, with the added complexity of allocating the source of the investment to each account.[21] Assuming the proposal remains as is, a planning point for associated CCPCs is to make passive investments out of after-tax SBD income to the extent possible (say, where one CCPC has all SBD income and an associated CCPC has no SBD income). The point is somewhat circular because the extra retained investment income may in turn reduce tax-deferred SBD income that can be used to earn investment income in the future.

The above proposal is scheduled to apply to taxation years that begin after 2018. An anti-avoidance rule (found in the draft transitional rules) provides that it will also apply to a taxation year that begins before 2019 and ends after 2018 if the preceding taxation year was, because of a transaction or event or series of transactions or events, shorter than it would have been otherwise, and one of the reasons for the transaction, event, or series was to defer the application of the proposal.

2018 BUDGET: SECOND PROPOSAL (CURRENTLY IN BILL C-74)

The 2018 Budget proposed another measure that was not explicitly discussed in the July 18, 2017, proposals. Under current rules, a CCPC may receive a refund out of its RDTOH when it pays eligible dividends, which provide an enhanced dividend tax credit. The enhanced credit for eligible dividends is provided on the premise that the dividends were paid out of business income that was subject to the general corporate tax rate, rather than SBD income or investment income that formed part of the RDTOH. To correct this apparent anomaly, the second Budget proposal provides that a refund out of RDTOH will be allowed only in the case where the CCPC pays non-eligible dividends, which qualify for a less generous dividend tax credit. However, an exception, discussed below, provides that the payment of certain eligible dividends can generate the refund.

In order to differentiate between the two types of income that can generate a refund, the RDTOH account of a CCPC will be split into two accounts. One account, the "eligible RDTOH" of the CCPC, will include the Part IV tax payable by the CCPC in respect of eligible dividends that it receives from a non-connected corporation, sometimes called eligible portfolio dividends.[22] It will also include Part IV tax payable by the CCPC on dividends that it receives from a connected corporation that received a refund of its Part IV tax because of the payment of the dividends out of its eligible RDTOH. This latter rule effectively tracks the payment of Part IV tax down a corporation chain, and preserves the refundable tax where one CCPC receives eligible portfolio dividends and then pays dividends to its corporate shareholder. For example, if a subsidiary CCPC receives eligible portfolio dividends, it will have Part IV tax payable on those dividends, and if it receives a refund of the Part IV tax when it pays taxable dividends to its parent CCPC, the Part IV tax payable by the parent CCPC will form part of the eligible RDTOH account of the parent. A refund of tax will be generated by the parent's payment of either eligible dividends or non-eligible dividends by a CCPC out of its eligible RDTOH.

The second account, the "non-eligible RDTOH" of a CCPC, will include current refundable Part I taxes on aggregate investment income. It will also include Part IV taxes as under the current rules, other than Part IV taxes that form part of the eligible RDTOH. For example, Part IV tax payable on a non-eligible portfolio dividend received by a CCPC will form part of its non-eligible RDTOH. A refund of tax will be generated by the payment of non-eligible dividends by the CCPC out of its non-eligible RDTOH.

An ordering rule provides that the payment of a non-eligible dividend by the corporation will generate a refund from its non-eligible RDTOH account before it obtains a refund from its eligible RDTOH account.[23] The ordering rule should be beneficial, in that it works to preserve the eligible RDTOH account ahead of the non-eligible RDTOH, and as noted, the eligible RDTOH can generate a refund upon the payment of either eligible or non-eligible dividends.

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The proposal is scheduled to apply to taxation years that begin after 2018. As with the first Budget proposal, an anti-avoidance rule provides that it will also apply to a taxation year that begins before 2019 and ends after 2018 if the preceding taxation year was, because of a transaction or event or series of transactions or events, shorter than it would have been otherwise, and one of the reasons for the transaction, event, or series was to defer the application of the proposal.

A transitional rule for the new RDTOH(s) applies for the first taxation year of a CCPC that is subject to the Budget proposal.[24] Out of the CCPC's existing RDTOH at the end of the previous taxation year, an amount equal to $38^{1}/_{3}$ per cent of the CCPC's general rate income pool at the end of the previous year (basically, taxable income that was subject to the general corporate rate) will be allocated to its eligible RDTOH. The remainder of the existing RDTOH, if any, will be allocated to the CCPC's non-eligible RDTOH. For non-CCPC corporations, the existing RDTOH will be allocated in full to eligible RDTOH. The Department feels that this transitional rule fulfills its previous commitment regarding the grandfathering of CCPC investments made prior to the application of the proposal.[25] CCPC investments made prior to the proposal will continue to generate a refund out of their RDTOH accounts, thus preserving the CCPC deferral advantage, albeit at the price of reducing their small business limits under the first Budget proposal. However, if the previous CCPC investments are significant in amount, the trade-off will be well worthwhile.[26]

APPENDIX

Example 1—Deferral v. No Deferral

Assume a taxpayer in a 50% personal tax bracket earns $200,000 of business income in year 1, either personally (Case 1) or through a CCPC (Case 2). The after-tax income is invested at the end of year 1. The return on investment income is 5% per year. The CCPC tax rate on SBD income is 13%. There is perfect integration between the corporate tax and the personal tax. The CCPC refundable tax rate on passive income is 50%. (To keep numbers simple, I have used a 50% CCPC rate on investment income. The CCPC rate may be slightly more—for example, it is 50.17% in Ontario. Still, the same analysis would apply using a different rate, as long as there was perfect integration.)

Case 1: Taxpayer carries on the business personally, and the after-tax business income of $100,000 is invested in a non-registered account. By the end of year 2, the amount grows by $5,000 before tax and to a total of $102,500 after tax.

Case 2: Taxpayer carries on the business through a CCPC, which invests the after-tax SBD income of $174,000 ($200,000 net of 13% tax). By the end of year 2, the amount grows by 5% to $182,700. The maximum dividend is paid to the taxpayer / shareholder. Assuming perfect integration, the $174,000 amount is subject to a further tax of $74,000 (37% of the initial $200,000 SBD income, which was already taxed at 13%), while the $8,700 of investment income is subject to total corporate and personal tax of 50%, or $4,350. The total tax of $78,350, when subtracted from the $182,700 amount, nets $104,350 after tax. Alternatively, instead of receiving a dividend, the taxpayer could receive a salary at the end of year 2, which would provide a similar result.

Case 2 (with deferral) would be the equivalent of Case 1 (with no deferral), if the $5,000 of investment income in Case 1 was subject to 13% tax instead of 50% tax ($650 tax), leaving net investment income of $4,350. Stated another way, Case 2 would be the equivalent of Case 1, if $1,300 of the investment income in Case 1 was subject to the shareholder's 50% rate of tax while the remaining $3,700 was tax-exempt.

The above example assumes perfect integration between the corporate tax and the personal tax. Under current law, there is some under-integration in most provinces, such that less investment income, but still a significant amount, is effectively exempt from taxation. The exact amount of tax-exempt income depends on the province, the rate of return, and the length of the deferral. See also Example 2 below, regarding the distinction between tax-exempt simple income and compound income.

Example 2—Simple v. Compound Income

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Although the CCPC deferral advantage is significant, there is one notable difference between it and the RRSP (or TFSA) tax exemption. The RRSP tax exemption defers the taxation of the initial income contributed to the plan and the annual investment income earned on that income, which, pursuant to the deferral principle, results in an exemption from tax for all of the investment income, both simple income (earned on the deferred initial income) and compound income (earned on the deferred annual investment income). The CCPC advantage defers the taxation of much of the initial after-tax business income, but nominally taxes the investment income earned on that income on an annual basis. Thus, the CCPC scenario results in an exemption from tax for the simple investment income earned on the deferred business income (because that income was tax-deferred), but not the compound income earned on the simple investment income (because the simple income was not tax-deferred). The simple / compound income distinction is discussed in Frankovic, "The Taxation of Prepaid Income", *Canadian Tax Journal* (2002) vol. 50, no 4, at 1254. A more detailed and algebraic explanation is found in the Hanna article mentioned in note 3. The distinction is illustrated in the following example.

Assume a taxpayer in a 50% tax bracket earns $200,000 of business income in year 1. It is invested at the end of year 1 until the end of year 3. The return on investment income is 5% per year.

Case 1 (deferral of all income; RRSP-type situation): The taxpayer invests the $200,000 deferred income, which grows to $220,500 by the end of year 3 ($10,000 investment income in year 2 plus $10,500 investment income in year 3). In year 3, she is subject to 50% tax on the entire amount, leaving her with $110,250 after tax. The treatment is equivalent to not deferring the taxation of the initial income—that is, taxing the $200,000 in year 1, leaving $100,000—and then exempting from tax both the 5% simple return on the $100,000 investment ($5,000 per year, or $10,000 in total) and the compound return (additional $250 earned in year 3).

Case 2 (deferral of initial income but not resulting investment income; CCPC-type situation): The taxpayer invests the $200,000 deferred income, except the investment income is taxed annually. At the end of year 2, the amount grows to $205,000 after tax ($10,000 investment income, 50% tax). By the end of year 3, this amount grows to $210,125 after tax (another $10,250 investment income, 50% tax). Net of the $100,000 tax payable in year 3 on the initial $200,000 amount, the taxpayer is left with $110,125 after tax. This treatment is equivalent to not deferring the taxation of the initial income, leaving $100,000 in year 1, and then exempting from tax the 5% simple return on the $100,000 investment ($10,000 total) but subjecting the compound return ($250) to 50% tax.

Example 3—Carrying on Business Personally v. Through a CCPC

The following cases consider a business carried on personally, and alternatively where the business is carried on through a CCPC but without the refundable corporate tax. The taxpayer / shareholder is in a 50% personal tax bracket and the business earns $200,000 in year 1. The after-tax business income is invested at the end of year 1. The return on investment income is 5% per year. The tax rate on SBD income is 13%.

Case 1: Taxpayer carries on the business personally. The after-tax amount of $100,000 ($200,000 business income net of 50% tax) is invested in a non-registered account. At the end of year 2, the amount grows 5% to $105,000, and net of 50% tax on the return, she is left with $102,500.

Case 2: Taxpayer carries on the business through a CCPC. The after-tax amount of $174,000 ($200,000 business income net of 13% tax) is invested and retained in the corporation. At the end of year 2, the amount grows by 5% or $8,700 to $182,700 before tax, and the maximum after-tax amount of this income is distributed to the taxpayer as a dividend. Assuming perfect integration, the $174,000 amount is subject to a further tax of $74,000 (37% of the initial $200,000 business income, which was already taxed at 13%), leaving $100,000 after tax on this portion of the dividend. The $8,700 investment income is subject to a non-refundable tax of 50%, or $4,350. This $4,350 portion of the dividend is subject to a shareholder tax rate of 42.53% (again, I am assuming perfect integration), leaving $2,500 after tax for this portion of the dividend. The taxpayer / shareholder is left with $102,500, the same amount as in Case 1. So the effective tax rate in Case 2 is 50% as with Case 1, even though the nominal tax rate on the $8,700 investment income in Case 2 is 71% ($4,350 + 42.53 X $4,350 = $6,200 nominal tax).

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CURRENT ITEMS OF INTEREST

HOUSE OF COMMONS COMMITTEE RECOMMENDS TAX ON DIGITAL SERVICES

The Standing Committee on International Trade published a report last week titled: *E-Commerce: Certain Trade-Related Priorities of Canada's Firms*. The report made several recommendations with respect to the effect of e-commerce on the competitiveness of small and medium-sized enterprises in Canada. The report made two notable recommendations with respect to taxation:

> *Recommendation 1*
>
> *That the Government of Canada ensure the existence of a taxation system that is fair and equitable for all Canadians. The Government should work with other countries in ensuring that online sales, and the profits earned by firms making such sales, are taxed in the country where the products are consumed and where the economic activities that created the income occur, which would be consistent with relevant recommendations made by the Organisation for Economic Cooperation and Development.*
>
> …
>
> *Recommendation 3*
>
> *That the Government of Canada apply sales taxes on tangible and intangible products that are sold in Canada by domestic firms and by foreign sellers, including when such sales occur using an e-commerce platform.*

Although the Prime Minister has previously stated that the government would not introduce a new tax on digital services, the Canadian government has committed to implementing a digital tax solution by 2020 as a part of the OECD's ongoing BEPS efforts.

BUDGET BILL RECEIVES FIRST READING

Bill C-74, *Budget Implementation Act, 2018, No. 1*, was read for the first time in the House of Commons on March 27, 2018. The bill proposes to enact the following income tax measures, most of which were announced in Budget 2018:

- ensuring appropriate tax treatment of amounts received under the *Veterans Well-being Act*;
- exempting from income amounts received under the Memorial Grant for First Responders;
- lowering the small business tax rate and making consequential adjustments to the dividend gross-up factor and dividend tax credit;
- reducing the business limit for the small business deduction based on passive income and restricting access to dividend refunds on the payment of eligible dividends;
- preventing the avoidance of tax through income sprinkling arrangements;
- removing the risk score requirement and increasing the level of income that can be deducted for Canadian armed forces personnel and police officers serving on designated international missions;
- introducing the Canada Workers Benefit;
- expanding the medical expense tax credit to recognize expenses incurred in respect of an animal specially trained to perform tasks for a patient with a severe mental impairment;
- indexing the Canada Child Benefit as of July 2018;
- extending, for one year, the mineral exploration tax credit for flow-through share investors;
- extending, by five years, the ability of a qualifying family member to be the plan holder of an individual's Registered Disability Savings Plan;
- allowing transfers of property from charities to municipalities to be considered as qualifying expenditures for the purposes of reducing revocation tax;
- ensuring that appropriate taxpayers are eligible for the Canada Child Benefit and that information related to the Canada Child Benefit can be shared with provinces and territories for certain purposes; and
- extending, by five years, eligibility for Class 43.2.

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The bill also proposes amendments relating to the indexation of excise duties on tobacco products, the new rules for the taxation of cannabis, and the federal carbon pricing legislation. Explanatory notes are expected to be published by the Department of Finance shortly.

NEWFOUNDLAND AND LABRADOR BUDGET

Newfoundland and Labrador Budget 2018, *Building Our Future*, was tabled by Minister of Finance and President of the Treasury Board Tom Osborne. The province is projected to run a deficit of $683 million in 2018–2019. Merely a few notable tax changes were announced:

- Effective as of 2019, the Budget proposes to introduce a $3,000 non-refundable search and rescue volunteer tax credit.
- One-third of the retail sales tax on auto insurance will be gradually eliminated over four years. On January 1, 2019, the tax will be reduced by 2%, followed by 1% reductions in 2020, 2021, and 2022.
- The exemption threshold for payroll tax will be increased from $1.2 million to $1.3 million, effective January 1, 2019.

ONTARIO BUDGET

Ontario Budget 2018, *A Plan for Care and Opportunity*, was tabled by Minister of Finance Charles Sousa. The Budget proposes several measures relating to income tax, the highlights of which are discussed below.

Personal Tax Changes

The single but significant personal tax change announced in the Budget was the elimination of both the 20% and 36% surtaxes. Effective July 1, 2018, the Budget proposes to replace these surtaxes by adjusting the base tax brackets. As a result, Ontario will have seven personal income tax brackets with rates that reflect the tax rates that were effective prior to the elimination of the surtax. Thus, Ontario's top marginal rate will be 20.53%. The intent behind this change is to simplify the system, add transparency to the province's tax rates, and ensure that high income earners do not receive more tax relief than others by using personal income tax credits (which reduce surtax payable).

Most taxpayers will not see a change in their tax burden, but others will see their tax burdens increase or decrease depending on their income level and use of non-refundable tax credits. The Budget estimates that this change will increase revenues by $275 million in 2018–2019.

The Budget also proposes to increase the rate for the Ontario Charitable Donations Tax Credit to 17.5% for all donations exceeding $200, so all taxpayers will have access to the same tax relief regardless of their income level.

Corporate Tax Changes

The Budget announced the following corporate income tax measures:

- the Ontario Research and Development Tax Credit will be enhanced by increasing the credit from 3.5% to 5.5% for expenditures (over $1 million in a tax year) incurred on or after March 28, 2018;
- the Ontario Innovation Tax Credit will be enhanced by increasing the credit from 8% to 12% where the ratio of R&D expenditures to gross revenue is 20% or greater (enhancement is prorated between 10% and 20%);
- the province is reviewing potential tax incentives to encourage intellectual property that was developed in Ontario to remain in Ontario once it is commercialized; and
- effective January 1, 2019, the Employer Health Tax Exemption will follow the eligibility criteria for the small business deduction.

Other Changes

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- Budget 2018 proposes to increase the excise duties from 16.475 cents to 18.475 cents per cigarette and per gram of tobacco products, effective March 29, 2018;
- once recreational cannabis is legalized, the full HST will apply to off-reserve sales to Status Indians; and
- the province intends to parallel its tax system with the federal measures pertaining to income sprinkling, reducing the small business limit when a corporation earns more than $50,000 of passive income, and the creation of artificial tax losses.

Note that all of these changes are contingent upon the results of the upcoming provincial election.

QUEBEC BUDGET

Quebec's Minister of Finance, Carlos Leitão, tabled the 2018–2019 Budget on March 27, 2018. The Budget proposes to introduce a multitude of tax measures relating to personal income tax, corporate income tax, and sales tax.

The personal tax measures introduced include:

- New first-time home buyers tax credit up to a maximum credit of $750;
- The RénoVert tax credit will again be extended by one year, to March 31, 2019;
- The Tax Shield will increase its eligible work income relative to previous year by $1,000;
- The Tax Credit for Experienced Workers will be available on up to $3,000 of income for workers aged 61 and over, and workers aged 62 and over will benefit from a $1,000 increase in their eligible work income limit;
- The dividend tax credit will be reduced for eligible and non-eligible dividends; and
- Other enhancements to the following credits:
    - Caregiver Respite Services Credit,
    - Volunteer Respite Services Credit,
    - Independent Living Tax Credit for Seniors,
    - The amount for a person living alone,
    - Childcare Credit, and
    - Tax Credit for a First Major Cultural Gift.

The corporate tax measures introduced include:

- Gradual reduction of the Health Services Fund contribution rate for all small and medium-sized businesses;
- Replacement of the additional capital cost allowance of 35% by an additional capital cost allowance of 60% for qualifying M&P equipment;
- Broadening the sectors of activity eligible for the Tax Holiday for Large Investment Projects;
- Enhancement of the refundable tax credit for on-the-job training periods;
- Introduction of a refundable tax credit to encourage qualifying training for workers employed in SMBs;
- Introduction of a refundable tax credit to support the digital transformation of print media companies;
- Change to the refundable tax credit for film dubbing;
- Changes to the refundable tax credit for Quebec film or television production eligibility of online-only productions;
- Change to the refundable film production services credit;
- Change to the refundable tax credit for the production of multimedia events or environments presented outside Quebec;
- Extension of and changes to the refundable tax credit for the production of ethanol in Quebec;
- Extension of and changes to the refundable tax credit for cellulosic ethanol production in Quebec;
- Extension of and changes to the refundable tax credit for the production of biodiesel fuel in Quebec; and
- Introduction of a temporary refundable tax credit for pyrolysis oil production in Quebec.

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Other business measures:

- Reduction of the non-refundable tax credit for Capital régional et coopératif Desjardins shares;
- Changes to various parameters of the investment of Capital régional et coopératif Desjardins;
- Temporary maintenance of the increased rate of the tax credit in respect of the acquisition of shares in Fondaction;
- Introduction of an environmental studies allowance in the *Mining Tax Act*;
- Temporary increase in the refundable tax credit for holders of a taxi driver's permit; and
- New QST rules and a registration regime will be introduced in order to apply the QST to taxable supplies made using e-commerce.

GOVERNMENT EXPANDS ELIGIBILITY FOR CHILD BENEFITS

On April 13, 2018, the federal government announced that the *Income Tax Act* will be amended to clarify eligibility for the Canada Child Benefit ("CCB"). Specifically, the CCB will be available to individuals caring for a child under provincial/territorial kinship arrangements, such as the Prince Edward Island Grandparents and Care Providers program. Eligibility will not be affected by any financial assistance received from such a program.

SASKATCHEWAN BUDGET

Saskatchewan's 2018–19 Budget: On Track was presented on April 10, 2018 by Finance Minister Donna Harpauer. The tax highlights from the Budget include:

- the previously-announced half-point reduction (to occur on July 1, 2019) to personal tax rates has been temporarily deferred with no future date;
- a new Saskatchewan Value-Added Agriculture Incentive, which provides value-added agriculture facilities a 15% non-refundable tax credit for capital investments in a new or expanded productive capacity of at least $10 million;
- a new Saskatchewan Technology Start-up Incentive, which will offer a 45% non-refundable tax credit for individual and corporate equity investments in eligible technology start-up businesses;
- the dividend tax credit rate for non-eligible dividends will be 3.333% for 2018 and 3.362% for 2019 and subsequent years; and
- unlike the federal government, the province will not consolidate its caregiver credits, so the caregiver and infirm dependant tax credits will be separately maintained.

PRINCE EDWARD ISLAND BUDGET

Prince Edward Island's 2018 Budget was presented on April 6, 2018 by Finance Minister Heath MacDonald. The government announced a handful of tax changes:

- The small business corporate income tax rate will decrease from 4.5% to 4% in this fiscal year, and the government is committed to future reductions.
- The dividend tax credit will be adjusted to preserve personal and corporate income tax integration.
- The basic personal amount will increase by $500 for the 2018 taxation year, with a further $500 increase for the 2019 taxation year. In addition, the spouse or common-law partner amount and eligible dependant amount will each increase proportionately.
- The government will provide a rebate on the provincial portion of HST paid on the first block of residential electricity, firewood, pellets, and propane.
- The new Small Business Investment Grant will provide a 15% rebate on business investments of up to $25,000.

FOCUS ON CURRENT CASES

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This is a regular 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.

TAX COURT FINDS THAT THE GAAR APPLIED TO DENY NON-CAPITAL LOSS CARRYFORWARDS IN AMALGAMATED COMPANY

***Birchcliff Energy Ltd. v. The Queen*, 2017 DTC 1151 (Tax Court of Canada)**

This case is a decision in which the Tax Court addresses whether the general anti-avoidance rule ("GAAR") applied to a series of transactions in which Birchcliff Energy Ltd. amalgamated with an unrelated company, Veracel Inc., that had accumulated non-capital losses from a business that it no longer carried on.

Interestingly, this decision replaces the earlier Tax Court judgment (2015 DTC 1198) that was declared a nullity by the Federal Court of Appeal (the "FCA") (2017 DTC 5056). The 2015 Tax Court decision was rendered by a judge about two years after a different judge had heard the evidence in the case. The parties had not objected to this approach. However, the FCA held that the Chief Justice of the Tax Court did not have the power to remove a matter from one judge and assign it to another judge to render a decision, given that findings of fact had to be made by the judge who had heard the matter. The FCA declared that the Tax Court's 2015 decision therefore was a nullity. The FCA referred the matter back to the judge who had heard the initial appeal for that judge to render judgement. In the resulting Tax Court decision, Justice Jorré held that the GAAR applied to deny the use of the non-capital losses in issue.

Veracel was a corporation that had accumulated $16 million in non-capital losses from its former business of developing, manufacturing, and marketing automated medical diagnostic instruments. Birchcliff was a corporation in the oil and gas business. Veracel wished to monetize its losses and other tax attributes and Birchcliff wished to gain access to them.

In 2005, after a series of transactions, Veracel and Birchcliff amalgamated under the name Birchcliff. The amalgamated company claimed Veracel's non-capital losses in its 2006 tax return. The Minister reassessed to deny these losses.

Generally, a corporation can carry forward, or back, non-capital losses pursuant to paragraph 111(1)(a) of the *Income Tax Act* (the "Act"). However, subsection 111(5) limits the ability of the corporation to use non-capital loss carryovers where there has been an acquisition of control of the corporation. In that case, the losses generally are available for carryover only if the loss business continues to be carried on for or with a reasonable expectation of profit and, to simplify, only against income from the loss business or a similar business.

As noted by the Court, "paragraph 256(7)(b) sets out rules regarding change of control when there is an amalgamation of corporations". In this regard, as explained by the Court, "there is no change of control as a result of an amalgamation unless one of subparagraph 256(7)(b)(ii) or 256(7)(b)(iii) deems such a change of control to occur." The Court provided the following useful summary of how the rules in paragraph 256(7)(b) operate:

> 1. Generally, when two unrelated companies amalgamate, the Act will, *in effect*, deem one of the two predecessor companies to have acquired control of the other just before the amalgamation.
> 2. The process of determination is carried out in the following way.
> 3. One, in effect, assumes, hypothetically, that each predecessor had a single shareholder.
> 4. If the shareholder of a particular predecessor has control of the amalgamated company, then that particular predecessor is deemed to have acquired control of the other predecessor just before the amalgamation.
> 5. However, there is one narrow exception. If neither of the two hypothetical shareholders would have control of the amalgamated company, then there is no deemed change of control of either predecessor.

The transactions in this matter were structured with a view to ensuring that there was no acquisition of control of Veracel, given that such an acquisition of control would have caused the losses from Veracel's dormant business to be unavailable following the acquisition of control. This included ensuring that, under

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the rules summarized above, Birchcliff would not, in effect, be deemed to have acquired control of Veracel immediately before the amalgamation.

In this matter, Birchcliff needed very substantial additional capital to carry on its oil and gas business. However, rather than have Birchcliff simply issue new equity, pursuant to a complex series of transactions and a court-ordered plan of arrangement, the loss company, Veracel, first raised capital by issuing subscription receipts for an amount in excess of the market capitalization of Birchcliff. Pursuant to the transactions and the plan of arrangement:

- the holders of the subscription receipts were entitled to a refund of the amounts paid for the subscription receipts if the plan did not proceed;
- the subscription receipts were converted into newly created Class B shares of Veracel immediately before amalgamation; and
- on the amalgamation, the Class B shares entitled holders to common shares of the amalgamated company.

After rejecting the Minister's positions that the issuance of the Class B shares was a sham and that the Class B shareholders were a group that had acquired control of Veracel, Justice Jorré examined the three requirements necessary for the GAAR to apply. First, whether there was a tax benefit. Second, whether the series of transactions that gave rise to the tax benefit included an avoidance transaction. Third, whether any such avoidance transaction was abusive.

On the first issue, Justice Jorré held that "there can be little doubt that the ability for the amalgamated corporation … to use the tax attributes of predecessor Veracel … is a tax benefit." On the second issue, having concluded that the series of transactions was not undertaken primarily for purposes other than to obtain a tax benefit, Justice Jorré found that "the series is an avoidance transaction". On the third issue, Justice Jorré found that the series of transactions leading to the amalgamation was abusive given the underlying policy of subsection 256(7) "that the 'minority' predecessor, i.e. the predecessor whose shareholders, were they acting in concert, would not have control in the amalgamated corporation, will lose its tax attributes, its losses, on an amalgamation with another corporation. It does not include what might be described as contingent shareholders like the Class B shareholders here." As explained by Justice Jorré:

> The artificial insertion of Class B shareholders of Veracel, persons whose shares' only purpose was to be converted into common shares, and whose shares had such a short existence that they had to be deemed by the plan of arrangement to be created before the amalgamation, is a manipulation of the shareholdings of a predecessor contrary to the object of the rules in subsection 256(7).
>
> Put another way, it would be contrary to the policy of the provision to take account of the Class B shares where the existence of the shares is an ephemeral one at the time of the amalgamation and where the very existence of those shares is predicated on the amalgamation itself occurring. It is only at that instant, the instant where various events are deemed to occur in a sequence, that the new Class B shareholders contribute to the capital stock of the corporation.

After finding that the GAAR applied, such that the tax benefit should be denied, Justice Jorré determined that the "obvious solution" was to ignore the Class B shares with the result that there was a change of control of Veracel immediately before the amalgamation.

The decision once again illustrates that pursuant to the GAAR, transactions that comply with the specific provisions of the Act in conferring a tax benefit may be challenged successfully where the transactions include an avoidance transaction which is considered abusive of specific provisions of the Act or of the Act read as a whole.

The decision has been appealed to the FCA.

—*Yaroslavna Nosikova*

A REMINDER THAT A SUBSEQUENT REASSESSMENT DISPLACES AN EARLIER REASSESSMENT

***Nagel v. The Queen*, 2018 DTC 1032 (Tax Court of Canada—Informal Procedure)**

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In the *Nagel* case, the Tax Court of Canada dismissed the self-represented taxpayer's application for an extension of time to file an objection or an appeal to a reassessment for the 2013 taxation year. The decision in the application turned on whether the Tax Court had jurisdiction to grant the taxpayer the relief sought in respect of the Minster's reassessment, in light of the fact that the relevant reassessment was a nil assessment. Moreover, the taxpayer's principal complaints about the reassessment were to her residence for provincial income tax purposes and her entitlement to the GST/HST credit, for which she did not expressly apply by checking the appropriate box in her tax return, which were aspects of the reassessment that the Tax Court was not authorized to deal with in any event.

The taxpayer in the *Nagel* case received her first reassessment for the 2013 taxation year on February 26, 2016. The notice of reassessment indicated that the net federal tax payable was zero, the taxing province of the taxpayer was "changed to" Saskatchewan, and the taxpayer had unused tuition and education amounts, as allowed by section 118.61 of the *Income Tax Act* (the "Act"). An amended tax return for the 2013 taxation year was put into evidence in which she reported her province of residence as Saskatchewan and did not check the box indicating that she was applying for the GST/HST credit in section 122.5 of the Act.

On May 24, 2016, the taxpayer served a notice of objection to the first reassessment of the 2013 taxation year. In a letter dated June 21, 2016, the CRA informed the taxpayer that her objection was invalid as she objected to issues which were not considered to be part of the assessment.

The taxpayer received her second reassessment of the 2013 taxation year on November 3, 2016. It appears that the only difference between the first reassessment and the second reassessment is that the taxpayer's province of residence was being changed from Saskatchewan to Nova Scotia, which is something the CRA had previously told the taxpayer that it was intending to do by letter dated October 28, 2016, after advising that her objection was invalid.

In the course of the hearing at the Tax Court, the taxpayer indicated that she had issues with the reassessment in respect of the province of residence and her entitlement to the unused tuition and education credits. It is not clear from the facts why the taxpayer wanted to change her province of residence to Saskatchewan; it may be because of preferential 2013 provincial personal tax rates when compared to Nova Scotia. It was also unclear why the taxpayer wanted to make an issue out of the CRA's treatment of her entitlement to the unused tuition and education tax credits, as her position appears to be that she was not entitled to claim that amount because she was ultimately liable to pay the underlying tuition expense that created the credit.

The Minister's position was that the Tax Court had no jurisdiction since both of the reassessments were nil reassessments and the taxpayer could not object or appeal from nil reassessments.

In its analysis, the Tax Court applied the nullity principle, which was confirmed in *Lornport Investments* (92 DTC 6231 (FCA)). In *Lornport*, the Federal Court of Appeal stated as follows:

> I have come to the conclusion, in the particular circumstances of this case, that the second reassessment, which was vacated by the court order of April 20, 1989, did not supersede and nullify the first reassessment. It seems to me that the court order amounted to judicial recognition that the second reassessment, issued as it was beyond the statutory time limit, was not legally issued. It did not, for that reason, displace and render the first reassessment a nullity. That reassessment continues to subsist, in my opinion.

The Court in *Nagel* applied the foregoing to conclude that the second reassessment was the only reassessment to be considered as it rendered the first reassessment a nullity. In other words, the second assessment of the taxpayer for the 2013 tax year displaced the first reassessment for the same year.

The Tax Court then went on to consider the second reassessment and noted that it was a nil assessment, since no tax was payable. The general principle is that no appeal lies from a nil assessment. This principle originated in *Okalta Oils* (55 DTC 1176 (SCC)), which held that a taxpayer can neither object to, nor appeal from, a nil assessment.

The Court acknowledged that there are some special rules in the Act which allow a taxpayer to object to and appeal certain of the Minister's determinations, such as loss determinations, a determination of disability tax credit eligibility, or a determination as to entitlement to certain specific types of credits under the Act, notwithstanding that the taxpayer has nil tax payable under a reassessment. However, a taxpayer's

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entitlement to the unused tuition, education, and textbook credits is not a determination that the Act allows a taxpayer to separately object to or appeal. And with regard to the GST/HST credit, as the taxpayer did not apply for an amount by checking the box on the tax return filed, the Minister did not make a determination and did not issue a notice of determination.

Thus, in the result, the Tax Court dismissed the application because the taxpayer could not serve a notice of objection or a notice of appeal to the Court since it was a nil assessment and did not reflect any determinations of the Minister that could qualify for the subject of a standalone objection or appeal under the Act.

The Tax Court, *in obiter*, then commented on the jurisdiction of the Court in respect for provincial matters. The Court noted that the jurisdiction to determine residency lies with the Supreme Court of Nova Scotia and the Court of Queen's Bench of Saskatchewan respectively, as the term 'court' defined in the respective provincial statutes includes the above and not the Tax Court.

The *Nagel* case is a reminder of how challenging the income tax appeals procedure can be for a taxpayer that is an unrepresented individual. At the Tax Court, the taxpayer filed an application for an extension of time to file an appeal and a notice of appeal was attached to the application. Initially the taxpayer brought an application for an extension of time to file an appeal, however during the hearing the taxpayer stated that she had indicated in her notice of objection that she wished to make a fuller response and later applied to the Court for an order to extend the time to object to a reassessment. The Minister's position was that the Tax Court had no jurisdiction as the first and the second reassessments were nil reassessments. The Minister failed to take into consideration the nullity principle which rendered the first assessment invalid.

This case is a clear example of how lost a taxpayer can get in the tax appeals quagmire, so to speak. Without proper advice or any guidance it seems that the taxpayer was confused. It would have been helpful if the CRA had gone a step further and provided some guidance to the taxpayer on the provincial authority that the taxpayer needed to approach for the determination of province for residency.

—Jaspreet Kaur

WHAT IS RELEVANT TO ALL TAXPAYERS IS RELEVANT TO EACH TAXPAYER: THE MINISTER'S DISCOVERY OBLIGATIONS IN THE CONTEXT OF CO-ORDINATED MULTI-PARTY INVESTIGATIONS

***Paletta v. The Queen*, 2018 DTC 1003 (Tax Court of Canada)**

This case addresses the scope of the Minister's discovery obligations to a specific taxpayer in the context of co-ordinated audits and investigations of many taxpayers involved in similar transactions. The Court, *per* D'Arcy J, took a broad approach to relevancy in such circumstances, finding information shared between CRA offices regarding all taxpayers to be relevant and therefore discoverable by each particular taxpayer.

The taxpayer in this case, Paletta, claimed $55 million of non-capital losses between 2000 and 2006 in respect of foreign currency trading activities. The Minister determined that the trades were a sham, and denied the losses. Paletta appealed.

The pleadings referred to a number of third parties that were purported to be involved in the impugned transactions, and who were similarly audited by the CRA. These taxpayers were audited as part of a broader investigation by multiple CRA offices which was co-ordinated through CRA headquarters to ensure consistency in the various assessments. There was a free flow of information between offices and auditors.

During examinations for discovery, the Minister refused to provide answers and information relating to Paletta's questions that probed the various audits and investigations of other taxpayers. As a result, Paletta brought a motion to compel the Minister's production of the refused information.

The Minister argued that only the information relied on by Paletta's auditor was relevant for the purposes of discovery. The Minister repeatedly stated that "information collected relating to the audit of other taxpayers is irrelevant and will not be produced."

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Paletta argued that any information used by its auditor to assist her investigation was relevant for the purposes of discovery. As Paletta's auditor took instructions from CRA headquarters and co-ordinated with other offices, information that furthered those efforts was relevant to its particular case as well.

Paletta requested five categories of information:

(1) a report prepared for the CRA by a third-party consultant for the purpose of reviewing various transactions similar to the ones at issue;
(2) working papers, position papers, and proposal letters from other CRA offices;
(3) instructions from and communications between CRA headquarters and other offices;
(4) CRA requests for and production of information from third parties involved in the transactions; and
(5) information relating to negotiations between the CRA and other taxpayers.

The Court began with the maxim that a party is entitled to all documents that are relevant with respect to the issues raised in the pleadings, whether the documents support or damage the other party's position. It noted that the third parties identified in Paletta's request were directly implicated by the pleadings. As a result, the Court's decision tended towards relevancy, and it ordered production of the requested information in all but the last category.

Regarding the first category, the Court noted that the consultant's report was clearly relevant because Paletta's auditor used it as the technical basis in drafting her position paper regarding Paletta, and attached excerpts of the report to her paper. The Court ordered production of the entire report subject to redactions for privacy (the auditor had previously produced only the excerpts attached to the paper).

In respect of the second and third categories, the Court noted that it was clear from the record that there had been "significant interaction with officials at CRA headquarters in Ottawa and with CRA auditors at other local CRA offices." Paletta's auditor shared work with and had been provided information from other offices as well as CRA headquarters in order to "leverage off of" that information and ensure consistency between offices. The Court found that in such circumstances, information relating to the other investigations was relevant to Paletta's particular audit, and ordered disclosure accordingly.

Regarding the fourth category, the Court found that any information that "assisted" Paletta's auditor was relevant, including information relating to third parties obtained by other offices. In so deciding, the Court rejected the Minister's narrower construction that only documents "relied on" by the particular auditor were relevant.

The Court found in favour of the Minister regarding the fifth category of information, being that which resulted from negotiations between the CRA and other taxpayers in furtherance of settlement. It found such information was subject to settlement privilege and therefore protected from disclosure.

In light of its overwhelming support of the taxpayer's requests, the Court concluded that the Minister had obstructed the discovery process by its refusals, and ordered cost consequences of $10,000 plus disbursements.

Paletta builds on a principle recently expounded by D'Auray J in *Burlington Resources Finance Company v. The Queen*, 2017 DTC 1096 (TCC): that the scope of discovery expands along with the amount of tax in dispute and the complexity of the issues. In the case at bar, the Court reminds us that this principle applies equally to the Minister as to the taxpayer. As a general rule, the information obtained and produced in inter-connected audits and investigations of multiple taxpayers will be relevant to each particular taxpayer, and the Minister will be required to disclose that information accordingly.

—Peter Leigh

FEDERAL COURT DISMISSES TAXPAYER'S MOTION TO DECLARE OUT OF TIME THE RIGHTS ARISING FROM GARNISHMENT ORDER INVOLVING INSURANCE POLICIES

***Ruh (Re)*, 2018 DTC 5007 (Federal Court)**

In the *Ruh* case, the Federal Court confirmed that a garnishment order issued pursuant to article 639 of the *Quebec Code of Civil Procedure* (as it read in 1995) was not subject to any limitation period. The

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garnishment order issued was with respect to three life insurance policies that the taxpayer owned with Sun Life, the garnishee. Each of the policies had a cash surrender value payable at the request of the taxpayer upon surrender of the policies.

The taxpayer owed tax arrears that had been assessed in 1993. On March 31, 1994, the Minister issued a requirement to Sun Life, requiring it to pay to the Minister any sums that Sun Life was called upon to pay to the taxpayer, or to a third party on the taxpayer's behalf, in the ninety days following the date of the requirement to pay. The maximum amount payable was stated to be $216,661.74. As the amount was not paid pursuant to the requirement, on September 27, 1994, the Minister filed with the Court a certificate pursuant to subsection 223(3) of the *Income Tax Act* (Canada) (the "Act") which attested that the taxpayer was liable for $223,094.36 plus interest compounded daily on the amount from September 3, 1994, until the date of payment.

On December 19, 1994, the Federal Court issued an interim garnishment order to Sun Life. On January 13, 1995, Sun Life filed an affirmative declaration to the effect that the taxpayer held three insurance policies with surrender value which was payable only at the request of the taxpayer and on surrender of the contracts to Sun Life.

On February 21, 1995, the Federal Court issued a final garnishment order pursuant to article 639 of the *Quebec Code of Civil Procedure* and ordered that any amount due or accruing by Sun Life to the taxpayer, particularly under the Sun Life of Canada insurance contracts, be transferred to the Crown. As stated by the Court, the garnishment order had the effect of assigning the taxpayer's receivable from Sun Life to the Crown.

In 1999 the taxpayer left Canada and became a resident of Spain.

On April 11, 2011, the taxpayer asked Sun Life to pay her any money available pursuant to the three insurance policies. On June 1, 2011, Sun Life interpreted this as a request to terminate the insurance contracts and informed the taxpayer that they could not proceed with the request because of the garnishment on the insurance policies. Sun Life informed the taxpayer that she would need to contact the CRA to obtain a release from the garnishment in order to release her contracts. Hence this motion by the taxpayer.

The taxpayer raised several issues as part of the motion, but the Court determined that the only issue to be decided in the motion was whether the rights conferred upon the Crown by the final garnishment order dated February 21, 1995, were out of time.

The taxpayer argued that the final garnishment order was the equivalent of a judgment of the Federal Court and that the general limitation period of ten years prescribed by article 2924 of the *Civil Code of Quebec* or six years pursuant to subsection 39(2) of the *Federal Courts Act* should apply, such that the rights arising from the garnishment order should be declared to be out of time.

The Court disagreed with the taxpayer's position. The Court, relying on numerous judgments, stated that the objective of article 639 of the *Quebec Code of Civil Procedure* was to protect the interests of the judgment creditor by ensuring that when amounts become payable to the judgment debtor by the garnishee when the condition is triggered, these amounts would be paid to the judgment creditor (*London Life* (2014 DTC 5108 (FCA)) and *Waldteufel* (95 DTC 5183 (FC))).

Roussel J stated as follows:

> If Parliament had wanted to set a maximum time period (a period of either six (6) or ten (10) years under the corresponding federal or provincial limitation period) for the fulfillment of the condition, Parliament would have done so. In fact, the courts have used article 639 of the CCP to give effect to the garnishment of a registered retirement savings plan when the amount of money payable could not be garnished before the expiry of the term (e.g. the end of the calendar year of the 71st birthday of the judgment debtor) or before the fulfillment of the condition (e.g. the right to surrender).

The Court stated that as long as the taxpayer did not surrender her insurance policies, the Crown had no right to the surrender value. However, the judgment creditor's right cannot depend on the judgment debtor's will. The Court observed that if the taxpayer's argument were accepted, the taxpayer could choose to exercise her right to surrender at the expiry of the time limitation, which would deprive the creditor of

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the amounts payable under the insurance policy and lead to an unjust result, contrary to the spirit of the provision.

This case deals specifically with garnishment orders not being subject to a limitation period. It provides notice that a taxpayer may not be able to use time as an excuse to avoid paying tax arrears owing to the Minister where the Crown has obtained a garnishment order from the courts. The Court interpreted the respective provisions textually, contextually, and purposively, taking into account Parliament's intention. This case supports the notion that taxpayers should generally be proactive in situations in which they are faced with unpaid assessments.

—*Jaspreet Kaur*

SR&ED CLAIM FOR EQUIPMENT COST TAINTED BY NON-QUALIFYING USE

***VLN Advanced Technologies Inc. v. The Queen*, 2018 DTC 1033 (Tax Court of Canada)**

The taxpayer in this case appealed a reassessment of its 2012 taxation year that reflected the Minister's decision to exclude from the taxpayer's scientific research and experimental development ("SR&ED") expenditure pool the cost of equipment that the taxpayer used to pursue research and development activities in Canada. The case turned on whether the taxpayer's use of the equipment in certain projects outside of the scope of the taxpayer's typical research and development work could be considered to be use of the equipment by the taxpayer to pursue SR&ED on its own behalf for purposes of the *Income Tax Act* (the "Act"). As discussed below, the Tax Court answered the question in the negative and dismissed the appeal.

The taxpayer was a corporation that had expertise in water jet technology and the application of that technology to various uses in industry. It was in the business of manufacturing water jet nozzles, providing consultation services, and developing new technologies. The equipment at issue was an automated water jet system that the taxpayer acquired from a US-resident vendor. The equipment purchase was part of a larger transaction with the vendor that included the taxpayer's sale of certain water jet-related patents to the equipment vendor and the taxpayer's agreement to undertake research and development and engineering work on behalf of the vendor for fees that would be offset against the US$450,000 purchase price for the water jet system.

The taxpayer included the cost for the system in its SR&ED expenditure pool in the 2012 taxation year. This meant that the taxpayer could fully deduct the cost of the equipment in computing its income for the year even though it was an expenditure on account of capital and claim investment tax credits in respect of that cost. (Although the Act no longer allows costs incurred on account of capital to be added to a taxpayer's SR&ED expenditure pool, a capital expenditure that otherwise met the SR&ED eligibility requirements could be included in the pool based on the way the relevant provisions in the Act applied to the year at issue.)

There were two aspects of the SR&ED eligibility criteria that were relevant to this appeal. First, an expenditure can only be included in the taxpayer's SR&ED expenditure pool if the corresponding work was undertaken by or on behalf of the taxpayer for the taxpayer's own account in connection with a business of the taxpayer. Second, where the relevant cost is a capital expenditure to acquire equipment, the equipment must have been acquired by the taxpayer with the intention of using it during its useful life towards prosecuting SR&ED in Canada for all or substantially all of the equipment's operating time. These criteria were relevant because the Minister's reassessment was based on the conclusion that the taxpayer acquired the equipment with the intention of using it to perform the research and development work for the equipment vendor that the taxpayer committed to undertake at the time it agreed to purchase the system and, once acquired, significant periods of the equipment's operating time were directed at undertaking contract research and development work for third parties.

The focus of the Court's decision was on the second criterion (i.e., intention). It appears that the taxpayer sought to satisfy the Court on this issue by having the chairman/director of the taxpayer corporation testify that the taxpayer had the intention of solely using the equipment towards its own research and development work and that the originally contracted research and development work for the equipment vendor had largely been completed before the taxpayer took delivery of the equipment. However, even though the Court found the chairman/director to be a credible witness, the Court still found it necessary to examine the actual use of

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the equipment to come to a conclusion on the intention issue. One of the implications of the Court's decision to look at actual use of the equipment to make a factual determination on the intention question is that the Court's evaluation of whether the taxpayer met the "all or substantially all" aspect of the intention requirement would be influenced by uses of the equipment in projects that the taxpayer may not have anticipated at the time it acquired the equipment.

The evidence on the actual use of the system was relatively straight-forward. There was a 12-month period between the time when the taxpayer committed to acquire the equipment and its delivery to the taxpayer and another four to five months before the taxpayer started putting the equipment into use in September 2012. During the period between September 2012 and July 2015, the taxpayer's utilization records showed that the equipment was used for 108.8 hours in total for 6 tasks:

(i) demonstration at a conference (3 hours),
(ii) debugging system and training personnel (14 hours),
(iii) collaborating with University of Ottawa graduate students on their pulse water jet research projects (26 hours),
(iv) conducting a feasibility study for a UK-resident company on whether the equipment could be adapted for use in decommissioning irradiated structures in nuclear facilities (20 hours),
(v) conducting a feasibility study for the Toronto Transit Commission on whether the equipment could be used to treat concrete tunnels (10 hours), and
(vi) testing water jet nozzles as part of projects that the Minister accepted as SR&ED qualifying activities (35.8 hours).

It seems that the Court was prepared to accept that debugging the system and training personnel could be regarded as use of the equipment towards prosecuting SR&ED on the taxpayer's own behalf; but that usage, together with the use of the equipment for testing water jet nozzles, accounted for just under 50 hours of system use, well short of what could be regarded as "all or substantially all" of the equipment's 108.8 hours of logged use. The Court then went on to consider the taxpayer's 56 hours of use of the equipment for the projects with the University of Ottawa and the two feasibility studies and whether those activities could be regarded as work that the taxpayer undertook to pursue its own SR&ED efforts. While the taxpayer asserted that its ability to use the data and findings from each of those projects supported the taxpayer's own SR&ED activities, the Court seemed to require evidence of a more direct connection to the taxpayer's own SR&ED projects before the Court would regard those efforts to be in futherance of the taxpayer's own SR&ED. For example, with respect to the feasibility studies, the Court noted that there was no evidence as to what aspect of scientific or technological uncertainty the taxpayer was investigating on its own behalf in those studies or the scientific methodologies that the taxpayer was implementing through that work towards investigating that uncertainty.

In the result, the Court held that the taxpayer did not acquire the system with the requisite intention of using it during all or substantially all of its operation time in its useful life towards prosecuting SR&ED in Canada on its own account. While the Court felt compelled to place considerable weight on the actual use of the system to make its determination as to the taxpayer's intended use of the equipment when it was acquired, the taxpayer could have presumably assisted itself in this regard if it had contemporaneously documented at the outset how the taxpayer was planning to use the equipment in its own SR&ED work during its useful life or made efforts at the time to prepare *pro forma* schedules projecting the use of the equipment during its expected life for its own SR&ED projects. Moreover, given that the University of Ottawa research projects and the two feasibility studies likely involved matters that were closely related to the SR&ED work that the taxpayer was undertaking on its own behalf, one cannot help but wonder whether it would have been a relatively easy exercise for the taxpayer to slightly change the nature or scope of its participation in those projects to ensure that it was concurrently investigating scientific or technological uncertainty on its own account using a scientific methodology.

—John Yuan

RECENT CASES

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APPEAL FROM IMPOSITION OF PENALTIES FOR GROSS NEGLIGENCE DISMISSED

The taxpayer's return for the 2009 taxation year had been prepared by the tax return preparation group Fiscal Arbitrators, which charged a fee equal to 20% of the total tax refund of $84,565. That return included a false claim for business losses and resulting loss carrybacks. Those claims were denied by the Minister on reassesssment, and penalties for gross negligence were imposed. The taxpayer appealed from the reassessment on the issue of the penalties.

The appeal was dismissed. The Tax Court of Canada held that in order to justify a penalty for gross negligence, the Minister was required to show, on a balance of probabilities, both that a false statement or omission was made in the appellant's return and that such false statement or omission was made by the appellant either knowingly or in circumstances amounting to gross negligence. The Court held that the evidence before it established that a false statement had been made in the return and in the loss carryback request, and that conclusion was not disputed by the appellant. The question for determination, therefore, was whether such false statement had been made knowingly or in circumstances amounting to gross negligence. The Court reviewed the information set out in the return and the circumstances in which it was signed by the appellant and concluded that there were a number of warning signs, including the "manifestly extraordinary tax result" and "exorbitant fee based on the tax refund", that should have alerted a person in the appellant's position of the need to make further inquiries or seek independent verification. The Court held that the conduct of the appellant in signing and filing the return without reviewing it or making such inquiries was a marked and substantial departure from the conduct expected of a reasonable person in the same circumstances. The appellant's argument that he had relied on his tax preparer was not sustainable, where the materials provided by that tax preparer were so obviously "wrong, deficient and nonsensical" and when the tax result obtained was so "extraordinary and suspicious". The appellant's conduct in the circumstances constituted gross negligence, for which penalties were properly imposed.

Peck v. The Queen

2018 DTC 1043

SOLICITOR-CLIENT PRIVILEGE ATTACHING TO DOCUMENT DISCLOSED TO A THIRD PARTY HAVING SUFFICIENT COMMON INTEREST

A lawyer for a company which provided tax advice on corporate transactions prepared a memo for his client with respect to a share acquisition from a third party. That memo, which was prepared with input from the lawyer for the third party, outlined the tax implications of each step of the transaction undertaken to carry out the share acquisition. That memo was provided to both the client and the third party. Following the completion of the transactions, the Minister served the third party with a Requirement for Information under section 231.2, seeking disclosure of the memo. The third party claimed solicitor-client privilege in respect of the memo, but its argument was rejected by the Federal Court, which held that the concept of solicitor-client privilege based on common interest privilege had no application and that the memo was therefore not subject to solicitor-client privilege in the hands of the third party. That decision was appealed to the Federal Court of Appeal.

The appeal was allowed. The Federal Court of Appeal held that section 231.7(1)(b) of the *Income Tax Act* (the “Act”) indicates that Requirements for Information do not apply to a document that is protected from disclosure by solicitor-client privilege as that term is defined in section 232(1) of the Act. The relevant definition provides that "solicitor-client privilege means the right, if any, that a person has in a superior court in the province where the matter arises to refuse to disclose an oral or documentary communication on the ground that the communication is one passing between the person and the person's lawyer in professional confidence …" The Federal Court of Appeal held that, as the only provinces that were identified as being potential provinces for the purposes of that definition were Alberta and British Columbia, the question for determination was whether a superior court in those provinces would find that the impugned memo was protected from disclosure by solicitor-client privilege under the law applicable in those provinces. The Court reviewed appellate jurisprudence from those provinces before concluding that, based on such jurisprudence,

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solicitor-client privilege is not waived when an opinion provided by a lawyer to one party is disclosed, on a confidential basis, to other parties with sufficient common interest in the same transactions. As well, in the Court's view, such principle applies whether the opinion is first disclosed to the client of the particular lawyer and then to the other parties, or simultaneously to all. The appellate Court concluded that, in the circumstances of the case, the parties on either side of the share acquisition transaction had sufficient common interest in those transactions to warrant a finding that, in Alberta or British Columbia, the impugned memo was protected from disclosure by solicitor-client privilege. The appeal was allowed and the judgment of the Federal Court was therefore set aside, and a judgment issued providing that the Minister's application to enforce the Requirements as they related to the impugned memo was dismissed, with costs to the appellant throughout.

Iggillis Holdings v. MNR

2018 DTC 5027

DISABILITY TAX CREDIT LEGISLATION TO BE INTERPRETED IN HUMANE AND COMPASSIONATE MANNER—ADMINISTERING SPECIFIC FOOD FOR SOMEONE BORN WITH PKU QUALIFIED AS THERAPY

The appellant was appealing a determination by the CRA that she was not entitled to claim the disability tax credit ("DTC") on behalf of her daughter Gwynneth who was born with phenylketonuria ("PKU"). PKU is an impairment of the body's ability to metabolize the amino acid phenylalanine ("Phe"), which if left untreated can cause permanent and severe brain damage. The treatment for PKU involves administration of a specific dosage of medical formula which is dispensed by prescription only, ingestion of required Phe through the consumption of specific medical foods (i.e., specially produced items distributed only through limited distributors which is fully funded once approved by prescription from a metabolic disorders clinic), and ingestion of Phe through ordinary food with very low Phe content. This involves weighing every bit of food, calculating Phe ingested, and recalculating to ensure the proper amount is being consumed. All foods need to be isolated, weighed, measured, and logged. The CRA denied the DTC on the basis that the impairment related to dietary restrictions and following a dietary regime, which is excluded as therapy under the DTC legislation.

The appeal was allowed. The disability tax credit legislation is to be interpreted in a humane and compassionate manner. To be eligible for the DTC it must be shown that there is a severe and prolonged impairment in one's physical or mental functions such that basic activities of daily life would be markedly restricted but for therapy that is essential to sustain a vital function of a person. Such therapy must be administered at least three times a week for a total average of not less than fourteen hours a week. Therapy does not include time spent on activities related to dietary restrictions or dietary regimes. Therapy under the DTC provisions means care or treatment of a physical or mental condition. Recent case law has found that the administration of daily precise amounts of Phe is therapy. This therapy includes planning, preparing meals and snacks, supervising consumption, educating all those who could provide food to Gwynneth, and calculating and recalculating daily Phe consumption. Without the therapy, Gwynneth would have potentially devastating and irreversible adverse consequences to her proper mental development and functioning. While the chart prepared by the appellant was an estimate, more than fourteen hours a week was spent on administering the Phe therapy.

Hughes v. The Queen

2018 DTC 1040

PLAINTIFFS AWARDED AGGRAVATED AND PUNITIVE DAMAGES IN MALICIOUS PROSECUTION ACTION AGAINST CRA

The plaintiffs were charged with 21 counts of tax evasion relating to their operation of a restaurant, and their alleged failure to report income from that business. They were acquitted on all charges, with the trial judge finding the husband to be a credible witness and the explanations provided to be consistent with material aspects of the evidence. The plaintiffs then brought an action for malicious prosecution against the Canada

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Revenue Agency ("CRA") and against the lawyer who had acted as agent for the CRA in the prosecution. By way of remedy, they sought both aggravated and punitive damages for the malicious prosecution or for breaches of their Charter rights, as well as compensation for legal fees and disbursements incurred.

Judgment was issued for the plaintiffs against the Canada Revenue Agency only. The Court noted that, in order to find an action for malicious prosecution, the plaintiffs were required to show that the defendant initiated the prosecution against them and that such prosecution terminated in the plaintiff's favour, that the prosecution was undertaken without reasonable and probable cause, and that the prosecution was motivated by malice or a primary purpose other than that of carrying the law into effect. The Court reviewed in detail the conduct of the audit which had led to the charges which were laid against the plaintiffs, as well as the series of communications among CRA officials and representatives of the Public Prosecution Service of Canada ("PPSC") during the charge approval process. The Court held that the evidence satisfied all four of the requisite elements of an action for malicious prosecution. It found that the charges should never have been proceeded with, as it was clear that the evidence obtained was not sufficient to meet the requisite charge approval standard, and that such fact had been communicated by PPSC lawyers to CRA representatives involved in the case. In addition, the Court characterized the conduct of the CRA and its employees, for whom the Agency was vicariously liable, to be "high-handed, reprehensible and malicious", involving the concealment of exculpatory evidence and the violation of the plaintiffs' fundamental rights. The plaintiffs were awarded aggravated damages in the amount of $300,000 each and punitive damages in the amount of $750,000. They were also awarded $350,000 in compensation for legal fees and disbursements incurred. The Court declined to award damages for breach of the plaintiff's Charter rights.

Samaroo v. CRA et al

2018 DTC 5026

TAXPAYER CHARGED WITH FAILING TO REPORT INCOME; TRIAL JUDGE ENTERED STAY OF PROCEEDINGS BASED ON UNREASONABLE DELAY; STAY OF PROCEEDINGS OVERTURNED ON APPEAL

Following charges laid on May 17, 2012, the accused taxpayer, a dentist, was convicted on August 9, 2016, by the Provincial Court of British Columbia of making false or deceptive statements, and of failing to report taxable income under the *Income Tax Act*. However, the trial judge entered a judicial stay of proceedings based on unreasonable delay under paragraph 11(b) of the *Canadian Charter of Rights and Freedoms*, after attributing 21.8 months of delay to the taxpayer, and finding a total period of 29.7 months of delay (the "Delay Ruling"). His conclusions, in part, were that: (a) the onus is on the Crown to show, under the transitional circumstances exception set out in *R. v. Jordan* (2016 SCC 27), that the time taken to conclude the trial was justified based on the parties' reasonable reliance on the law as it was prior to the appearance of the *Jordan* decision; and (b) the Crown in this case failed to discharge this onus. The Crown appealed from the Delay Ruling to the Supreme Court of British Columbia.

The Crown's appeal was allowed. In the *Jordan* case, the Supreme Court held that the Crown, the defence, and the courts have a responsibility to ensure that criminal proceedings are carried out in a manner that respects an accused's constitutional right to be tried within a reasonable time, and for Provincial courts that time is 18 months from the charge to the actual or anticipated end of trial, beyond which the delay is presumed to be unreasonable. The trial judge erred in not attributing 7 months of delay to the taxpayer during a time when the Crown was available to reset trial dates. The trial judge also erred in calculating another delay attributable to the taxpayer, as well as in his failure to apply correctly the transitional exceptional circumstance in this case. In addition, at various times throughout the proceedings the taxpayer had remained passive and delayed certain matters, whereas counsel for the Crown did not do this. The judicial stay of proceedings was set aside accordingly.

R. v. Balogh

2018 DTC 5022

Footnotes

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[1] "Minister Morneau Announces Next Steps in Improving Fairness in the Tax System by Closing Loopholes and Addressing Tax Planning Strategies" (along with draft legislation and consultation documents), Department of Finance, July 18, 2017.

[2] "Targeted Tax Fairness Measures Will Protect Middle Class Small Business Owners", Department of Finance, October 18, 2017.

[3] Light was first shed on the principle in the seminal article written by MIT professor Carey Brown, "Business-Income Taxation and Investment Incentives", in *Income, Employment and Public Policy: Essays in the Honor of Alvin H. Hanson*, 300 (1948). The principle is well-entrenched in the tax policy literature. Perhaps the most comprehensive article is Christopher Hanna, "Demystifying Tax Deferral", vol. 52, no. 2 SMU Law Review 383. More recently, a shorter but important article was written by Harvard Law professors Daniel Halperin and Alvin C. Warren, "Understanding Income Tax Deferral", 67 Tax L. Rev. 317 (2014).

[4] The example assumes that the 5% return is available for the entire $200,000 amount in the deferral case, and not just the $100,000 amount from the no deferral case. Where the return is different on the invested amount between $100,000 and $200,000, the amount of tax-exempt income will differ. This point is also entrenched in the tax policy literature, and is discussed in some detail in the Halperin and Warren article cited in note 3 above.

[5] See Example 1 in the Appendix.

[6] See Example 2 in the Appendix.

[7] See "Consultation Document: Tax Planning Using Private Corporations", which formed part of the July 18, 2017 proposals (herein, the "July 18 Consultation Document").

[8] For example, assume a taxpayer in a 50% tax bracket earns employment income and half of that income is tax-exempt. Although the nominal rate of tax on employment income will remain 50%, the taxpayer's effective rate of tax on employment income will be 25%. It is quite clear that the 25% rate is a more accurate depiction of how much tax the taxpayer pays on employment income. Accountants sometimes use the term "effective tax rate" to mean the average statutory (or nominal) rate. That concept differs from the concept used in the tax policy literature and in this article.

[9] See Example 3 in the Appendix.

[10] See UBC Professor Kevin Milligan, "Integration and the Taxation of Passive Income: An Economic Perspective", in http://blogs.ubc.ca/kevinmilligan: "Some have argued that the resulting tax rate on passive income inside the firm [the alleged 73% tax rate] is excessive. But, any analysis needs to look at the whole flow of income from beginning to end. Inside the firm the taxation of the principal is very light to start, so the heavier taxation of the accruing income balances things out"; Carleton Professor Francois Brouard as quoted in Miccal Ahmed, "Trudeau government facing uphill battle on tax reforms", Capital News, September 29, 2017: "Some calculations the Conservatives are putting forward is that the tax rate will be 72 per cent. It is like comparing apples and oranges. No one pays 72 per cent. Not before. Not after. Not ever." More generally, see UBC Law Professor David Duff's testimony in *Proceedings of the Standing Senate Committee on National Finance*, Issue No. 45, November 6, 2017.

[11] Kim Moody, of the firm Moody Gartner Taw Law, was one of the more vocal critics in the 73% crowd. Moody concluded that anyone not agreeing with his claim that the "real" tax rate under the July 18 proposals would have been 73% "displays a complete lack of understanding of the private corporation tax proposals" (Moody Gartner Blog, dated December 11, 2017). I suggest that the tax policy experts cited in note 10 understood the tax proposals better than most, particularly since they analyzed the proposals taking into account the impact of tax deferrals on effective tax rates.

[12] In the July 18 Consultation Document ("Possible Approaches"), the Department's proposals included different tax treatment of CCPC investment income depending on the source of the income—that is, whether the income was earned out of SBD income, general corporate business income, or contributions made by a shareholder. As some commentators noted, tracking and allocating the sources to different pools or accounts would have added to existing complexity.

[13] The current advantages include the SBD itself, enhanced refundable investment tax credits, an unlimited deferral of capital gains for re-investments in eligible small business corporations, the capital gains exemption, and preferential employee stock option treatment, to name a few.

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[14] Using the deferral principle and basic tax arithmetic (see also the text in and around notes 5 and 6 above), it can be shown that owners of CCPCs who use the investment income exemption retain a tax subsidy that can potentially add up to the equivalent of hundreds of thousands of dollars of extra RRSP room. The Department knows this and appears to be willing to live with it: “The tax benefit of saving within a private corporation can also exceed the tax benefits that individuals can receive from passive investments in RRSPs or TFSAs” (“Limitations of the Current System”, July 18 Consultation Document).

[15] The definition of “qualified small business corporation share” is found in subsection 110.6(1). The definition of “connected corporations” is found in subsection 186(4) and is discussed in note 22.

[16] The active asset definition also contains a look-through rule that applies where a partnership owns such assets or shares and the CCPC has an interest in the partnership whose fair market value is 10% or more of the fair market value of all of the interests in the partnership.

[17] Note 2 above.

[18] Current tax incentives are listed in note 13.

[19] Subsection 129(4), “income or loss”, which is effectively incorporated into the draft definition of “adjusted aggregate investment income”.

[20] In the Budget documents, “Growth / A Fair Tax System for all Canadians”, the Department indicates that it did follow through with grandfathering provisions: “No existing savings will face any additional tax upon withdrawal, thereby maintaining the Government’s commitment to protect the tax treatment of all past savings and investments.” What the Department means is that income from past investments will continue to be eligible for the RDTOH, not that the past investments will be grandfathered from the SBD reduction proposal. As indicated in an analysis by the law firm McCarthy Tetrault, the SBD reduction proposal “may have an impact on those corporations that were otherwise eligible for the small business tax rate and that had significant investment assets at the time that these changes were proposed (which is to some extent inconsistent with the Government’s October 18, 2017, statement).” (McCarthy Tetrault website, “2018 Canadian Federal Budget Commentary—Tax Initiatives”, February 28, 2018).

[21] See note 12 regarding the proposals in the July 18 Consultation Document.

[22] A connected corporation means a corporation that is controlled by the CCPC, and a corporation in which the CCPC owns 10% or more of the shares of the corporation on a votes and fair market value basis; see subsection 186(4). A non-connected corporation is a corporation other than a connected corporation.

[23] Draft clause 129(1)(a)(ii)(B).

[24] Draft subsection 129(5).

[25] See note 20.

[26] For CCPC investments accumulated before 2019 and paid out in 2019 or subsequent years as dividends, the CCPC deferral advantage will be diminished somewhat owing to the decrease in the dividend tax credit beginning in 2019. The decrease coincides with, and is a result of, the decrease in the SBD rate in 2019.

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