Tax Notes

July 2021
Number 702



# THE TAXATION OF RESTRICTIVE COVENANTS (NON-COMPETE AGREEMENTS)

*— Frankie Fenton of Frankie Fenton, Tax and Accounting Services, Langley, BC*

Generally speaking, the purchaser of a business may demand a covenant from the vendor that it not compete with the business the purchaser is acquiring, usually for a period of years and often within a specific geographic area. Most of the rules deal primarily with the position of the vendor giving the covenant, who is most often an individual rather than a corporation, although it is certainly possible for a corporate vendor to give such an undertaking. In any event, the tax consequences for both the vendor and the purchaser must be considered in light of the applicable rules.

The costs of the covenant to the purchaser will normally be booked as part of the cost of acquisition in the first instance, and for the vendor as part of the proceeds of disposition, and adjustments may be required on Schedules 1, 6, and 10 to obtain the required tax results.

The general rule is that amounts received or receivable in a particular year under a restrictive covenant, as defined, are included in income in full in that year, unless some other specified treatment is explicitly provided for. The general rule applies only to amounts received or receivable by the taxpayer or a person or partnership not dealing at arm's length with the taxpayer. There is no mirror rule for the person paying these amounts except where a joint election is provided for or the amount is considered employment income. In the absence of a rule, one would assume the payer is obtaining Class 14.1 property.

There is a safeguard against double counting, in that a taxpayer does not include amounts included in income in a prior year or amounts included in the income of a taxpayer's company (a company in which the taxpayer has 90% or more of the voting shares which represent 90% or more of the fair market value of the company).

## Definition

A "restrictive covenant" is broadly defined in subsection 56.4(1)[1] in relation to a particular taxpayer (which for these purposes includes a partnership), and means an agreement entered into, an undertaking made, or a waiver of an advantage or right by that taxpayer (other than an arrangement or undertaking for the disposition of the taxpayer's property), whether enforceable or not, that affects or is intended to affect, in

[1] *Income Tax Act*, subsection 56.4(1), Definitions.

any way whatever, the acquisition or provision of property or services by a taxpayer or by another taxpayer that does not deal at arm's length with the taxpayer.

The definition is broad enough to capture covenants attached to land and to employment as well as covenants attached to the purchase and sale of shares or business assets.

## General Carve-Out

There are exceptions. The definition of a restrictive covenant does not include:

(i) an agreement or undertaking for the disposition of the taxpayer's property; or

(ii) a limited class of deemed "non-dispositions" where a right acquired for not less than fair market value is exchanged for property under an arrangement to establish the right.

The exception for a pure disposition of property seems intended to ensure that a mere purchase and sale agreement with no covenant attached will not be affected by these provisions.

### History

Draft legislation first published in 2004 and finally passed into law on June 26, 2013, spells out the consequences for a taxpayer of entering into a "restrictive covenant". The cases which provoked this legislation generally involved the purchase and sale of shares accompanied by a covenant by the vendor to not compete with the purchaser, one of which was *Manrell v. The Queen* (2003 DTC 5225),[2] heard in 2003. As discussed below, in the *Manrell* case the courts held that the payments received in respect of the covenant were not taxable to the vendor. The legislative response is far broader than necessary to deal with that issue, as the definition makes clear.

## Allocation Rule

An essential part of the legislation specifically applies the allocation rules (section 68 of the *Income Tax Act*) to restrictive covenants. These rules say that where part of an amount received or receivable by a taxpayer may be seen as consideration for a disposition or for services rendered by the taxpayer, and part may be considered for a restrictive covenant, the proceeds must be allocated on a reasonable basis regardless of the form or effect of a contract or agreement governing the disposition and proceeds.

The allocation rule, together with the exclusions from the restrictive covenant definition, appear designed to carve up an agreement for a disposition of assets which includes a covenant to not compete into:

(i) the agreement in respect of the disposition, which is presumably on capital account, giving rise in most cases to a capital gain or loss, or a disposition of Class 14.1 property; and

(ii) the agreement not to provide the specified arm's length services to anyone, which latter agreement the courts have held not to be a disposition of property.

Since the general rule taxes amounts receivable but not yet received, it is of course possible that there will be intervening events and the amounts will never be received. In this case, there is an offsetting deduction from income from all sources in the year the amount owing is established to be a bad debt. If an amount deducted as a bad debt under this provision is later recovered, the recovery is included in income when received.

[2] *Tod T. Manrell v. Her Majesty the Queen*, 2003 DTC 5225 (FCA).

## Cautionary Note re Allocation

In *Manrell*, virtually the whole proceeds of disposition were assigned to the non-competition agreement, and the issue of the correct allocation of proceeds of disposition to the non-taxable agreement, as opposed to other assets giving rise to capital taxable gain, was not in dispute. One assumes that it will be very much in dispute in future. The allocation of proceeds in an agreement between an arm's length purchaser and seller will no doubt carry some weight in the courts, but it remains to be seen how much. The CRA has said, in Ruling 9800145:[3]

> Finally, we wish to stress to you that under section 68 of the Act the parties must make a reasonable allocation of the consideration among the assets sold. If the allocation is unreasonable, the Department can apply the provisions of section 68 to deem what may reasonably be regarded as the proceeds for the various assets, including the goodwill.

A general discussion of the principles to be followed in valuing a non-competition agreement is found in Wolters Kluwer Canada Limited *Tax Topics* No. 1638.[4]

## Other Exceptions

There are now several further exceptions to the compulsory allocation of proceeds to a non-competition agreement rather than to proceeds of disposition. The most recent exception relates to covenants given to eligible individuals.

## Election in Prescribed Form

In some cases, joint elections can be made between the purchaser and the vendor for specific tax treatment of covenant amounts.

The joint elections are to be made in prescribed form along with a copy of the restrictive covenant. If the person granting the covenant was resident in Canada, the filing deadline is the filing-due date of that person for the year in which the covenant was granted. In any other case, the joint election must be filed within six months of the day on which the covenant was granted.

## Withholding Tax

All payments to non-residents to which the restrictive covenant rules apply are subject to non-resident withholding tax. It is perhaps doubtful if treaty relief would apply to reduce the 25% withholding rate, but where payments are made to a treaty country, the applicable treaty should always be checked to see if a payment can be fitted within its parameters. Where a payment to a non-resident could be viewed as both a payment on account of a covenant and a payment on account of a rent, royalty, or the like, the covenant rule will prevail, presumably making a reduced treaty rate less likely.

The withholding rules which impose tax where one non-resident makes payments to another will also apply where payments for a restrictive covenant affect:

- the acquisition or provision of property or services in Canada,
- the acquisition or provision of property or services outside Canada by a person resident in Canada, or
- the acquisition or provision outside Canada of a taxable Canadian property.

[3] Technical Interpretations, *Non-Competiton Agreements — Client Lists*, (Apr. 27, 1998).

[4] Newsletter, *Tax Topics* 1638, July 31, 2003.

# COVID-19 UPDATE

*Given the rapidly changing information related to COVID-19 we are providing continuously updated information at https://blog.intelliconnect.ca/.*

## Federal

### New Marketing Funding for Small Businesses (June 21, 2021)

The federal Government announced the launch of Shop Local, a Canada-wide investment of $33 million to encourage Canadians to shop locally. The funding will be provided through provincial and territorial chambers of commerce to support awareness-building campaigns that promote consumer confidence and local businesses. The amount of funding allocated to each chamber is based primarily on the percentage of small businesses in its region. Chambers may use this funding to support a range of activities that encourage consumers to shop locally in a way that is safe and aligns with current public health guidelines. Chambers may solicit applications directly from local organizations or associations or have open calls for proposals that promote consumer awareness and demonstrate benefits to the broader business community. This investment will be flexible to respond to the unique circumstances in regions across the country and allow chambers of commerce to tailor campaigns to local needs and priorities, ultimately helping small businesses as they recover from this unprecedented public health and economic crisis.

### Tax Court Cancels In-Person Sittings (June 1, 2021)

On June 1, 2021, the Chief Justice of the Tax Court of Canada ("TCC") cancelled all in-person sittings scheduled between August 16, 2021, and September 10, 2021, inclusively. The TCC will continue to endeavour to conduct virtual hearings for some proceedings previously scheduled to occur in person between August 16, 2021, and September 10, 2021, inclusively. The TCC will identify appeals for virtual hearings and contact parties to determine with them if the hearing could proceed virtually. All parties affected by the sittings schedule have been or will be contacted directly by the Registry staff. Conference calls and virtual hearings previously scheduled to proceed between August 16, 2021, and September 10, 2021, inclusively, will proceed as scheduled. The Court and its Registry offices remain open with reduced staff. The Hamilton office remains closed.

### CRA Clarifies SR&ED Deadline for British Columbia and Nova Scotia (June 7, 2021)

The filing due-dates for corporate income tax returns for tax year-ends from November 30, 2019, to February 29, 2020, were extended to September 1, 2020. Accordingly, the federal SR&ED reporting due-date for these tax years was extended to September 1, 2021.

However, the CRA recently clarified that this extension does not apply to the British Columbia SR&ED Tax Credit and the Nova Scotia R&D Tax Credit. For example, British Columbia and Nova Scotia corporations with a December 31, 2019, tax year-end should file Forms T661, T2SCH31, T666 (for British Columbia), T2SCH340 (for Nova Scotia), and any other relevant forms no later than June 30, 2021.

### Extension of Business Support Programs (June 2, 2021)

The Business Credit Availability Program and Highly Affected Sectors Credit Availability Program are being extended to December 31, 2021. Both programs were set to expire on June 30, 2021.

### Additional Canada Child Benefits (May 28, 2021)

On May 28, 2021, Prime Minister Trudeau announced that families entitled to the Canada Child Benefit ("CCB") will receive additional support of up to $1,200 for each child under the age of six. Families with a net income of $120,000

or less will receive up to four tax-free payments of $300. Families with a net income above $120,000 will receive up to four tax-free payments of $150, for a total benefit of up to $600. To ensure that more money goes to the families that need it the most, families with net incomes that are too high to be entitled to the CCB will not receive these additional payments. The first and second payments were issued on May 28, with subsequent payments on July 30 and October 29, 2021.

### Canada To Reimburse Self-employed Workers Who Repaid CERB (May 27, 2021)

As announced in February, self-employed workers who applied for the Canada Emergency Response Benefit ("CERB") and would have qualified based on their gross income are not required to repay the benefit, provided they also met all other eligibility criteria. The Government of Canada announced further details on how this approach will be applied. Self-employed workers whose net self-employment income was less than $5,000 and who applied for the CERB will not be required to repay the CERB as long as:

- they have filed their 2019 and 2020 income tax returns by December 31, 2022;
- their gross self-employment income was $5,000 or more in 2019 or in the 12 months prior to their initial application; and
- they met all other CERB eligibility criteria.

The CRA will review the 2019 and 2020 income tax returns of workers in this situation to verify that these conditions are met.

Starting May 27, 2021, self-employed workers who meet the remission order criteria and who had voluntarily repaid all or part of the CERB to the CRA or Service Canada can request a reimbursement of their payments from the CRA. These workers can do so by completing the CRA's *CERB Reimbursement Application for Self-Employed Individuals* form (www.canada.ca/content/dam/cra-arc/formspubs/pbg/t180/t180-21e.pdf) and submitting it to the CRA electronically or by mail. The CRA will begin processing applications after June 15, 2021. Eligible Canadians who repaid the CERB can expect reimbursements within approximately 90 days of submitting their applications.

## Provincial

### Alberta

#### One-Time Payment for Essential Workers (June 22, 2021)

Alberta announced 76,500 more workers will receive a one-time payment to recognize the risks they have taken to support Albertans and the economy. Workers in new job categories will be eligible for the same $1,200 payment. This includes workers in social services and the private sector who provided critical services to Albertans, were essential to the supply and movement of goods, and faced greater potential risk of exposure to COVID-19 through their work environments.

Employers of support staff working in licensed child care programs, disability support workers providing independent living supports, respite, community access, and employment supports, and front-line workers in seniors-serving organizations and non-profit affordable housing providers will be contacted by the Government of Alberta to confirm details.

Eligible private sector workers making $25 per hour or less will also qualify for the benefit. These workers include: truck drivers, farmworkers, security guards, cleaners, funeral workers, employees at quick service and dine-in restaurants, and taxi drivers who can demonstrate they worked at least 300 hours during the eligibility period. Private sector employers can apply on behalf of employees as of June 22. Employers have until July 23 to apply.

### Additional Relief for Alberta's Tourism Industry (May 26, 2021)

Alberta announced a further extension of the tourism levy abatement, which originally ended on March 31, so that hotels and other lodging providers will now be able to keep tourism levy amounts collected between April 1 and June 30, 2021. Interest otherwise payable under the *Tourism Levy Act* for the failure to remit tourism levy will not be assessed in respect of these amounts. Hotels, short-term rental hosts, and other lodging providers that have already remitted tourism levy amounts collected on or after April 1 will receive a refund from Alberta's Tax and Revenue Administration. Businesses are still required to file returns as per the *Tourism Levy Act* and will be expected to resume regular tourism levy payments on amounts collected on or after July 1.

### Extending Small Business Grant (May 26, 2021)

The deadline for applications for the spring 2021 payment from Alberta's Small and Medium Enterprise Relaunch Grant ("SMERG") has been extended from May 31 to June 30. SMERG offers financial assistance to Alberta businesses, cooperatives, and non-profit organizations with fewer than 500 employees that have faced restrictions or closures due to COVID-related public health orders and experienced revenue losses of at least 30%. Eligible organizations will receive a payment of up to $10,000, which follows the previous intake that provided up to $20,000. Funds can be used as business owners see fit.

## British Columbia

### Property Tax Relief for Farms Extended (June 14, 2021)

For the second consecutive year, the province is waiving the income requirements normally required for existing BC farm operations when qualifying for farm classification. By once again eliminating the income requirement as BC recovers from COVID-19, farmers will not have to worry about the possibility of losing their farm classification and having an increase in property taxes in 2022. Each year, BC Assessment sends out self-reporting income questionnaires and conducts intermittent inspections to determine whether a property should maintain its farm status for the upcoming tax year. To be classified as a farm in BC, properties must meet certain criteria, including generating a minimum amount of gross income from a qualifying agriculture use based on the size of the parcel of land. For further information on farm classification, visit BC Assessment: info.bcassessment.ca/farm.

### Supporting Indigenous Tourism Businesses

The BC Indigenous Tourism Recovery Fund supports Indigenous tourism businesses, including lodges and resorts, outdoor adventure experiences, galleries, and gift shops owned by Indigenous people. The fund is a partnership with Indigenous Tourism BC. Businesses have received up to $45,000 to navigate the ongoing economic impacts of the provincial restrictions. Indigenous tourism businesses are using the grant to pay for things like rent, utility bills, installing health and safety measures, and shifting services online. For additional information, see: www.indigenousbc.com/.

## Manitoba

### Bridge Grant Program Reopens (June 22, 2021)

The provincial government announced it is reopening the Manitoba Bridge Grant program to provide an estimated $5 million in support for seasonal businesses, new applicants, and others affected by public health restrictions. The province has opened the bridge grant intake to businesses that did not previously apply, such as new and seasonal businesses that were not operating as of the original November 10 program deadline. Eligible storefront businesses will receive $5,000 and home-based businesses will receive up to $5,000 based on 10% of their most recent calendar year revenues. Nearly 1,000 businesses may be eligible.

The province is also extending the $2,000 food waste top-up to new applicants, as well as previous bridge grant

recipients that offer prepared food services but did not receive the May 15 deposit as it was only provided to restaurants. Approximately 600 businesses that offer prepared food services, such as hotels, lodges, outfitters, bars, and lounges, will automatically receive the $2,000 top-up June 25.

A new applicant that offers prepared food services would receive a $5,000 grant plus the $2,000 top-up for a total of $7,000. New applicants will not receive retroactive payments for previous rounds of the program, and businesses that previously received a Manitoba Bridge Grant or whose application was rejected are ineligible to reapply for the $5,000 payment.

Businesses are invited to check eligibility and apply for a Manitoba Bridge Grant by the deadline of July 16.

### New Wage Support Program for Employers (June 24, 2021)

The Manitoba government is introducing the $30 million Healthy Hire Manitoba Program, a new wage support to help private-sector employers reopen and encourage employees to get vaccinated and return to work.

Under the Healthy Hire Manitoba Program, local employers can apply for up to $50,000 in provincial support to help cover the wages of new employees who can attest they have been vaccinated or will be vaccinated. Eligible employers will receive a grant equivalent to 50% of wages for a maximum of 10 employees, with a maximum of $5,000 per employee. The wage support covers full pay periods for employees hired on or after June 10, 2021, with the last pay period ending October 15.

Employers must be an active and permanent Manitoba-based business, not-for-profit, or registered charity physically operating in the province. The Healthy Hire Manitoba Program is available for newly-hired employees who started working no earlier than June 10 or a rehired employee who worked for that employer in a previous year or who was laid off as a result of the public health restrictions.

More information and full eligibility criteria for the new Healthy Hire Manitoba Program will be posted online at manitoba.ca/covid19/programs/index.html.

### Education Property Rebates and Rent Freezes (May 21, 2021)

The Manitoba government announced it will begin mailing education property tax rebate cheques to the owners of residential, farm, and commercial properties in Manitoba. *Budget 2021: Protecting Manitobans, Advancing Manitoba* committed $248 million in education property tax rebates to the owners of approximately 658,000 eligible properties. Depending on the municipality, owners of multiple properties may receive one combined bill.

To provide property owners their rebate as soon as possible, the government passed new legislation. Manitobans do not need to apply for the rebate, as the province will calculate the amount and automatically mail cheques before the municipal property tax due date. In 2021, home and farm owners will receive a 25% rebate, which will increase to 50% in 2022. Other property owners will see a 10% rebate this year. The average rebate will be an estimated $1,140 per property over the next two years. The province will also reduce various related credits and rebates to ensure all property owners are paying 25% less on residential and farm properties, regardless of whether they qualify for existing credits and rebates. For more information about Manitoba's education property tax rebate, visit www.manitoba.ca/eduproperytax.

The legislation also makes a change to the *Residential Tenancies Act* to freeze the rent increase guideline at 0% in 2022 and 2023.

## New Brunswick

### Travel Incentive Expanded (June 1, 2021)

The Explore NB Travel Incentive program will be extended to visitors from the Atlantic provinces when the reopening of the provincial borders allows. The Explore NB Travel Incentive program provides a 20% rebate on eligible expenses of up to $1,000 that are made while making an overnight stay in New Brunswick. Travel can take place between May 27 and October 31 and applications will be open from July 5 to November 30.

### Small Business Grant Enhanced and Extended (May 28, 2021)

Opportunities NB is launching the second phase of the New Brunswick Small Business Recovery Grant program. Phase 2 of the program includes enhancements to improve accessibility and assist small businesses that have been impacted by the pandemic.

Businesses that accessed the grant under the first phase can apply for the full amount available under Phase 2, which applies to losses incurred beginning April 1, 2021.

Amendments for the second phase include the following:

- Eligible businesses can apply for a non-repayable grant of up to $5,000 to help offset the ongoing impact of the pandemic when subject to elevated Public Health measures and restrictions.
- Previously, businesses could only access the grants under Orange, Red, or Lockdown Public Health levels. Now, businesses can access this support when subject to Yellow, Orange, Red, or Lockdown levels.
- Within the $5,000 available to business, a one-time subsidy of up to $300 to reimburse costs incurred in the preparation of applications.
- Reducing the 30% year-over-year drop in revenue threshold to 20% when compared to the same month in 2019.
- The program will remain open to eligible businesses until New Brunswick reaches the Green level of recovery.

Applications opened on June 1.

Businesses within the defined eligible sectors that have been subject to elevated Public Health measures (i.e., Yellow, Orange, Red, or Lockdown) and/or impacted by measures limiting unnecessary travel into New Brunswick are able to apply for up to $5,000 in non-repayable funding support, assuming they meet the other criteria.

Eligible business types include restaurants (excluding businesses with drive-through options), caterers, and drinking establishments; personal services (barbers, hair stylists, and spas); gym and fitness facilities; amusement centres, bingo halls, arcades, cinemas, and large live performance venues; eligible tourism operators; and non-essential retail businesses located in lockdown zones.

## Nova Scotia

### Funding for Tourism and Accommodation Operators (June 15, 2021)

An $18.2 million tourism restart package announced by the Nova Scotia government on June 15, 2021, will provide operators with new grant programs and marketing support as well as offering tourists more outdoor public attractions and free admission to provincial museums.

The Tourism Accommodations Restart Customer Attraction Program will help registered tourism accommodations develop and implement tailored marketing activities to encourage overnight stays. Eligible operators will receive a grant of $1,000 per room for the first 10 rooms and $500 per room for each additional room. This is a $10.5 million program administered by Tourism Nova Scotia. Eligible businesses must be registered as a host under the *Tourist*

*Accommodations Registration Act*, offer at least one or more rooms to the travelling or vacationing public, and be HST registered. Funds may be used for various advertising options, developing packages, and incentives to encourage overnight stays, such as an overnight plus a bottle of local wine, or family weekend packages with free breakfasts, as well as customer-focused upgrades or amenities. Applications opened June 23.

The Small Tourism Operators Restart Program will offer a one-time grant payment of $5,000 to help tourism businesses that were affected by COVID-19 restrictions but were not eligible for earlier provincial programs. The grant will help operators with advertising and other restart expenses such as purchasing personal protective equipment and cleaning supplies. This is a $2 million program administered by Tourism Nova Scotia. Eligible businesses include tour operators, scenic and sightseeing transportation operators, outdoor adventure operators and outfitters, businesses that operate nature parks and zoos, amusement or theme parks, recreational vehicle parks, and campgrounds and travel agencies. Eligible operators must be HST registered. Applications opened June 23.

### Prince Edward Island

#### Expanded Property Tax Relief for Tourism Businesses (June 8, 2021)

An interest relief program for PEI tourism operators has been modified to help mitigate the effects of the ongoing COVID-19 pandemic. The Tourism Interest Relief Program will be expanded to include reimbursements on interest payable for property tax bills until December 31, 2021. In addition, the program will be extended from its initial end date of September 20, 2021, to September 30, 2022.

# CURRENT ITEMS OF INTEREST

## Progress of Legislation

Bill C-30, *Budget Implementation Act, 2021, No. 1*, received Royal Assent on June 29, 2021.

Bill C-208, *An Act to amend the Income Tax Act (transfer of small business or family farm or fishing corporation)*, received Royal Assent on June 29, 2021.

Bill S-222, *Effective and Accountable Charities Act*, was passed by the Senate on June 17 and received First Reading in the House of Commons on June 23. The bill was not progress further since theHouse has adjourned until September 20.

Previously announced changes to the *Income Tax Regulations* were published in the Canada Gazette on June 23. These Regulations, which relate to COVID-19 relief for deferred salary leave plans and pension plans, are now effective. (See SOR/2021-127.)

## Legislation Proposes Disability Benefit Framework

On June 22, 2021, Minister of Employment, Workforce Development and Disability Inclusion Carla Qualtrough introduced Bill C-35, *Canada Disability Benefit Act*, which would establish the framework for a new Canada Disability Benefit. The Canada Disability Benefit would supplement, not replace, existing federal and provincial-territorial supports with a goal of lifting hundreds of thousands of persons with disabilities out of poverty. The government is consulting with stakeholders and persons with disabilities on the design of the benefit leading up to the development of regulations.

Bill C-35 includes a consequential amendment to the *Income Tax Act*.

## New Consultation on Investment Tax Credit for Carbon Capture, Utilization, and Storage

In Budget 2021 the federal government announced that it would soon launch a consultation on introducing a new investment tax credit for carbon capture, utilization, and storage ("CCUS"). The consultation officially launched on June 7, 2021, and comments must be submitted by September 7, 2021.

The CCUS investment tax credit will be available starting in 2022. On the same timeline, the government will also determine how comparable tax support could be provided to producers of green hydrogen. The investment tax credit would be available for a breadth of CCUS applications across industrial subsectors (e.g., concrete, plastics, fuels), including blue hydrogen projects and direct air capture projects, but not enhanced oil recovery projects. The government is seeking input on the design of the investment tax credit from all industrial subsectors.

## MPs Agree to Motion on Tax Avoidance

On June 9, 2021 Members of Parliament agreed to the following motion (M-69):

> That, given that the pandemic and the pressure it is putting on public finances has created the urgent need to close the loopholes being taken advantage of by some taxpayers through the use of tax havens, in the opinion of the House, the government should:
>
> (a) amend the Income Tax Act and the Income Tax Regulations to ensure that income that Canadian corporations repatriate from their subsidiaries in tax havens ceases to be exempt from tax in Canada;
>
> (b) review the concept of permanent establishment so that income reported by shell companies created abroad by Canadian taxpayers for tax purposes is taxed in Canada;
>
> (c) require banks and other federally regulated financial institutions to disclose, in their annual reports, a list of their foreign subsidiaries and the amount of tax they would have been subject to had their income been reported in Canada;
>
> (d) review the tax regime applicable to digital multinationals, whose operations do not depend on having a physical presence, to tax them based on where they conduct business rather than where they reside;
>
> (e) work toward establishing a global registry of actual beneficiaries of shell companies to more effectively combat tax evasion; and
>
> (f) use the global financial crisis caused by the pandemic to launch a strong offensive at the Organisation for Economic Co-operation and Development against tax havens with the aim of eradicating them.

## Information Circular Updated

The CRA recently published the new IC 71-17R6, *Competent Authority Assistance under Canada's Tax Conventions*, which replaces IC 71-17R5.

## Consultations on Tax Implications of International Accounting Rules for Insurance Contracts

The Department of Finance launched consultations on the tax consequences of new IFRS 17 with insurance industry stakeholders on May 28, 2021. IFRS 17 is new international accounting rules for insurance contracts that come into effect on January 1, 2023.

The government intends to implement changes that will generally support the use of IFRS 17 accounting for income tax purposes. However, adjustments would be made to recognize profits as taxable income so that it remains aligned

with economic activities, as under current rules.

Stakeholders are invited to provide comments on the government's proposed approach by July 30, 2021. Comments can be sent by email to ifrs17consultation-consultationifrs17@canada.ca.

## Newfoundland and Labrador Budget 2021

Newfoundland and Labrador *Budget 2021: Change Starts Here* ("Budget 2021") was tabled on May 31, 2021, by Deputy Premier and Minister of Finance Siobhan Coady. Budget 2021 projects a deficit of $826 million for 2021–2022, with a return to fiscal balance within five years.

Budget 2021 announced several taxation changes, which include:

- Increased personal tax rates on individuals earning over $135,973, effective January 1, 2022;
- A new refundable Physical Activity Tax Credit on up to $2,000 on sports and recreational activities for 2021 and subsequent years;
- An increase to the Mother Baby Nutrition Supplement from $60/month to $100/month, beginning July 1;
- A new tax on sugar-sweetened beverages, effective April 1, 2022; and
- Increases to tobacco tax, effective June 1.

# RECENT CASES

## Application for cancellation of immediate collection order dismissed

This was an application for judicial review of an order issued against the taxpayer authorizing the Minister, in accordance with subsection 225.2(2) of the *Income Tax Act*, to immediately execute collection procedures relating to an income tax assessment. Such orders are issued when a judge is satisfied there are reasonable grounds to believe the collection of all or any part of an amount assessed in respect of a taxpayer would be jeopardized by a delay in the collection of that amount. Subsection 225.2(8) allows a taxpayer to request a review of such authorization, which is the basis of this case.

The application was dismissed. In such revision requests, the initial onus is on the applicant to provide evidence that there are reasonable doubts to believe the criteria justifying the application of subsection 225.2(2) were respected. Following that, the Minister must justify application of the immediate collection procedures. The taxpayer argued that the Minister's allegation of undeclared substantial revenue relating to the sale of natural supplements was without base as he never sold those products. The Minister submitted that the assessment is presumed valid and added that the taxpayer did not challenge the allegations that led to the order. The Minister also added that information provided by the taxpayer in his affidavit contradicted statements he made in an American case. The taxpayer admitted having made a big error in the affidavit provided in a 2017 American case about selling natural products. The judge stated that the taxpayer's role in such cases is to demonstrate by affidavit or counter-interrogations of the Minister's witnesses that the evidence originally submitted to justify the order did not reasonably meet the criteria required by subsection 225.2(2). The Federal Court found the taxpayer failed to produce any such evidence demonstrating the Minister did not satisfy the requirements of subsection 225.2(2). The judge noted that there were no counter-interrogations of the Minister's witnesses. Accordingly, the application to cancel the immediate collection order was dismissed.

*Canada (MRN) v. Moise*

2021 DTC 5055

## Work undertaken to develop dual-purpose solar-powered shingles did not qualify as SR&ED expenditures for income tax purposes

This was an appeal of a reassessment of scientific research and experimental development ("SR&ED") expenditures incurred by the appellant in the 2013 taxation year. The activity in question was work the appellant undertook to develop what it described as a dual-purpose solar shingle — a solar panel that could replace shingles. The solar shingle would serve as a source of power and be mounted directly on the roof so that shingles would not be necessary. The respondent assessed the appellant on the basis the expenditures did not qualify as SR&ED. While, allegedly, expert reports were presented, they were not accepted as evidence as the judge agreed with the respondent that they did not comply with the expert report requirements. The judge did not agree that it was in the interests of justice that the appellant be entitled to file Report 2. Upon recognizing the failure of Report 1 to meet the expert report requirements, the appellant proceeded twice to try to file what were described as amended expert reports, but which, in the judge's view, were properly characterized as new expert reports. It would completely undermine the purpose of the rule requiring 90 days advance notice of the expert report if, following a determination that a report did not qualify with the expert report requirements, a party was permitted to keep trying until its expert report complied. Yet this is exactly what the appellant sought to do. In the judge's view, the interests of justice were best served by proceeding with the appeal.

The appeal was dismissed. The appellant bore the burden of demonstrating, on a balance of probabilities, that the activities it undertook with respect to the Solar Shingle Project during the 2013 taxation year constitute SR&ED. SR&ED envisages a new or improved product or process involving something more than the application of routine engineering principles. Creativity must be employed. Although the SR&ED need not result in a new or improved product or process, the objective of the research must be realistic and there must be meaningful technological advancement. The appellant did not satisfy the judge on a balance of probabilities that the problems identified were technological uncertainties, as that expression is interpreted in the context of SR&ED, or that the approaches taken to address the problems the appellant faced were novel or anything other than the application of known mechanical or electrical engineering principles, including solutions known to work in the solar panel industry. The respondent assumed the appellant did not keep sufficient records and documents in respect of the work performed. The judge found that the evidence supported no other conclusion. The appellant bears the burden of establishing that it conducted activities that constituted SR&ED by leading evidence to rebut the respondent's assumptions. The evidence did not persuade the judge that Mr. Baird and the other three individuals involved in the Solar Shingle Project were knowledgeable and competent in the field of solar power or solar panel manufacturing and design. Moreover, he was not persuaded that the appellant undertook sufficient research to conclude that the appellant's identified technological uncertainties would have been considered uncertain to people in the field. The appellant did not convince the judge that adding an air gap was anything other than applying known techniques, including a technique known to work both by the solar panel industry and Mr. Baird. The respondent assumed there was no technological uncertainty and that the appellant's activities were ones for which the required knowledge was in the public domain. The appellant bore the burden of providing the court with evidence that this assumption was incorrect. The appellant bears the burden of establishing that it conducted activities that constituted SR&ED by leading evidence to rebut the respondent's assumptions. In the view of the court, it has failed to do so. Accordingly, the appeal is dismissed.

*Logix v. The Queen*

2021 DTC 1028

## Review of denial of mentally ill taxpayer's application for relief allowed

The taxpayer sought relief from interest and penalties on late returns on grounds of long-term mental illness. A delegate of the Minister denied his request, stating that he could have established "mechanisms" to comply with his tax obligations. A second delegate agreed that the long-term character of the taxpayer's condition gave him opportunities to establish such a "mechanism" and agreed with the first-level determination.

The application was allowed. The delegate's reasons were not "sufficiently transparent, intelligible or justified in light of the record." The taxpayer presented documentary evidence from his carers of his mental health issues and that his condition was increasingly debilitating. The taxpayer's bulk filing of returns and establishment of a GST/HST account were not to the contrary; the delegate did not explain how these were occasions to establish a mechanism for compliance. The delegate's argument that the taxpayer had many years to ensure compliance was based on the very period of mental illness that was the basis of the taxpayer's argument.

*Allen v. Canada (AG)*

2021 DTC 5049

## CRA's RFIs to foreign jurisdictions upheld

The Respondents, under audit, had denied having foreign assets, but Québec tax authorities found two Swiss bank accounts related to the Respondents. The CRA submitted Requests for Information ("RFIs") to Swiss Federal Tax Administration concerning the Respondents. The Respondents filed applications seeking to quash the requests.

The Federal Court dismissed the applications. Under the *Vavilov* standard of reasonableness, an RFI is reasonable if the CRA has authority to issue it and complies with statutory requirements. Here, the CRA did not use information illegally acquired from Québec tax authorities; it did not use unverified information so as to engage section 24 of the *Canadian Charter of Rights and Freedoms*; it did not violate attorney-client privilege; it made reasonable use of internal procedures before contacting the Swiss; and, it did not disclose confidential information.

*Levett v. Canada (AG)*

2021 DTC 5046

## Taxpayers partly successful in appeal of RRSP trust reassessments

The taxpayer was the annuitant of a Registered Retirement Savings Plan ("RRSP Trust") in which he accumulated substantial assets. CIBC Trust Corporation ("CIBC Trust") acted as trustee. The taxpayer established and promoted several income funds (the "Income Funds"), each of which raised a relatively modest amount of capital relying on the exempt distribution rules of the provinces of Alberta and British Columbia. The investors in each fund were essentially the same but the taxpayer also participated, acquiring units personally and through investment vehicles he owned or controlled. Following the closing of the exempt distributions, the taxpayer (acting alone or in concert with two other individuals and their respective RRSPs) then arranged for the RRSP Trust to acquire in excess of 99% of the units of the Income Funds. The Income Funds were then invested in flow-through investment vehicles that served as conduits for the acquisition of business ventures or investments controlled directly or indirectly by the taxpayer, the profits of which flowed back to the Income Funds and were distributed to unitholders, including the RRSP Trust. It was not disputed that the taxpayer intended from the beginning to structure the Income Funds as qualified investments for RRSP purposes and one of the key issues in the appeal was whether they met the definition of a "mutual fund trust". The Minister took the position that the steps undertaken to establish the Income Funds were not legally effective so that they were not a "qualified investment" for RRSP purposes, or alternatively, they were a sham or mere window dressing intended to allow the taxpayer to manipulate the RRSP regime by using the funds in the RRSP Trust to acquire and actively manage businesses or investments, the profits of which flowed back to the RRSP Trust where they continued to accrue on a tax-exempt basis. The Minister also relied on the general anti-avoidance rule ("GAAR").

The appeals were partially allowed. The court concluded that the steps undertaken by the taxpayer to establish the Income Funds were not legally effective so that they were not qualified investments for RRSP purposes. Absent a sham, subterfuge, or other vitiating circumstances, the application of subsection 56(2) should not extend to income generated by investments held in an RRSP, even if the conclusion is that they were non-qualified investments. The court found that an assessment pursuant to the GAAR would not be "reasonable in the circumstances" as contemplated in subsection 245(5). Accordingly, the court allowed the appeal from the reassessments made pursuant to

subsection 56(2). The court similarly concluded that absent a sham, subterfuge, or other vitiating circumstances, income generated by investments held in an RRSP should not be characterized as "excess contributions" subject to an assessment pursuant to subsection 204.1(2.1). The court found that an assessment pursuant to the GAAR would not be "reasonable in the circumstances" as contemplated in subsection 245(5) and allowed the appeal from the assessment made pursuant to subsection 204.1(2.1). Since the court concluded that the Income Funds were not qualified investments, it followed that the Minister was entitled to assess the RRSP Trust on the income generated by the Income Funds pursuant to subsection 146(10.1) with the applicable late-filing penalties. In the context of GAAR, this would exclude the sum of $136,654,427 since that amount resulted from the transfer of the Foremost Industries Income Fund ("FMO") units held in the RRSP Trust to the 2003–2004 Income Fund and thus did not constitute income from a non-qualified investment. The court allowed the appeal from the assessment made pursuant to subsection 146(10.1) and referred the matter back to the Minister for reconsideration and reassessment in light of this. Finally, since the court concluded that the Income Funds were not qualified investments, the Minister was entitled to assess the RRSP Trust pursuant to subsections 207.1(1) and 207.2(3). This would include the units of the 2003–2004 Income Fund acquired by the RRSP Trust during the 2005 taxation year valued at $152,874,000 in exchange for the FMO units. The court thus dismissed the appeal from the reassessment made pursuant to these provisions.

*Grenon v. The Queen*

2021 DTC 1025

## Tax Court rules participants in complex reorganization were associated, impacting entitlement to the SBD

The only issue in these appeals was whether the appellants were associated corporations in their 2012 and 2013 taxation years which may impact their entitlement to the small business deduction ("SBD"). In the relevant years, following a complex reorganization, there were fifteen pairs of corporations, each pair consisting of a Partnerco and a Serviceco, controlled by a single principal. The appellants are four of those pairs. All the parties agreed the Partnercos were required to share a single specified partnership business limit to determine each Partnerco's qualification for the SBD in respect of its share of the partnership's active business income. The appellants did not dispute that each pair must share a single business limit. This was the basis on which the appellants filed their income tax returns for the 2012 and 2013 taxation years. However, the respondent and the appellants disagreed on whether all thirty corporations (or, put another way, all fifteen pairs) were associated and so must share a single business limit. The respondent reassessed the appellants for their 2012 and 2013 taxation years on the basis they were associated with each other and with the other eleven pairs. In doing so, the respondent contended that one of the main reasons for the separate existence of the corporations was to reduce taxes payable under the *Income Tax Act* in their 2012 and 2013 taxation years, with the result that they are deemed to be associated. The assessments raised by the CRA follow their conclusion that one of the main purposes, if not the only main purpose, for the reorganization giving rise to the thirty corporations was the reduction of the taxes by multiplying access to the SBD. The appellants conceded that the reorganization leading to thirty corporations resulted in a reduction of tax through additional access to the SBD. However, they asserted that the additional SBD was not one of the main reasons for the reorganization or the separate existence of the Partnercos and Servicecos in the relevant years.

Some appeals were dismissed and others were allowed. Costs were awarded to the respondent. The question to be answered was whether, having regard to all the facts and circumstances, it was reasonable to consider that one of the main reasons for the separate existence of the Partnercos and the Servicecos was the reduction of tax. The reassessments also increased the income of the appellants that are Partnercos. The respondent's position was that certain amounts deducted in computing income of the partnership were not deductible (the "disputed expenses"). The parties settled that aspect of the appeals prior to the hearing. Accordingly, while the judge's order reflected the parties' agreement with regard to the disputed expenses, the deductibility of the disputed expenses was not addressed in the judge's reasons. The respondent's position was simple. Before the reorganization, the corporation claimed the SBD. Following the reorganization, thirty corporations claimed the SBD in respect of income that, but for the Reorganization, would have been earned by the corporation and AODBT Management Services Limited Partnership, a limited partnership which provided administrative services to the corporation, and presumably the principals, collectively. As partners in the partnership, the Partnercos collectively were limited to the same $500,000 business limit as the Corporation had been prior to the reorganization. However, according to the respondent, the pairs resulting from the reorganization, and the arrangements between a Partnerco and its paired Serviceco, were intended to permit substantially more income to be taxed at the SBD rate. Thus, one of the main purposes, if not the only main purpose, for the reorganization giving rise to the thirty corporations was reduction of taxes by multiplying access to the SBD. The onus is on the taxpayer to produce an objectively reasonable explanation that none of main reasons was the reduction of taxes. A mere denial of a purpose, even where accompanied by a list of other purposes, by itself is not persuasive. The appellants failed to persuade the judge that the Respondent is incorrect. In the judge's view, the subjective statements of purpose advanced by the appellants' witnesses were not consistent with the other evidence of the purposes. While tax-efficient financing of share purchases was a factor that led the Corporation to explore alternative ways to effect share transfers, the principals chose simplicity over a structure that solved that problem. In order to sacrifice simplicity, something more was needed. In the judge's view it was clear that the something more that led the principals to agree to reorganize into the corporate partnership was that significantly more income would be eligible for the SBD. Everything about the reorganization, including the existence of fifteen pairs, the arrangements between the Partnercos and Servicecos, the determination of the ideal service fees between them, and the establishment of a minimum nominal salary for every principal, regardless of circumstance, was based on achieving that result. Accordingly, the Court found that the appellants failed to convince it that reducing taxes was not one of the main reasons for the reorganization. Therefore, based on the evidence, the judge found that multiplication of the SBD was a main reason for the reorganization and the separate existence of a Partnerco and Serviceco for each principal in the relevant taxation years. Costs were awarded to the respondent.

*Nicole L. Tiessen Interior Design v. The Queen*

2021 DTC 1023

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Wolters Kluwer Canada Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
1 800 268 4522 tel
1 800 461 4131 fax
www.wolterskluwer.ca

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