Lessons from Prior Changes to Capital Gain Inclusion Rates

Capital gains were first taxed in Canada in 1972. At that time, one-half of a capital gain was included in a taxpayer’s income. Since then, four changes have been made to the capital gain inclusion rate, each with detailed rules of implementation to determine when and how the rate amendment was effective. Understanding the previous changes can help taxpayers anticipate how future changes may be implemented, and it may facilitate planning to mitigate any adverse implications. We are not aware of any current proposals or official governmental discussions regarding a change to the inclusion rate; nevertheless, given the obvious fiscal pressures, one should not be surprised if an inclusion rate change is once again considered.

The Department of Finance has taken various approaches to implementing prior changes to the inclusion rate. Each approach has implications for planning opportunities.

The 1988 and 1990 Changes: Calendar-Year and Blended Rate Approach

The 1988 federal budget announced two increases in the inclusion rate. The first was an increase to two-thirds effective for 1988 and 1989 (“the 1988 change”); the second was a further increase to three-quarters, effective for taxation years after 1989 (“the 1990 change”). The 1988 change was retroactive (it was effective from the beginning of the calendar year in which it was announced); the 1990 change was prospective. Specifically, the 1988 change was effective on January 1, 1988 for most taxpayers, and the 1990 change was effective on January 1, 1990 for all taxpayers.

These two changes were easy to implement for taxpayers with taxation years that aligned with calendar years. All capital gains realized before the effective date were subject to the old inclusion rates, and all capital gains realized after the effective date were subject to the new inclusion rates. For corporations that did not have calendar year-ends, the change to the inclusion rate was prorated on the basis of the number of days in the corporation’s taxation year that preceded or followed the effective date; all capital gains realized in the year were subject to this prorated rate regardless of whether they were realized before or after the effective date of the change, resulting in a blended rate.

For instance, a corporation with a year-end of June 30, 1988 was subject to a blended inclusion rate of 58.33 percent (the midpoint between one-half and two-thirds), because one-half of the days in its taxation year fell in a period when the inclusion rate was one-half, and one-half of the days in its taxation year fell in a period when the inclusion rate was two-thirds. Along with this inclusion rate change, a corporation could elect a year-end immediately before the inclusion rate change, so that all of the days in its taxation year fell into the period before the inclusion rate change. Therefore, its capital gains were subject to the one-half rate rather than a higher prorated rate. Because the 1988 change coincided with changes to the general corporate federal tax rate, for some corporations the effective date of the 1988 change was July 1, 1988 to align with the general rate change.

The 1988 federal budget also added subsection 111(1.1), which applied an adjustment factor to a net capital loss carryforward. The adjustment factor was calculated by dividing the fraction of a loss that is an allowable capital loss in the year by the fraction that was an allowable capital loss in the year in which the loss was realized. The effect is that the net capital loss available to be applied in a particular year is adjusted to be equal to the amount that an allowable capital loss would have been if the capital loss had been realized in the particular year rather than the prior year. For example, if a taxpayer had realized a $100 capital loss in 1987, the allowable capital loss would have been $50 because the fraction of a loss that was an allowable capital loss in the loss year was one-half. If that net capital loss was carried forward and applied in 1989, it would be adjusted by the fraction obtained by dividing two-thirds (the fraction of a loss that was an allowable capital loss in 1989) by one-half (the fraction of a loss that was an allowable capital loss in 1987), with the result that the taxpayer had $66.67 of net capital loss available to be applied against taxable capital gains in 1989.
The 2000 Changes: Announcement Date and Separate Periods Approach

Another approach to changing the inclusion rate is seen in the 2000 amendments (“the 2000 changes”). In the 2000 federal budget, the government announced that the inclusion rate would change from three-quarters to two-thirds, effective on the announcement date of February 28, 2000. In the fall economic statement, the government announced that the inclusion rate would change from two-thirds to one-half, effective on the announcement date of October 18, 2000.

The 2000 changes were implemented by dividing the taxation year into separate periods and applying a different inclusion rate depending on the period in which a capital gain was realized.

- The first period began at the beginning of the taxpayer’s taxation year and ended on February 27, 2000. Capital gains realized in the first period were subject to a three-quarters inclusion rate.
- The second period began on February 28, 2000 and ended on October 17, 2000. Capital gains realized in the second period were subject to a two-thirds inclusion rate.
- The third period began on October 18, 2000. Capital gains realized in the third period are subject to the current one-half inclusion rate.

Complex calculations were required if a taxpayer realized capital gains in multiple periods or net capital gains in some periods and net capital losses in others. The effect of these calculations was that the applicable inclusion rate depended on the period in which a capital gain or loss was realized.

Again, subsection 111(1.1) applied an adjustment factor to a net capital loss carryforward, with the result that the net capital loss available to be applied in the particular year was adjusted to be equal to the amount that an allowable capital loss would have been if the capital loss had been realized in the current period rather than in the prior year.

Lessons from Past Changes

Parliament has the ability to change the inclusion rate in any fashion that it chooses; nonetheless, it is instructive to bear in mind what has been done in the past when one is attempting to anticipate what may be done in the future. For example:

- An inclusion rate change may be announced during a particular calendar year with effect from the beginning of that year, especially if the change is signalled in a prior statement or white paper.
- Alternatively, an inclusion rate change may be announced during a particular year with effect for dispositions occurring on or after the announcement date.
- There is no precedent for announcing an inclusion rate change in a particular calendar year with effect for a previous year.
- Inclusion rate changes have dealt with loss carryforwards by allowing $1 of losses to be applied to shelter $1 of gains, irrespective of the inclusion rate for the loss year or gain year.

If a taxpayer is concerned about an increase to the inclusion rate and wants to mitigate that risk, lessons from past changes to the inclusion rate should inform any planning.

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Succession Planning in Uncertain Economic Conditions

Many Canadian family businesses are suffering under the economic and market pressure brought about by COVID-19, but such circumstances may actually present unprecedented succession, estate, and TOSI (tax on split income) planning opportunities.

Consider, for example, a family business (Famco) that had a market valuation of $3 million before the COVID-19 pandemic. Famco is in the goods-selling business and is solely owned by Mom. Mom has two adult children, Son and Daughter, both over the age of 24. Son is active in Famco’s business but Daughter is not. Mom wants to pass the business to Son while providing financial security to Daughter and retirement income to herself. Although a traditional estate freeze plan has always been an effective way to meet Mom’s objective, the economic downturn turbocharges the usefulness of a freeze and may introduce options that were previously unavailable. For the purposes of illustration, assume that the FMV of Famco has dropped 40 percent to $1.8 million. (We are not business valuers, and the prolonged uncertainty makes valuation a more difficult [and more dispute-prone] exercise than ever, but we believe that it is probable that the value of many Canadian businesses has fallen materially since the COVID-19 pandemic began.)

In the example, Mom can execute a traditional freeze whereby she freezes the value of her $1.8 million holding in fixed-value preferred shares. Son and Daughter (or a family trust) can acquire nominal-value voting or non-voting common shares. This structure is already a much more powerful freeze than one executed at a pre-pandemic value of $3 million. If Famco’s business and value rebound after the pandemic, all of the value accretion over $1.8 million will be streamed out of Mom’s hands (and out of her estate on her eventual death) and into the hands of the next generation. Wasting-freeze
strategies can provide retirement income to Mom through periodic share redemptions by Famco, further reducing her future estate's value. As well, this structure provides opportunities to maximize any available capital gain exemptions among family members. This is a good result, but the lower valuation provides other potential planning opportunities.

A family member who holds “excluded shares” (as defined in subsection 120.4(1)) and has attained age 24 before the relevant time may earn unlimited dividends or capital gains on those shares without TOSI applying even if he or she is not active in the business. One of the requirements for excluded shares is that the individual hold shares representing 10 percent or more of the votes and value of the corporation. The lower valuation makes this target more accessible. Prior to the COVID-19 pandemic, for both children to avoid TOSI via the excluded-shares exemption, each would have had to make a $300,000 investment to meet the 10 percent value threshold. Now, only $180,000 is required to achieve excluded-shares status, provided that other excluded-shares requirements are met. Although Son can likely rely on the excluded-business exemption to avoid TOSI in any case, the family may want both siblings to be on equal footing in terms of investment. Note that excluded shares must be held directly by an individual, so the implications of non-tax issues (such as creditor exposure and an inactive family member having voting shares) must be considered.

Each of the children may make the $180,000 investment from his or her own funds or may borrow from a financial institution. Alternatively, Mom can gift cash to the children to fund the purchase; attribution does not apply to gifts to children over 17 years of age. If Mom loans cash to the children, however, a proper prescribed-rate loan arrangement is necessary to avoid attribution under subsection 56(4.1). The prescribed rate of interest was reduced from 2 percent to 1 percent as of July 1, 2020.

If Mom wants additional liquidity, she can sell some of her Famco shares to the children on a taxable basis. The lower valuation today means a smaller taxable gain. If Mom is willing to take a promissory note from the children that is payable over several years, she can claim the capital gain reserve pursuant to subparagraph 40(1)(a)(iii) to spread the tax over 5 years (or 10 years under subsection 40(1.1)) if Famco shares are QSBC shares. Note that if Mom claims the reserve, the children’s basis in their Famco shares will be restricted for section 84.1 purposes because of subsection 84.1(2.1).

Interestingly, even if the children are unable to raise the capital required to make the $180,000 investment or purchase, nominal-value common shares issued to them on the freeze could quickly reach the 10 percent value threshold if the value rebounds after the pandemic. In Famco's case, an increase in value of $360,000 would result in each child having the 10 percent of value shareholding that is required for excluded-shares status.

Suppose that the family had executed a freeze of the Famco shares before the COVID-19 pandemic. Results similar to those described above can be achieved by thawing the old freeze and refreezing at today’s lower value. The new valuation may be subject to more CRA scrutiny than the valuation of a regular freeze, and the CRA has previously stated (in CRA document no. 2000-0029115, November 17, 2000) that it may consider a benefit to have been conferred on a refreezer if the decrease in value of the freezeor’s shares was the result of a stripping of corporate assets.

Another planning consideration is a purification of Famco's assets if necessary to comply with the QSBC conditions. If Famco has built up significant non-business assets that have suffered a loss in value, executing a purification now will cost less in tax. If this action triggers a capital loss in Famco, any positive capital dividend account (CDA) balance should be paid out prior to the realization of the loss. If the asset transfer triggers a capital gain, business losses of the current year will shelter the gain, but the non-taxable portion of the gain will still increase the CDA.

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Colitto Reversed: Section 160 Applies to a Director’s Liability in or in Respect of the Year That the Failure Occurs

In Canada v. Colitto (2020 FCA 70), the FCA overturned the TCC’s decision, and the taxpayer’s victory, in Colitto v. The Queen (2019 TCC 88). The decisions deal with the interaction of subsection 160(1) and subsections 227.1(1) and (2).

In general terms, subsection 160(1) imposes liability on the recipient of property resulting from certain non-arm’s-length property transfers. The amount of the liability is, generally speaking, the difference between the FMV of the property received and the consideration given therefor, except that the liability is limited to the amount of the transferor’s total tax debt in or in respect of the taxation year in which the property was transferred or in any preceding taxation year.

Generally, subsection 227.1(1) provides that if, as in this case, a corporation has failed to remit source deductions, the persons who were directors of the corporation at the time that the corporation was required to remit the deductions are jointly and severally liable to pay the amount not remitted plus the related interest and penalties.

However, subsection 227.1(2) provides that a director is not liable under subsection 227.1(1) unless certain conditions...
are satisfied. One of these conditions (paragraph 227.1(2)(a)) requires that a certificate for the amount of the corporation’s liability under subsection 227.1(1) has been registered in the FC under section 223 and that execution for that amount has been returned unsatisfied in whole or in part.

The facts of the case are relatively simple. Domenic Colitto, the respondent’s spouse, was a director and shareholder of Core Precision Technologies Ltd. (“Precision”). Precision failed to remit source deductions to the minister between February and August 2008. The parties had agreed that Mr. Colitto had not satisfied the due diligence defence with respect to Precision’s failure to remit.

On May 8, 2008, the year in which Precision was in default of its remittance obligations, Mr. Colitto made two transfers of real property to his wife, Caroline Colitto, for nominal consideration ($2 for each transfer). The value of the first property was $41,250, and the value of the second was $187,500.

On October 10, 2008, the minister issued a notice of assessment to Precision for unremitted source deductions, interest, and penalties totalling $631,554 in respect of which no notice of objection was filed. On August 6, 2009, Precision’s tax debt was registered in the FC under section 223. On November 23, 2010, the sheriff was directed to enforce the writ. On January 4, 2011, Precision’s tax debt was executed and returned unsatisfied.

On March 28, 2011, the minister assessed Mr. Colitto in the amount of $733,813. On January 13, 2016, the minister assessed the respondent under section 160 for $228,746 in respect of the transfers made by Mr. Colitto. (The amount of the assessment was the maximum amount permitted under section 160.)

At the TCC, the respondent’s appeal was allowed on the basis that Mr. Colitto’s liability under section 227.1 did not arise until 2011, when Precision’s tax debt was executed and returned unsatisfied. Therefore, the court held that the transfers were not caught by section 160 because Mr. Colitto was not liable to pay an amount “in or in respect of” the taxation year in which the properties were transferred. The court reached this conclusion by means of a textual, contextual, and purposive interpretation of subsection 227.1(2), which in the court’s view did not impose liability on a director until one of its three conditions of application had been satisfied (in this case, the condition in paragraph 227.1(2)(a)).

The FCA disagreed with the TCC’s interpretation of the interaction between section 160 and section 227.1. The FCA conducted its own textual, contextual, and purposive analysis of the relevant statutory provisions; it noted that the only issue in dispute was whether Mr. Colitto’s liability under subsection 227.1 was “in or in respect of” his 2008 taxation year.

The FCA concluded that subsection 227.1(1) was ambiguous regarding the year in which the liability arises. However, the FCA held that any such ambiguity is eliminated when one considers the purpose of subsection 227.1(2). In the FCA’s view, the TCC erred in concluding that liability under subsection 227.1(1) did not arise “unless and until” the conditions in subsection 227.1(2) were satisfied. The FCA held that the word “until” was not present in the statute, and the TCC had erred by reading “until” into the statutory language.

In the FCA’s view, the purpose of subsection 227.1(2) is the avoidance of double taxation. That is, paragraph 227.1(2)(a) “operates to avoid double taxation by prohibiting the Minister from recovering unremitted source deductions from a director otherwise liable for the deductions if the corporation has already paid all of the liability.” The TCC’s interpretation of section 227.1 would render the section “nugatory and pointless” by allowing a director to rearrange his or her affairs, before the relevant conditions were satisfied, to avoid personal financial responsibility. The FCA concluded that Parliament could not have intended this result. Therefore, it held that Mr. Colitto’s liability under section 227.1 arose “in or in respect of” his 2008 taxation year and allowed the appeal. That is, for the purposes of applying section 160, Mr. Colitto’s liability under section 227.1 arose “in or in respect of” 2008, the year of Precision’s failure to remit.

With all due respect to the FCA, we take issue with the reasoning that it relied on in reaching its conclusion. First, it was not necessary for the TCC to insert the word “until” after “unless” in order to regard subsection 227.1(2) as creating a condition for the application of subsection 227.1(1). Merriam-Webster Online defines “unless” to mean “except on the condition that.” If something cannot occur “except on the condition that,” then arguably it cannot occur until that condition is satisfied.

In addition, the FCA relied on a purposive interpretation to give meaning to the interaction between section 160 and section 227.1. The court identified the avoidance of double taxation as the purpose to which subsection 227.1(2) was directed. However, the language used in the subsection achieves the purported purpose by setting out steps that must be satisfied. Parliament chose to set out the specific steps necessary for the liability to arise. The FCA concluded that the effect of applying section 227.1 as written when one is considering its interaction with section 160 would be to undermine its purpose by allowing a director to intentionally dissipate his or her assets before the steps set out in paragraph 227.1(2)(a) are undertaken. In effect, the FCA has not interpreted the meaning of section 227.1 but rather has interpreted its meaning in connection with the application of section 160.

The purpose of section 227.1 is not defeated by requiring that the conditions in subsection 227.1(2) be satisfied. Rather, the minister’s collection powers were defeated by the interaction between section 160 and section 227.1. Parliament chose to use the language “in or in respect of” a taxation year in section 160 because it presumably was of the view that a taxpayer’s transfers made during certain times when the tax-
payers was not a tax debtor should not attract section 160 liability.

The question is really what purpose is intended when the policy in section 160 interacts with the policy underlying section 227.1. The result of the FCA’s interpretation in this case is that even though the minister would not have been able to collect from Mr. Colitto himself in 2008 (because the requirements of subsection 227.1(2) had not yet been satisfied), the minister can retrospectively attack transfers made by Mr. Colitto in that year. It is far from clear to us that this policy result was intended. Furthermore, in Canada Trustco Mortgage Co. v. Canada (2005 SCC 54), the SCC cautioned that “where Parliament has specified precisely what conditions must be satisfied to achieve a particular result, it is reasonable to assume that Parliament intended that taxpayers would rely on such provisions to achieve the result they prescribe.”

Sections 227.1 and 160 are draconian provisions that impose one person’s tax liability on another. In this case, the language of subsection 227.1(2) was clear and had a precise result. In our view, the proper result would have been for the CRA to simply apply the text as written. It should be left to Parliament to fix the language of sections 160 and 227.1 if it is of the view that its intention has been defeated.

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Background
The appellant and her husband, Mr. White, had been married for many years. They had a joint bank account that they used to pay certain personal and household expenses. Mr. White was a part owner of a logging company in British Columbia. The company began experiencing financial difficulties in 2004 and ultimately sold its assets and ceased to carry on business in 2006. At the time that it went out of business, it still had net tax owing under the ETA, along with unremitting source deductions on employee salaries under the ITA. Mr. White was a director of the company, and on August 25, 2009 he was assessed personally for the tax debt owing by the company.

Mr. White did not find full-time employment until March 2013. Between March 15, 2013 and March 26, 2014, he deposited $89,806 of employment earnings into the joint bank account. On March 1, 2016, the CRA assessed the appellant in relation to the amounts deposited by Mr. White into the account. At the time, Mr. White owed $49,962 in relation to his director’s liability assessment under ETA section 227.1 and $90,886 in relation to his director’s liability assessment under ETA subsection 323(1).

Applicable Law
ETA section 325 creates liability for non-arm’s-length transfers (the ITA equivalent is section 160). The test for the application of ETA section 325 and ITA section 160 was set out by the FCA in Canada v. Livingston (2008 FCA 89) as follows:

1) The transferor must be liable to pay tax under the Act at the time of transfer;
2) There must be a transfer of property, either directly or indirectly, by means of a trust or by any other means whatever;
3) The transferee must either be:
   i. The transferor’s spouse or common-law partner at the time of transfer or a person who has since become the person's spouse or common-law partner;
   ii. A person who was under 18 years of age at the time of transfer; or
   iii. A person with whom the transferor was not dealing at arm’s length.
4) The fair market value of the property transferred must exceed the fair market value of the consideration given by the transferee.

The TCC's Decision
Because Mr. White was liable for tax at the time of the transfer and no consideration flowed from the appellant to him, the first, third, and fourth Livingston criteria outlined above were met. The sole issue before the TCC was whether there was a transfer of property from Mr. White to the appellant, “either directly or indirectly, by means of a trust or by any other means.”

Third-Party Liability for Non-Arm’s-Length Transfers
The CRA has broad tax-collection powers that can extend beyond the tax debtor to encompass third parties. If the CRA is unable to collect an amount owing from a tax debtor, it can raise an assessment against certain third parties by way of a derivative assessment—for instance, a director’s liability assessment. Another type of third-party liability involves non-arm’s-length transfers of property pursuant to ETA section 325. This provision aims to prevent tax debtors from hiding their assets from the CRA’s collection efforts by transferring them to a family member or to another related party.

In White v. The Queen (2020 TCC 22), the TCC considered whether a deposit by a tax debtor into a joint bank account (owed with the debtor’s wife, who was the appellant in this case) constituted a transfer of property for the purposes of ETA section 325 such that the wife could be liable for a portion of the tax debt under a derivative assessment. In reviewing the deposits to and withdrawals from the joint bank account, along with the ultimate use of the withdrawn funds, the court provided further clarity on when a transaction constitutes a transfer of property.
The TCC adopted a broad definition of “transfer,” requiring only that one party divest itself of property and vest it in another party. However, because Mr. White continued to have full access to the funds in the joint bank account and had paid his personal expenses through the account, the TCC found that he had not divested himself of the funds.

Another consideration was the purpose of section 325, which lent support to the conclusion that the deposit was not a transfer. The TCC found that the CRA could still have taken collection action against the funds in the joint account, and therefore Mr. White was not hindering the CRA’s collection efforts by depositing the funds into the account.

The TCC also cited two prior cases in which a deposit by a person into a joint bank account did not in itself constitute a transfer of property to the other joint account holder. Rather, the transfer occurred only when the transferor was divested of the funds—for instance, when the transferee subsequently used the funds to pay a mortgage on a house that she owned alone (White v. The Queen, 95 DTC 877 (TCC)), or when the transferor removed his name from the joint bank account (Yates v. Canada, 2009 FCA 50).

In the case at bar, the TCC reviewed the transaction history of the joint bank account and concluded that only certain categories of transactions could definitively be said to be transfers to the appellant: (1) transfers from the joint bank account to the appellant’s own bank account, (2) transfers from the joint bank account to the appellant’s line of credit account, and (3) mortgage payments drawn from the joint bank account in respect of a home owned solely by the appellant.

The appellant’s assessment under the ITA was therefore vacated, and the assessment under the ETA was referred back to the minister for reconsideration in accordance with the TCC’s findings.

**Commentary**

The CRA’s practice appears to have been to issue assessments on the basis of the deposits made by a tax debtor into a joint bank account without considering the subsequent use of the funds. In accordance with the TCC’s decision in White, the CRA will now be required to take additional steps when looking at the transactions in the joint bank account and at whether the transferee withdrew funds and used them for his or her own benefit. The burden is typically on the taxpayer to demolish the minister’s assumptions, and this case provides taxpayers with an avenue to challenge an assessment under ETA section 325: according to the statutory wording, it can apply “at any time.” In White, the transferee’s assessment under ETA section 325 occurred several years after the transferor was assessed for director’s liability. As a result, taxpayers should be wary of this provision when they receive any funds or property from a non-arm’s-length party for no consideration, or for consideration below FMV.

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**Post Mortem Pipeline: The CRA Relaxes Its Position**

For several years, the CRA has accepted that an estate may use the post mortem pipeline technique to distribute a company’s surplus. The deemed disposition of private company shares that occurs on a shareholder’s death (subsection 70(5)) often results in a significant tax burden. The CRA allows an estate to dispose of a testator’s shares, which have a high ACB because of the application of paragraph 70(5)(b), to a new corporation and to receive, in consideration, a promissory note for a sum equal to the FMV of those shares at the time of death. An estate thus has access to the surpluses of the company of which the testator was a shareholder at the time of death, without any tax incidence other than that triggered by the capital gain on the deemed disposition upon death. This so-called pipeline allows the estate to avoid the tax otherwise payable if the underlying surplus is treated as an actual or deemed dividend. The CRA usually consents to such planning, subject to several conditions. Two of those conditions are (1) that repayment of the note not commence earlier than one year after the note’s issuance, and (2) that the repayment be spread over several months (see, in particular, CRA document nos. 2018-0748381C6, May 29, 2018; 2018-0777441R3, 2018; 2018-0767431R3, 2018; and 2018-0754531R3, 2019). However, in an advance income tax ruling (CRA document no. 2018-0789911R3, 2019), the CRA relaxed its longstanding position and accepted that upon the sale of shares to a new company an estate could immediately receive cash directly from the surpluses of the company in the testator’s possession to “fund income taxes resulting from the application of subsection 70(5)” (my translation).

This is an interesting development that will give estates rapid access to the cash they need to pay the income taxes triggered by the testator’s death. The CRA’s earlier position made things difficult for executors, who had to wait a year before receiving the sums generated by the pipeline. The CRA had previously accepted that a target company could lend an estate a sum that bore interest at market rates in order to fund the payment of income taxes pending repayment of the note.
The risk of subsection 84(2)’s application explains why the CRA imposes conditions for issuing advance rulings on this subject. The provision would have the effect of converting the payment of the note, a capital transaction, into a deemed dividend if the distribution of funds occurred “on the winding-up, discontinuance or reorganization” of the business of the company of which the testator was a shareholder. Such an outcome could result in a distribution for the estate. Requiring (1) that a company continue to carry on its business throughout the series of transactions and (2) that a note be repaid gradually and only as of the first anniversary of its issuance makes the distribution of funds less likely to occur “on” the discontinuance or reorganization of the company. In Descarries v. The Queen (2014 TCC 75), Hogan J found that for subsection 84(2) to apply, the distribution of funds had to coincide with the winding up, discontinuance, or reorganization of the business. The one-year time limit and progressive repayment schedule usually required as a condition of a favourable ruling reduces the risk of a subsection 84(2) assessment. The CRA has identified the prompt payment of a target company’s surplus to the estate, shortly after death, as one of the two factors that could trigger the application of subsection 84(2); the other is the company’s status as a “cash corporation,” meaning that it has only cash assets and no activities or business (see CRA document nos. 2011-0401861C6, June 2, 2011, and 2018-0748381C6, May 29, 2018). The CRA now seems to be modifying its approach somewhat—at least when the early payment is used by the estate to pay taxes.

On the facts cited in the advance ruling, the CRA agreed not to reclassify the payment on the note as a dividend despite the early payment of part of the amount due. It appears that the “winding-up, discontinuance or reorganization” test for the application of subsection 84(2) was not met.

At the time of his death, the testator owned all of the shares of a management company (Holdco) and a portion of the shares of a real estate company (Realco), all of which were subject to a deemed disposition under subsection 70(5). Realco had other shareholders, including Holdco, whose shares were QSBC shares. The value of the common shares that Holdco held in Realco appeared “significant” (my translation) in relation to the total value of Holdco’s assets. On the first transaction of the pipeline—namely, the purchase of the Holdco shares by a new company, Newco—the sale price was paid to the estate partly in cash and partly by Newco’s issuing a note and shares. The money was derived directly or indirectly from Realco’s retained earnings and capital, and it was funnelled to Newco through loans from Realco and a loan from Holdco that was financed by a redemption of Realco’s preferred shares. Realco sold its stock market investments and term deposits and borrowed sums from its financial institution for the purpose of these transactions. The money obtained was also used to pay for a preferred share redemption in favour of Realco’s other shareholders. It can be inferred that despite the distribution of funds, Realco did not substantially change its business: the fact that co-shareholders were still in place after this series of transactions attests to its continuity. Moreover, an automatic offer of sale in the event of death set out in a shareholders’ agreement was ignored in order to respect the testator’s wish to have his heir become a shareholder of Realco.

After an undisclosed period, Holdco and Newco amalgamated. This transaction bumped the ACB of the Realco shares in accordance with paragraph 88(1)(d). The amalgamated company proposed to repay the loans owed to Realco through the progressive sale of its stock market investments and with dividends from Realco. The advance ruling specified, as did the earlier pipeline rulings, that the companies in question “must continue to operate their respective businesses” (my translation) throughout the series of transactions, and it cited the new shareholders’ intention not to terminate the businesses.

In the advance ruling, the CRA appeared to recognize that the absence of an actual winding up, discontinuance, or reorganization may, in appropriate circumstances, be sufficient to preclude the application of subsection 84(2). The one-year time limit, previously required as a condition of a favourable ruling, is not based on legislation or jurisprudence, but gives the CRA assurance when it issues advance rulings. However, it complicates the lives of executors and heirs. Let us hope that the CRA’s latitude in the advance ruling represents a recognition that pipeline transactions don’t always result in a substantial change to the business activities of the companies involved, and that such a short time limit isn’t always required to confirm that fact.

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Acquisition of Control on a Change of Trustee

The acquisition of control of a corporation can trigger significant tax consequences. An acquisition of control generally occurs when a person acquires de jure control of a corporation. Subsection 256(7) provides exceptions to this rule and deems control not to have been acquired, inter alia, when there is a change in the trustees of a trust controlling the corporation if certain criteria are met. However, unwary taxpayers and their advisers may be surprised by the limited application of this exception in practice.
In CRA document no. 2019-0812781C6, a corporation is controlled by a spousal trust under which the trustees have the power to encroach on the capital, but only for the benefit of the spouse. One of the trustees is changed. The CRA said that the condition in subparagraph 256(7)(i)(ii) was not met, and the exception to the change-of-control rule in paragraph 256(7)(i) did not apply. The CRA said that this was because the trustees had a power to encroach on the capital in favour of the spouse or common-law partner, and this power precluded the application of the exception in the subparagraph.

The CRA has taken the position that a change in any of the trustees of a discretionary trust results in a new group that controls the corporation and, subject to the exceptions in paragraph 256(7)(a), in an acquisition of control of the corporation. This raises a potential policy issue when there is no change in beneficial ownership as a consequence of the change in the trustees.

Paragraph 256(7)(i) was introduced to address this issue for non-discretionary trusts. Specifically, paragraph 256(7)(i) provides that control of a corporation is deemed not to have been acquired solely because of a change in a trustee or a legal representative having ownership or control of the trust’s property if two conditions are met:

(i) the change is not part of a series of transactions or events that includes a change in the beneficial ownership of the trust’s property, and
(ii) no amount of income or capital of the trust to be distributed, at any time at or after the change, in respect of any interest in the trust depends upon the exercise by any person or partnership, or the failure of any person or partnership, to exercise any discretionary power.

Obviously, the provision is broadly worded and, on the basis of the interpretation in the CRA document, it appears that the CRA takes the position that for subparagraph 256(7)(i)(ii) to apply, the trustees cannot have any kind of discretion whatsoever over the distribution of either the income or capital of the trust. In other words, the relief under paragraph 256(7)(i) does not seem to apply to discretionary trusts. This appears to be consistent with the CRA’s existing positions. Although the trustees can encroach on capital only in favour of the spouse or common-law partner, that power still constitutes a discretionary power with respect to the capital of the trust. For this reason, the spousal trust is a still a discretionary trust, and thus the relief under paragraph 256(7)(i) is not available.

Because there is no change in the beneficiary in this example, one may think that the change of trustees should not lead to an acquisition of control. An acquisition-of-control result would seem contrary to the policy intent for loss-restriction provisions, which aim to limit trust loss-trading activities between arm’s-length parties—except that, in this case, there is no arm’s-length acquisition of an interest in the trust.

In the document, the CRA acknowledges the tax policy concerns that arise when trustees are changed, but it points to the clear language of the subparagraph in defence of its interpretation. Advisers should be aware of this when drafting the terms of a spousal trust. If it is thought essential to give the trustees a discretion over the timing of distributions of income or capital during the currency of the trust, careful planning may be required at a subsequent time if it becomes necessary to change the trustees.

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Technology Corporations’ Access to COVID-19 Subsidies

Should technology corporations claim the Canada emergency wage subsidy (CEWS) under new subsection 125.7(2) now, or should they wait until the CEWS filing deadline (currently, September 30, 2020)? The question is especially relevant for a corporation that both qualifies for the subsidy and is able to meet its current cash flow needs without the CEWS benefit. Advisers to shareholders and investors will want to consider the reduction in the SR & ED credits under the recapture rules in subsection 127(27), given that the CEWS amount is government assistance.

Although the reduction is minimal if CEWS is claimed only for the initial period of 12 weeks, it can become material if the subsidy is claimed for an extended time. Recently, the current CEWS program was extended until August 29, 2020.

Consider a technology company (Techco), a CCPC. It is undertaking activities that are innovative and that will lead to technology advancements, some or all of which also meet the qualifying criteria for SR & ED tax credits (subsection 248(1)). Assume that Techco has a sustainable revenue stream despite a slowdown due to the current economic conditions and that it is able to satisfy the “qualifying revenue” criteria for CEWS. Assume also that Techco will elect the cash method under paragraph 125.7(4)(e) to meet the CEWS eligibility criteria. Should Techco claim CEWS? That may be a difficult question to answer.

Consider a single Techco employee, all or substantially all of whose time was spent in eligible SR & ED activities. Assume that she earns an annual wage of $100,000 subsidized by the full CEWS weekly amount of $847 for the current maximum period of 24 weeks. (Here, I am considering the extension of CEWS until August 29, 2020.) The resulting subsidy of $20,328 will reduce the qualifying SR & ED expenses by a corresponding amount. If we ignore (1) any adjustments in the qualifying expense calculation due to the application of the prescribed
proxy cap rules and (2) any applicable provincial benefits, the overall loss in SR & ED tax credits from claiming CEWS is approximately 7 percent, which is higher than anticipated and could be material.

A stakeholder in Techco should be aware of the following points when the corporation is considering a CEWS claim:

- Is an overall decline of 7 percent in SR & ED tax credits as a consequence of the CEWS claim worth the short-term increase in cash flow? Note that this percentage will increase further if the CEWS program is extended beyond the current 24 weeks, which is already an extension from the earlier 12-week period. The additional CEWS amounts will lead to further reductions in available SR & ED tax credits. The exact amount will depend on the length of any extension and the particular circumstances of the corporation involved.
- What are the compliance costs and risks involved, especially given the broad anti-avoidance rules in subsection 125.7(6), if the CRA subsequently challenges the amount of CEWS paid?
- Is the corporation really in need of the subsidy, or is it applying for CEWS only because it is available under the new rules?
- Should the corporation be concerned that under the rules, as they are drafted at present, a CEWS claim cannot be amended after it is submitted? In “COVID-19 Tax Update: CEWS Q&A, Other Developments and CRA Discussions,” CPA Canada noted that the CRA has introduced a separate process through “Represent a Client” and “My Business Account” that will allow claimants to amend the amount claimed, which may add additional compliance and reporting costs. This will be an important consideration for a corporation whose taxation year ends before September 30, 2020 (currently, the deadline for a CEWS application) and that has received a notice of assessment in respect of its SR & ED filings. Such a corporation may want to re-evaluate the merit of a CEWS claim if it appears that the CRA will be successful in reducing its SR & ED tax credits.
- CRA document no. 2020-084671117 (May 6, 2020) deals with extraordinary items that can be excluded when one calculates “qualifying revenue” and the items are not expected to occur “regularly or frequently within several years.” Grants or other government assistance that an entity is eligible to receive may not meet that criterion. Specifically, a corporation that elects under the cash method for a CEWS claim may not be able to consider SR & ED tax credits as an extraordinary item and thus not as an income exclusion. This may create uncertainty at the time of the CEWS claim. The applicant may be claiming SR & ED credits in that year, but that claim may subsequently be challenged by the CRA. If the applicant does succeed in maintaining its SR & ED claim, there may then be a question whether similar claims will be occurring “regularly or frequently within several years.”

The SR & ED rules that reduce qualifying expenditures (due to CEWS) apply only to the salaries of employees who are engaged directly in qualifying SR & ED activities. CEWS should be considered for other employees’ salaries if those employees do not engage directly or indirectly in SR & ED-related activities. (Assume that Techco elects under the proxy method for the purposes of the SR & ED tax credit calculations.)

Consider the implications if Techco receives an interest-free and/or forgivable loan from the government. If the loan is interest-free, the forgone interest may be considered an inducement to Techco includable in income under paragraph 7(1)(k). (See also Interpretation Bulletin IT-273R2 [archived], paragraph 7.) If all or a portion of the loan is forgivable, the forgiven amount may be regarded as a similar inducement, although it is not clear when such an amount will be includable in income. But the Techco SR & ED tax credits will be subject to the recapture rules only if the forgivable portion of the loan is directly attributable to the wages of an employee who is performing qualifying SR & ED activities. In some cases, Techco will have non-capital losses and/or an SR & ED pool of deductible expenses available to offset the effect of any such income inclusions, and these will have to be taken into account.

In summary, corporations—especially technology corporations—should carefully consider a range of factors before applying for CEWS benefits. The current application process for CEWS is relatively simple. But a corporation will want to analyze the other tax consequences that may be triggered by receipt of CEWS to ensure that the benefits of receiving the subsidy outweigh any tax advantages that may be lost.

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