Small Business Times

August 2016
Number 63

SELL NOW! (HOW THE 2016 BUDGET WILL IMPACT BUSINESS OWNERS' EXIT STRATEGIES)

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This article originally appeared in the April 2016 edition of Tax Notes.

Back in 2014 I wrote an article reviewing the significant impact on business owners of potential changes to the taxation of eligible capital property ("ECP"), as that term is defined in section 54 of the *Income Tax Act* (Canada) (the "Act"),[1] that had been floated in the 2014 federal Budget ("2014 Budget").[2] The 2014 Budget papers were somewhat light on details and included a promise to hold consultations about the proposed changes.

Although the consultations never took place and the status quo continued for the past two years under the former Conservative government, this has all changed as part of the new Liberal government's ambitious 2016 federal Budget ("2016 Budget"). In particular, the 2016 Budget includes in its Notice of Ways and Means Motions ("NWMM") detailed legislative proposals to eliminate the current ECP regime ("Current Regime") by causing ECP to be taxed in essentially the same manner as ordinary depreciable capital property ("New Regime") effective January 1, 2017.

Since my 2014 concerns will likely now become a reality in 2017, I thought it would be worth dusting off that old article and updating it a bit.

Assuming legislation released with the 2016 Budget to implement the New Regime is enacted substantially as proposed in the NWMM, then beginning in 2017 business owners' exit strategies will become much less tax effective. While at first glance a move from the Current Regime to co-ordinate it with the existing capital cost allowance regime applicable to other depreciable capital property seems completely logical and relatively innocuous,[3] it is the change to how ECP is taxed upon its disposition that

[1] Unless otherwise noted, all statutory references are to the Act. A good summary of the broad class of property that can comprise ECP is found in Brent Kerr's "Eligible Capital Property: Update on the Rules", 2006 British Columbia Tax Conference, (Vancouver: Canadian Tax Foundation, 2006), 17:1-29 at 13 and includes: goodwill; customer lists; milk quotas, marketing quotas and farm quotas; licences of an unlimited duration; taxi and other government licenses; perpetual or indefinite franchises; certain trademarks which do not give rise to deductible expenses; other intellectual property such as from copyrights and trade secrets; and property resulting from incorporation and certain other qualifying corporate reorganization expenses.

[2] See Tax Notes No. 614, March 2014, as well as in the Estate Planner No. 230, March 2014, both published by Wolters Kluwer (CCH) Limited.

[3] In some cases the impact of the changes may even be positive. For example, vendors with capital losses will now be able to offset capital gains on a sale of ECP against their capital losses, which would not have been the case under the Current Regime.

Wolters Kluwer

should cause owner-managers who may be considering selling their businesses to start thinking about selling a lot more seriously.

In this regard, for most owner-managers whose ECP has been internally generated and subject to few, if any, eligible capital expenditure claims, the recapture element associated with the sale of ECP is usually not a big deal. However, for many clients, ECP and, in particular, goodwill will be the single biggest asset they will have to sell, and the shift from the Current Regime of taxing such income at 50% of the active business rate to the traditional capital gains regime applicable to other depreciable property under the New Regime will result in a significant loss of tax deferral in situations where the owner-manager has no personal need for the full amount of the proceeds of sale.

For example, assume that your client Ely has been carrying on a hat business under the name Ely's Caps Limited ("Ely Cap" for short), and the goodwill of Ely Cap has recently been valued at $20 million. What would be the impact to Ely and Ely Cap under the Current Regime, and under the New Regime, assuming that it is implemented as suggested in the 2016 NWMM?

Under the Current Regime, if Ely Cap sold all of its business assets (I'll assume that the remainder of its assets, inventory, etc. would be sold at cost), the $20 million of proceeds receivable for the goodwill would give rise to a $15 million income inclusion under paragraph E of the cumulative eligible capital definition in subsection 14(5). Two thirds (2/3) of this income inclusion, an amount of $10 million, would be taxable at ordinary corporate rates pursuant to paragraph 14(1)(*b*). As a result, assuming that Ely Cap would otherwise have used up its $500,000 small business deduction in the year, in Ontario the $10 million of taxable income will be subject to corporate taxes at a rate of 26.5% for a total of $2.65 million of tax.

In addition, the sale will give rise to a $10 million addition to Ely Cap's capital dividend account (after the end of Ely Cap's current taxation year), which will allow Ely to remove $10 million of cash from Ely Cap for his personal use with no additional taxation.

If Ely wanted to remove the remaining $7.35 million of goodwill proceeds ($10 million net of the $2.65 million of corporate tax) for his personal use, Ely would likely do so by way of Ely Cap declaring eligible dividends on his shares of Ely Cap, which would result in him paying additional tax of 39.34%,[4] being another $2.89 million and change. If Ely were to do this, the total tax payable on a $20 million sale of goodwill would be approximately $5.54 million.

Under the New Regime, the full $20 million of proceeds would be subject to corporate capital gains tax rates, which in Ontario are currently about 25.08% and which would give rise to tax of slightly more than $5,015,000 in the corporation. As was the case under the Current Regime, this sale would generate a capital dividend account in Ely Cap of $10 million, which could be distributed to Ely tax free. However, due to ongoing and continuing tax rate changes that have increased the tax rate for ordinary taxable dividends to 45.89% in 2017 when the New Regime comes into force,[5] the integrated tax rate to remove the remaining goodwill proceeds of $4,985,000 ($10 million less $5,015,000 of corporate tax) from Ely Cap would increase the total tax payable on the sale of its goodwill (net of refundable taxes receivable by Ely Cap) to approximately $5,640,000.

As the Ely Cap example makes clear, there will be a cost of making a personal distribution of the corporate after-tax ECP proceeds under the New Regime of about $100,000 ($5,640,000 - $5,540,000).[6] On the other hand, by leaving the ECP proceeds in excess of capital dividend account amounts in a vendor corporation such as Ely Cap, it will be possible to enjoy some personal deferral of tax in both of these cases. In particular, under the Current Regime, this deferral would be about $2,890,000 ($5,540,000 - $2,650,000),[7] and under the New Regime it will be reduced to about $625,000 ($5,640,000 - $5,015,000).[8]

The "cost" of the loss of this deferral should not be understated since, as a practical matter, most clients in Ely's situation and in situations involving far more modest sales than Ely's would likely not draw more than the CDA balance

[4] For simplicity I have assumed that Ely pays tax at the top marginal tax rates in Ontario. It should be noted that on death and possibly in other situations the use of "pipeline"- type structures could allow for a reduction in the additional taxes otherwise payable. Such structures have their own tax risks associated with them and are beyond the scope of this article.

[5] The ordinary dividend tax rate, which is 45.30% in 2016, is anticipated to increase to 46.34% in 2018 and to 46.75% in 2019.

[6] Determined by calculating the difference between the total integrated tax under the New Regime and under the Current Regime.

[7] Determined by calculating the difference between the total integrated tax under the Current Regime and the corporate tax under the Current Regime.

[8] Determined by calculating the difference between the total integrated tax under the New Regime and the corporate tax under the New Regime.

out of Ely Cap for a very long time, *if ever*. As a result, in many cases the corporate deferrals under both regimes will really amount to effective personal tax "savings" and the change from the Current Regime to the New Regime on a $20 million sale of Ely Cap's goodwill will "cost" Ely Cap nearly $2,365,000 ($5,015,000 - $2,650,000)[9] by forcing it to pay those additional corporate taxes in the year of the sale.

Assuming the New Regime becomes law, then it would certainly appear that given the massive transition of wealth that is set to occur over the next number of years this new 12% tax will likely be a significant revenue generator for the Canada Revenue Agency, though for reasons that I still can't understand, the Department of Finance still hasn't touted the change in this manner.[10]

Although the New Regime is not yet law, business owners who were already thinking about selling would be advised to carefully reconsider the timing of their exit because now may be a very good time to sell. At the very least, consideration should be given to implementing strategies[11] that may allow business owners to enjoy the benefits of the Current Regime while they still can.[12]

Special thanks to Ryan Chua of Minden Gross LLP for his comments on earlier drafts of this article. All errors and omissions are the author's.

2016 PROVINCIAL BUDGETS

Three provincial budgets have been tabled since our last edition. Several changes will affect small businesses.

Manitoba (May 31, 2016)

Notable Budget measures affecting small business include:

- The Small Business Venture Capital Tax Credit, which was scheduled to expire at the end of 2016, will be extended until December 31, 2019. The Budget also noted that the government intends to review the tax credit parameters to improve accessibility for Manitoba companies.
- The Green Energy Equipment Tax Credit will be expanded to provide a 15% credit for gasification equipment and equipment for co-generation of energy using biomass fuel.
- The Interactive Digital Media Tax Credit will be reviewed to consider enhancements to the eligibility criteria, in particular, for larger digital media companies who establish a significant job-creating presence in Manitoba.
- The sales tax exemption for temporary museum and art gallery exhibits brought into the province will be expanded to include permanent exhibit acquisitions. This exemption will apply to museums and art galleries whose revenue is greater than 50% by donations, grants or government funding.
- Contractors who manufacture and install residential kitchen cabinets can choose to calculate the sales tax payable on their manufacturing costs by using either the general manufacturing formula for goods installed into real property or a simplified formula of 70% of the total contract price (excluding any GST and sales tax previously paid on materials).
- An out of province business must register to collect and remit retail sales tax if it holds an inventory of taxable goods in the province, available for sale to Manitoba customers.

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[9] Determined by calculating the difference between the corporate tax under the New Regime and the corporate tax under the Current Regime.

[10] The 2016 Budget papers do show an increasing positive fiscal impact from these changes (2016-17 - $30 million and 2017-2018 - $190 million of new revenue). Query if even these numbers are too modest.

[11] A discussion of such transactions, which are sometimes referred to as goodwill (ECP) bump or "crystallization" strategies is beyond the scope of this article.

[12] Assuming the New Regime is legislated, expect a return to the old status quo of vendors having a very strong preference to sell shares (it appears that the CCA rate for new ECP acquisitions will be set to emulate the existing eligible capital expenditure rates with some slightly more favourable variations for existing ECP, so that the New Regime should be relatively tax neutral for purchasers). Due to the low tax rates applicable to ECP sales, this may not have always been the case in the more recent past, even for vendors whose shares would otherwise have qualified for capital gains exemption treatment. Though, in some situations it has been possible for both vendors and purchasers to achieve the best of both worlds from a tax perspective by employing so-called "hybrid" sale structures, whereby transactions are structured to allow vendors to sell their shares and also sell assets of the corporation. For more on hybrid sale structures, see Charles P. Marquette, "Hybrid Sale of Shares and Assets of a Business" in "Personal Tax Planning" (2014), vol. 62, no. 3 Canadian Tax Journal, 857-879.

Northwest Territories (June 1, 2016)

No new tax increases or new tax measures affecting small businesses were announced in the Budget.

Saskatchewan (June 1, 2016)

No new tax increases or new tax measures affecting small businesses were announced in the Budget.

CRA FOLIOS

IC-70-6R7: Advance Income Tax Rulings and Technical Interpretations (April 22, 2016)

This circular cancels and replaces Information Circular IC-70-6R6 dated August 29, 2014. This circular explains the role of the Income Tax Rulings Directorate, the difference between Technical Interpretations and Rulings, and the Process, Nature, and Required Information for both Technical Interpretations and Rulings. This circular also discusses circumstances where a Technical Interpretation or a Ruling will not be issued by the Directorate.

WHAT'S NEW

Progress of Legislation: Bill C-15 Receives Royal Assent

Bill C-15, *An Act to implement certain provisions of the budget tabled in Parliament on March 22, 2016 and other measures*, which contains several income tax, GST/HST, and excise tax measures from the 2016 federal Budget and certain remaining measures from the 2015 federal Budget that had not been enacted when Parliament dissolved, received Royal Assent on June 22, 2016. Some notable measures affecting small business include:

- maintaining the small business tax rate;
- various GST/HST and excise tax amendments;
- amendments to section 55;
- withholding for non-resident employers; and
- synthetic equity arrangements.

Prescribed Interest Rates: Third Quarter of 2016

The CRA has released the prescribed annual interest rates to be applied for the period from July 1, 2016, to September 30, 2016. These rates will apply to amounts owed to the CRA, and any amounts owing by the CRA to individuals and corporations. The only change since last quarter is the rate for corporate taxpayers' pertinent loans or indebtedness.

The rates charged in the third quarter of 2016 will be as follows:

- on overdue taxes, Canada Pension Plan contributions, and employment insurance premiums: 5%.
- on corporate taxpayer overpayments: 1%.
- on non-corporate taxpayer overpayments: 3%.
- used to calculate taxable benefits for employees and shareholders from interest-free and low-interest loans: 1%.
- for corporate taxpayers' pertinent loans or indebtedness: 4.50%.

A listing of the prescribed interest rates for each quarter, dating back to 2000, is reproduced at ¶300 and under "Quick Links" in the *Canadian Tax Reporter* on DVD and online.

CRA Releases Updated Guidelines for Resolving Claimants' SR&ED Concerns (May 30, 2016)

The CRA has recently made changes to the guidelines for resolving claimants' SR&ED concerns and to improve the timeliness and consistency of the administrative review process. Specifically, the revisions include the following:

- •Implementation of the request for an Administrative Review Form RC532 that claimants' must complete to request an administrative review;
- •Implementation of a National SR&ED Administrative Review Intake Centre that will receive and catalogue all requests for administrative reviews, and forward each request to the appropriate tax services office; and
- •The wording in the guidelines has been revised for clarity.

What's New for Corporations 2016 (April 26, 2016)

In April, 2016 the CRA issued a news release discussing recent changes to tax legislation affecting corporations. Specifically, the news release discussed the following legislation changes in some detail:

- Avoidance of the Business Limit and the Taxable Capital Limit;
- Capital Cost Allowance Revisions;
- Eligible Capital Property;
- Measures Related to International Tax;
- Multiplication of the Small Business Deduction; and
- Small Business Tax Rates.

TECHNICAL INTERPRETATIONS

The following are summaries of recent income tax interpretations, issued by the Minister of National Revenue. Copies of these interpretations can be found in our online Federal Income Tax service, under Window on Canadian Tax.

Proposed Eligible Capital Property Rules

In a situation where a taxpayer acquired goodwill from a non-arm's length taxpayer prior to January 1, 2017, and disposes of the goodwill after January 1, 2017, to an arm's length person, will the grind (originally recognized under variable A. 1 in the definition of "cumulative eligible capital" in s. 14(5) of the *Income Tax Act*) be restored for purposes of calculating the capital gain?

CRA Response: Under the current version of the proposed rules, no. The CRA has referred this matter to the Department of Finance for their consideration in the finalization of the proposed legislation.

External Technical Interpretation, Business and Employment Division, June 7, 2016, ¶13,478

Replacement Property

Whether a commercial rental property (land and building) could be considered replacement property for a former property (expropriated farmland).

CRA Response: While it remains a question of fact, it is the view of the CRA that in order to comply with the conditions set out in s. 44(5)(*a*.1) of the *Income Tax Act* (the "Act"), the replacement property should have the same physical characteristics as the former property. Since the commercial rental property (which includes land and a building) does not have the same physical characteristics of the farmland (land only), the commercial rental property would not be considered replacement property within the meaning of s. 44(5) of the Act regardless of the fact that both the farmland and the commercial rental property may be used to earn rental income.

External Technical Interpretation, Business and Employment Division, June 7, 2016, ¶13,471

Impact of Small Business Deduction on Ability to Pay Eligible Dividends

The CRA was asked if a corporation was required to deduct the small business deduction under s. 125(1) of the *Income Tax Act* (the "Act"). The corporation intended not to claim the small business deduction to which it was entitled to increase its general rate income pool ("GRIP") and pay more eligible dividends to its shareholders. Relying on the wording of s. 125(1) of the Act, the CRA confirmed that it had the option but not the obligation to claim the small business deduction. If no small business deduction was claimed by the corporation, there was no resulting reduction of its "adjusted taxable income" and "general rate income pool" (see the definitions of the two terms in s. 89(1) of the Act) and more eligible dividends could be paid to the corporation's shareholders.

External Technical Interpretation, Reorganizations Division, June 20, 2016, ¶13,467

Neuman Type Situation

What are the tax consequences for the shareholders of a corporation and the corporation that may arise on the issuance of shares which carry an entitlement to discretionary dividends for nominal consideration and the payment of any discretionary dividends from such shares?

CRA Response: Consistent with the Supreme Court of Canada's decision in *Neuman v. R.*, [1998] 3 CTC 177, it is the CRA's view that, generally, s. 56(2) of the *Income Tax Act* (the "Act") will not apply to arrangements involving the payment of dividends by a corporation, provided that the applicable taxpayer does not have a pre-existing entitlement to the dividends and provided that proper consideration was given for the shares when issued.

The tax consequences of the subscription of the Class B preferred share by "Mrs. A" would depend, among other things, on the fair market value of such shares upon subscription. It is possible that one could take the position that an economic advantage is being conferred by "Opco" on Mrs. A as the holder of the Class B preferred share. In such circumstances, the CRA could conclude that s. 15(1) of the Act applies upon the issuance of the Class B preferred share. Alternatively, it may be possible that the circumstances would suggest that Mr. A rather than Opco is conferring the benefit on Mrs. A. If it could be demonstrated that there was a transfer of economic interest in Opco from Mr. A to Mrs. A similar to the situation in *Queen v. Kieboom*, 92 DTC 6382, Mr. A would be considered to have disposed of a right, interest, or right to dividends in Opco to Mrs. A. Under these circumstances, because Mr. A and Mrs. A are spouses, the automatic rollover provision in s. 73(1) of the Act would apply such that the disposition of Mr. A's economic interest would be at cost. In the event that the taxpayer elects not to have s. 73(1) of the Act apply, s. 69(1) of the Act would apply, in which case the disposition is deemed to have occurred at fair market value.

If Mr. A is considered to have disposed of a right, interest, or right to dividends in Opco to Mrs. A, the attribution rules should be considered and it is possible that s. 74.1(1) of the Act would apply to reassign to Mr. A any dividends paid on the Class B preferred share held by Mrs. A.

While the CRA has considered the application of s. 245(2) of the Act in respect of Neuman type income-splitting arrangements in the past and has taken the position that GAAR does not apply, it has also specifically stated that this comment regarding the non-application of GAAR relates only to the Neuman case. Accordingly, all of the relevant facts and circumstances of any given situation should be considered to determine whether the use of discretionary dividends on shares would cause the application of s. 245(2).

External Technical Interpretation, Reorganizations Division, March 14, 2016, ¶13,463

Post Mortem Pipeline Planning

The taxpayer sought an advance income tax ruling in respect of a post-mortem "pipeline" transaction involving a private corporation. Based on the redacted ruling, it appears as though the facts are as follows:

- "A" and "B" were spouses and residents of Canada. Each is now deceased.

- A and B had four children: "Beneficiary1", "Beneficiary2", "Beneficiary3", and "Beneficiary4". Each of the children is a resident of Canada.
- At some point prior to the death of A and B, they settled a joint-spousal trust for their exclusive benefit during their lifetimes. The trust held shares of a Canadian-controlled private corporation (the "Corporation"), the assets of which consisted of marketable securities. Shares of the Corporation had been redeemed from time to time to provide income to the trust and to generate a refund of any "refundable dividend tax on hand" of the Corporation.
- Certain shares of the Corporation were also held by various holding corporations ultimately owned by each of the children.
- A predeceased B. As a consequence of B's death, all of the shares of the Corporation owned by B were subject to a deemed disposition at fair market value pursuant to s. 70(5) of the *Income Tax Act* (the "Act"). This results in a realization of any accrued capital gains to that date. Similarly, the shares owned by the trust were subject to a deemed realization pursuant to s. 104(4)(*a*) of the Act.
- The terms of the trust, and B's will, provide that the four children are to receive the shares of the Corporation equally following B's death.

A "pipeline" transaction is a form of transaction whereby the assets of a corporation are distributed to shareholders utilizing the high adjusted cost base resulting from the capital gains realized on death, rather than as a distribution in the form of a dividend. In this sense, the use of a pipeline is often justified as avoiding "double-tax" in the sense that there has been tax imposed as a capital gain on the death of the shareholder followed by further tax in the form of a dividend realized when the assets on distributed. Both of these taxes would be shareholder-level taxes on ultimately the same assets (additional corporate-level tax may apply if the assets of the corporation have accrued but unrealized capital gains). The CRA has issued numerous favourable rulings on pipeline transactions over the years. In this case, the proposed pipeline proceeded as follows:

- The children of A and B incorporated a new corporation, Newco.
- The children will transfer the shares in the Corporation received on B's death to Newco in exchange for a promissory note having a principal amount equal to such child's adjusted cost base of such shares (being the fair market value of the shares at B's death, and shares of Newco. Similar transactions will be undertaken by the trust and the holding corporations.
- Following a period of at least one year, Newco and the Corporation will amalgamate and the promissory notes will be repaid.

In general, in implementing a pipeline, the concern is that s. 84(2) of the Act could be applied to the repayment of the promissory note. Section 84(2) provides that where a corporation resident in Canada distributes funds or property to shareholders on the winding-up, discontinuance, or reorganization of its business, it will be deemed to have paid a dividend. The deemed dividend in respect of each class of shares will be deemed to be: (a) the amount or value of the funds or property distributed, minus (b) the reduction in the paid-up capital in respect of the shares of that class. Where the corporation is wound up this would ordinarily be the full amount paid up on those shares.

As a result of this concern, it is commonplace for a pipeline ruling to provide the one-year "cooling off" period prior to a distribution of the corporation's assets. It appears that the CRA requires such a provision in order to provide a favourable ruling.

A favourable ruling was provided.

Reorganization Division, Income Tax Rulings Directorate, April 6, 2016, ¶13,445

Corporate Reorganization

As part of a complex and lengthy corporate reorganization involving at least 30 corporations, the taxpayer sought an advance income tax ruling from the CRA.

Although heavily redacted, the ruling indicates that the complex network of corporations is ultimately held by a single family, including multiple family trusts, a spousal trust, and the individuals themselves who appear to be a husband, wife, and four (presumably adult) children. It appears that part of the reason that the taxpayer sought a ruling was to ensure that the donation of certain public company shares to the family's private foundation would receive a particular tax treatment. As well, the ruling asks for comfort on whether s. 74.4 of the *Income Tax Act* (the "Act") would apply to the transfers made by the individual shareholders.

The donation of the public company shares was made by one of the corporations in the group, having just received the shares from another corporation in the group pursuant to a transaction to which s. 85 of the Act applied. The donor corporation then made a gift of the shares to a foundation that is a "registered charity" for purposes of the Act. The donated shares were subsequently purchased back from the foundation by another corporation in the group for fair market value proceeds. Although a disposition of capital property ordinarily results in a 50% inclusion rate for tax purposes, s. 38(*a*.1) of the Act modifies the 1/2 inclusion of capital gains in circumstances where the gain arises from a gift to a qualified donee of certain types of property.

Where a capital gain results from the making of a gift to a qualified donee (as defined in s. 149.1(1) of the Act) of certain types of publicly-traded securities, the taxable capital gain inclusion is nil. A qualified donee generally includes most registered charities as well as the Crown. The types of property to which this reduced inclusion rate applies are shares, debt obligations, or rights listed on a designated stock exchange (see the commentary for s. 262 of the Act), shares of a mutual fund corporation and units of mutual funds, interests in segregated funds and designated debt obligations. The beneficial capital gains treatment accorded to donations of these securities to qualified donees other than private foundations under s. 38(*a*.1) was originally introduced in 1997 for a four-year period as a half-inclusion rate. This was extended indefinitely in 2001. The inclusion rate was decreased to zero for gifts made after May 1, 2006. In 2007, the exclusion of gifts to private foundations was removed so that gifts of these securities made to private foundations on or after March 19, 2007, also qualify for the zero inclusion rate.

In this case, the taxpayer may have been concerned with the fact that the donor corporation had only acquired the shares momentarily before the donation and therefore the donated shares may not have been capital property to the donor. However, the CRA has a longstanding position that property held as capital property retains its character as such in the hands of a transferee corporation that received the property under a transfer to which s. 85 applied. See, for example, CRA Document No. 2013-0500891I7 "Hedging" (March 05, 2014).

The taxpayer also sought a ruling specifically on the potential application of s. 74.4 of the Act to the transfers made by individuals (including the family trusts). Section 74.4 extends the attribution rules to certain situations where an individual has transferred or loaned property to a corporation (other than a small business corporation) either directly or indirectly by means of a trust or any other means, for the purpose of reducing the individual's income and benefiting the individual's spouse, or a minor child who is non-arm's length or a niece or nephew.

The amount attributed is deemed to be interest received by the individual who transfers or lends property to a corporation (other than a small business corporation) and therefore the deemed amount is not eligible for the dividend tax credit under s. 121 of the Act. The attribution of deemed interest occurs whether or not the corporation pays dividends or increases in value. The amount of deemed interest is not prorated to take into account the percentage interest in the corporation held by the designated person. Therefore, the amount of deemed interest is the same whether designated persons own a minority, a majority, or all of the shares of the corporation. For more on s. 74.4, see ¶9530.

The taxpayer received favourable rulings.

Reorganization Division, Income Tax Rulings Directorate, April 6, 2016, ¶13,444

Carrying on Business in Canada and Permanent Establishment

(1) Whether the secondment arrangement between a non-resident corporation and a related Canadian corporation causes the non-resident corporation to be considered to render services in Canada for purposes of Regulation 105 of the *Income Tax Regulations* (the "Regulations").

(2) Whether the non-resident corporation is carrying on business through a permanent establishment ("PE"), as defined in Article 5 of the Canada-XXXXXXXXXX Treaty, situated in Canada.

CRA Response:

(1) No. The conclusion is consistent with our prior positions that the provision of employees by a non-resident corporation under a secondment arrangement, where the non-resident is reimbursed at cost and no mark-up is charged, does not cause the non-resident corporation to be rendering services in Canada for purposes of Regulation 105.

(2) No. The conclusion in respect of the secondment arrangement is consistent with our prior positions that the provision of employees under a secondment arrangement does not cause a non-resident corporation to be carrying on a business in Canada. The subcontracted activities of the non-resident will not meet the permanent establishment threshold in Article 5 of the Canada-XXXXXXXXXX Treaty.

Tax Ruling, International Division, XXXX, 2015, ¶13,409

Multi-wing Split-up Butterfly

The CRA issued an advance income tax ruling in respect of a "butterfly" transaction involving four siblings who are splitting up the family business following the death of their father.

In general, a dividend received by a taxable Canadian corporation from another Canadian corporation is included in the recipient corporation's income but ultimately is received tax-free due to the deduction available in s. 112(1) of the *Income Tax Act* (the "Act"). However, in order to prevent potential "capital gains stripping" transactions through the use of inter-corporate dividends, s. 55(2) of the Act will generally recharacterize such a dividend as a capital gain where certain conditions are met unless one of several exemptions are available. One of the primary exemptions is the so-called "butterfly" rule in s. 55(3)(*b*) of the Act, which generally provides that the assets of a corporation can be distributed *pro rata* among corporate shareholders provided numerous conditions are met. In the 2015 Federal Budget, significant amendments to s. 55(2) and related provisions were announced. While still unenacted, it is expected that these amendments will eventually come into force, resulting in a material expansion of the scope of s. 55(2) (see ¶7975 for additional detail); however, the butterfly exemption in s. 55(3)(*b*) are not proposed to be amended.

Section 55(3)(*b*) applies only if the dividend was received in the course of a reorganization in which a distribution took place. "Distribution" is defined in s. 55(1) of the Act. In general terms, a distribution means a transfer of property by a distributing corporation to one or more transferee corporations, where each transferee corporation receives approximately its *pro rata* share of each type of property of the distributing corporation owned immediately before the distribution.

A transferee corporation's *pro rata* share of each type of property transferred is based on the proportionate shareholdings in the distributing corporation held by the transferee corporations immediately before the distribution. Each transferee corporation must receive the proportionate value of each type of property, equal to the proportion of the fair market value of the shares in the distributing corporation owned by the transferee corporation immediately before the distribution, divided by the fair market value of all of the outstanding shares of the distributing corporation.

The CRA has expressed the view that types of property can be divided into three general categories of (i) cash and near cash, (ii) business assets, and (iii) investments. If, for example, the distributing corporation owned real estate (a business asset, or alternatively investment property) and also short-term securities (near cash), the butterfly exemption would not apply if it distributed all of the real estate to one transferee and all of the securities to another.

In the ruling, the CRA was presented with the following facts:

- "DC1" and "DC2" are taxable Canadian corporations carrying on an active real estate business in Canada.
- The shares of DC1, which appears to be the more valuable corporation of the two, are held by five Canadian-resident individuals: "A", "B", "C", "D", and a trust (the "Trust"). The Trust was formed on the death of "F", who is the father of each of A, B, C and D. The Trust is a spousal trust established to benefit "E" (F's widow, and A, B, C, and D's mother) with a gift-over upon E's death that provides that the four children are to share equally in the remaining capital following E's passing.
- Each of A, C, and D will incorporate a new corporation, which will act as the transferee corporation. B's existing corporation will be the transferee corporation for B.

- Each of A, B, C, and D will transfer their DC1 shares to their respective transferee corporation, taking back shares of the transfer corporation as consideration. Elections under s. 85 of the Act will be filed in the prescribed manner and within the prescribed time period to provide that the transfer to the transferee corporations occurs on a tax-deferred basis. The trust will transfer its DC1 shares to B's transferee corporation under s. 85.
- DC1 and DC2 will amalgamate (following the continuance of DC1 to the same corporate jurisdiction as DC2) to form DC-Amalco. This results in a single corporation that will act as the distributing corporation in the proposed transaction.
- Each of the transferee corporations will incorporate a wholly-owned subsidiary. DC-Amalco will categorize all of its property into the three types of assets listed above: (i) cash and near cash; (ii) business assets; and (iii) investment property. DC-Amalco will transfer a *pro rata* share of each of its types of property to the subsidiaries of each transferee corporation based on such transferee corporation's shareholdings in DC-Amalco. Although not explicitly stated, it may be the case that the subsidiary corporations were used in order to prevent so-called "corporate incest", whereby a subsidiary corporation (in this case DC-Amalco) acquires shares in its shareholder (the transferee corporations).
- As consideration for the transfer, the subsidiaries of the transferee corporations will assume certain liabilities and issue special shares. Elections under s. 85 will be filed in the prescribed manner and within the prescribed time period to provide that the transfer to the transferee corporations occurs on a tax-deferred basis.
- Each of the subsidiaries will redeem its respective special shares, issuing a demand, non-interest bearing promissory note as payment of the redemption amount. The subsidiaries will then be wound-up into their respective transferee corporations, such that the demand notes issued by the subsidiaries will be assumed by the transferee corporations. The transferee corporations will also thereby acquire DC-Amalco's former assets.
- DC-Amalco will purchase for cancellation all its shares owned by the transferee corporations, as consideration for the purchase, DC-Amalco will issue non-interest bearing promissory notes to each of the transferee corporations.
- The promissory notes owed by each transferee corporation will be set-off against the corresponding note owed by DC-Amalco to such transferee corporation.

As a result of the foregoing transactions, all of the assets of DC1 and DC2 will have been split among the four siblings (indirectly through their respective transferee corporations). Although a much broader exemption under s. 55(3)(*a*) of the Act is generally available among related groups (subject to the proposed changes announced in 2015), s. 55(5)(*e*) of the Act provides that siblings are deemed not to be related for purposes of s. 55, and therefore the s. 55(3)(*b*) butterfly transaction was the only available method for splitting up the business on a tax deferred basis.

The CRA issued favourable rulings.

Reorganizations Division: Income Tax Rulings Directorate, 2015, ¶13,392

RECENT CASES

Minister not bound by foreign judgments where such judgments not reviewed by Canadian court

Tax Court of Canada, February 12, 2016

During the 2004, 2005 and 2006 taxation years, the corporate taxpayer's foreign affiliates transferred amounts to it and declared such transfers to be dividends. The taxpayer obtained rectification orders from courts in Barbados and Cyprus which re-characterized those amounts as transfers from the foreign affiliates resulting in indebtedness of the taxpayer. The Minister of National Revenue nonetheless assessed the taxpayer on the basis that the transferred amounts were dividends. The taxpayer appealed from that assessment, and sought a determination by the Court of whether the minister was required, by virtue of the foreign rectification orders, to treat the transferred amounts as indebtedness rather than dividends.

The court determined that the minister was not bound by the foreign rectification orders. The Court held that rectification orders requested by the parties to a transaction in order to rectify the tax consequences of that transaction are not automatically granted. Rather, it is open to the courts to intervene to find that the amendments made by the parties to the acts at issue are legitimate and necessary, and judicial recognition of the validity of such amendments in the context of tax planning is to be approached cautiously. The Court held that in the present case a domestic court would have to consider relevant factors so as to ensure that the foreign judgments did not disturb the structure and integrity of the Canadian legal system, or conflict with domestic law. A careful review of the foreign judgments would be required in order to ensure that a Canadian court did not extend judicial assistance if the Canadian justice system would be used in a manner not available in strictly domestic litigation. The Court concluded, therefore, that the foreign judgments would have be homologated by a competent tribunal in the province of Quebec in order to bind the minister. The Court noted as well that, although it did not have jurisdiction to grant the equitable remedy of rectification, it was open to the appellant to rely on the foreign judgments in presenting its evidence at trial, where the presiding judge could determine the weight to be given such judgments in ruling on the validity of the assessment. The Court concluded that the minister was not bound by the foreign judgments in issuing the assessment.

Canadian Forest v. The Queen, 2016 DTC 1041

Small business deduction properly denied — management services provided were a personal services business

Tax Court of Canada, March 3, 2016

The taxpayer was appealing reassessments that denied its claim for a small business deduction and limited expenses claimed on the basis that it was providing services as a "personal services business" ("PSB"). The taxpayer was incorporated by Ivan Cassell in 1983 to operate a home comfort centre for Imperial Oil. After several years, he went to work for Ultramar for about six years as a supervisor, looking after all the independent retail agents of Ultramar located on the west coast of Newfoundland and southern Labrador. In 1990 he left Ultramar and bought an area of retail business from them outside the major urban centres of Newfoundland. Cassell began growing ICL's retail oil and gas business by acquiring several gas stations in areas that the major oil companies were leaving . The retail oil and gas business of ICL was carried on under the business name Western Petroleum ("WP"). In 2005 WPNL was incorporated and ICL transferred its WP business to WPNL and the business expanded throughout Newfoundland. Cassell was the president and director of WPNL. At issue were the services provided by Cassell to WPNL in his capacity as president of ICL. The services were provided under an oral agreement and included banking, negotiating contracts, and dealing with suppliers.

The appeal was dismissed. If Cassell would reasonably be regarded as an employee but for the existence of ICL, the small business deduction is not available to ICL and the PSB provisions would apply. The PSB provisions are designed to deny tax advantages that may be obtained by providing services through a corporation rather than personally. There is no one conclusive test or determinative factor but issues of control, risk of loss and opportunity for profit or risk of loss are to be considered. The stated objective of Cassell providing services to WPNL was to grow its business with no mention of ICL's business. There was no written agreement between ICL and WPNL, no HST was charged on fees paid by WPNL and ICL did not advertise its services. ICL leased gas stations to third parties, distinct from their providing management services, which generated income for WPNL. When the tenants were delinquent in paying rent, they were not pursued for the rent so that WPNL would continue to gain revenue. The profitability of WPNL took precedence over the earning of rent by ICL, confirming that Mr. Cassell's focus was solely on the profitability of WPNL's business. Someone in business on his own account would not have such a focus. The functions performed by Cassell after the transfer to WPNL were the same as those performed by him as a senior employee of ICL. Any opportunity for profit was tied to the success of WPNL and there was limited exposure to risk of loss. Cassell had the use of a company car and had a makeshift desk to work at when he went into the office. Although there was no direct control of Cassell's activities he had weekly meetings at WPNL which is consistent with what one would expect in terms of control for a senior employee. There was no evidence to support a conclusion that Cassell was providing services as a person in business on his own account. But for the existence of ICL, Cassell would reasonably be regarded as an employee and the services provided to WPNL were those of a PSB. The small business deduction was properly denied.

Ivan Cassell Limited v. The Queen, 2016 DTC 1048

Dissolved corporation required to effect revival in order to initiate appeal to Tax Court

Federal Court of Appeal, March 30, 2016

The appellant corporation was incorporated in 2000 under the Ontario *Business Corporations Act* (BCA) but was dissolved, and its certificate cancelled, in early 2007. In 2010, an assessment was issued against the corporation by the Minister of National Revenue and the corporation appealed from that assessment. The Tax Court of Canada held that the appellant, as a dissolved corporation, lacked the capacity to initiate an appeal to that Court from an assessment issued against it under the *Income Tax Act*. The Tax Court adjourned the appellant's pending appeal for 60 days in order to allow it to take steps to revive its corporate status. Instead, the appellant appealed to the Federal Court of Appeal from the order holding that it lacked capacity to appeal from its assessment to the Tax Court.

The appeal was dismissed. The appellate Court held that the question of whether a dissolved corporation has the legal capacity to initiate and continue an appeal in the Tax Court of Canada was a question of law, reviewable on a standard of correctness. It held as well that the Tax Court had reached the correct conclusion with respect to that question, but differed from the Tax Court on the reasons. The Tax Court had held that changes in statutory language relating to the effects of corporate dissolution made previous decisions of the Federal Court on that issue distinguishable, but the appellate Court determined that the Tax Court erred in reaching that conclusion. It was, however, open to the Federal Court of Appeal to depart from its prior decisions where warranted, and it concluded that such a departure was justified. Specifically, the appellate Court held that when the current legislative regime was considered, it was correct to conclude that the filing of a notice of appeal in the Tax Court constituted the initiation of a legal proceeding. As subsection 242(1) of the BCA does not authorize a dissolved corporation to initiate a civil proceeding, it followed that the Tax Court did not err by adjourning the appeal and requiring the corporate appellant to revive its corporate status so that it could continue the appeal. The appellate Court held as well that, while there were circumstances in which the statute did not permit the filing of articles of revival, other mechanisms existed to permit revival, such that the right of revival was real and not illusory. The appeal was dismissed, and the adjournment ordered by the Tax Court was continued for a further 60 days in order to allow the appellant to revive its corporate status.

1455257 v. The Queen, 2016 DTC 5046


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