Small Business Times

August 2020
Number 79

Capital Gain and Capital Loss Basics 2

CDA — A Way To Strengthen Relationships 3

CDA Basics 3

Strategic CDA Plan — A simple Example 4

COVID-19 Update 4

Technical Interpretations 7

Wolters Kluwer

TAX PLANNING FOR THE NON-SPECIALIST ADVISOR
UNLOCKING LIQUIDITY IN CORPORATE CAPITAL LOSSES — PLANNING TO MAXIMIZE THE CAPITAL DIVIDEND ACCOUNT — PART I

Michael Goldberg, BComm, LLB, TEP, FEA, Partner, Tax Lawyer, Minden Gross LLP, MERITAS© Law Firms Worldwide and founder of "Tax Talk with Michael Goldberg", a quarterly conference call about current, relevant, and real life situations for professional advisors who serve high net worth clients.

Recently, I published a short note on LinkedIn[1] with a list of some recessionary planning tools and strategies that advisors may wish to consider using to assist their clients in these difficult times. In that short note I also mentioned I was hoping to write about some of those ideas. This three-part series of articles (the "Series") is part of my effort at following through on my good intentions.

In particular, the Series has been designed to encourage advisors to strategically plan corporate loss transactions to enable their clients to maximize the tax-free benefits of the Capital Dividend Account ("CDA").[2]

As the Series progresses, the discussion will progress from a review of the most basic principles to more advanced planning concepts. This Part I of the Series will review gain and loss taxation at its most basic, and it will also review certain key aspects of the CDA relevant to the theme of the Series, including what I refer to as Strategic CDA Planning. Part II of the series will flesh out a number of other relevant CDA matters and introduce what I refer to as a 4C Strategy. Finally, Part III of the Series will review some strategies to enhance Strategic CDA Planning and also discuss a few cautions.

****

In the middle of a recession, any way that we, as advisors, can assist clients to keep their hard-earned money and generate liquidity will be incredibly valuable to them. In addition, providing advice of this nature may assist advisors in strengthening their relationships with clients.

---

[1] https://www.linkedin.com/posts/magoldberg_tax-planning-in-recessionary-times-michael-activity-6685984129349234688-sivQ

[2] As that term is defined in subsection 89(1) of the *Income Tax Act* (Canada) R.S.C. 1985 Ch .1 (5th Supp.), as amended (the "Act"). Unless otherwise noted all statutory references are to the Act.

I often refer to the process of taking *tax lemons* (for example, capital losses) and making them into something positive (for example, maximizing the benefits of the CDA) as making *tax lemonade*.

Capital Gain and Capital Loss Basics

Even in recessionary times commerce continues, and that includes the sale by clients of properties they own; some with embedded gains and some with embedded losses.

There are many reasons why clients may sell properties that they own. It could be that liquidity is desired. Maybe the client just wishes to diversify out of an asset. Perhaps the client is moving from one financial advisor to a new advisor who insists on a liquidation of the prior financial advisor's portfolio.

Regardless of the reasons, such transactions have tax consequences.

A gain[3] will generally arise upon a disposition[4] or deemed disposition[5] of a property if the proceeds of disposition[6] of the property exceed the aggregate of the "adjusted cost base"[7] ("ACB") of the property and the amount of disposition-related outlays or expenses. If the value of a property disposed of is less than its ACB and the amount of disposition-related outlays or expenses, a loss[8] will generally arise upon a disposition or deemed disposition.

Where the property was held on capital account, any gain will usually be taxed as a capital gain and any loss will usually be taxed as a capital loss.[9] Presupposing that the disposition of a property has been on capital account is an assumption that cannot always be assured. However, when dealing with dispositions of Canadian securities, a Canadian resident may improve their likelihood that transactions are on capital account by filing an election pursuant to subsection 39(4).

Throughout the remainder of the Series it will be assumed that all sale transactions discussed are on capital account.

Once a gain or loss has been determined to be on capital account, the general rule is that 50% of the capital gain or capital loss will be considered to be either a taxable capital gain or an allowable capital loss.[10] A taxpayer may utilize allowable capital losses realized in a particular taxation year to reduce income from taxable capital gains realized in the particular taxation year.[11] If there are excess unapplied allowable taxable capital losses the excess may be carried back for up to three taxation years or carried forward indefinitely.[12]

While in most cases loss transactions should not give rise to any income tax liability to the vendor,[13] unless corporate sale transactions are structured to maximize CDA, corporate capital loss transactions could cost your clients **material** amounts of tax-free cash.

---

[3] The general rules relating to the calculation of gains of a taxpayer in a taxation year are found in paragraph 40(1)(*b*).

[4] As that term is defined in subsection 248(1).

[5] Some examples of deemed dispositions under the Act include: on death (subsection 70(5)); on emigration (paragraph 128.1(4)(*b*)); on an acquisition of control (paragraph 111(4)(*d*)); and on a trust's 21st anniversary (paragraph 104(4)(*b*)).

[6] As that term is defined in section 54.

[7] As that term is defined in section 54.

[8] The general rules relating to the calculation of losses of a taxpayer in a taxation year are found in paragraph 40(1)(*b*). However, the ability to claim losses under the Act can be restricted or even denied. For example, a loss realized from the disposition of many types of "personal use property", as that term is defined in section 54, is deemed to be nil. Another example is a loss that is determined to be a "superficial loss", as that term is defined in section 54. In the case of superficial losses, the ability to claim the loss may be postponed or even denied under certain circumstances.

[9] Detailed rules and exceptions to the rules for determining the existence of capital gains and capital losses are found in section 39.

[10] Detailed rules and exceptions to the rules for determining the inclusion rate are found in section 38.

[11] Subsection 3(*b*). I often find people forget that capital gains can also be reduced by non-capital losses and allowable business investment losses ("ABILs"), as that term is defined in paragraph 39(1)(*c*).

[12] Paragraph 111(1)(*b*). ABILs that remained unclaimed for 10 taxation years following their realization become "net capital losses" (as defined in subsection 111(8)). While "non-capital losses" (as defined in subsection 111(8)) are subject to the same loss carryback rules as allowable capital losses, non-capital losses can only be carried forward for 20 taxation years.

[13] Sales of "depreciable property" can give rise to recapture in accordance with section 13.

CDA — A Way To Strengthen Relationships

The CDA is a purely corporate concept. It is also extremely complex. As a result, the discussion that follows is intended to provide a "high level" review of the matters discussed. Actual details of CDA concepts and calculations of CDA balances are much more involved than will be described below.

In good times and/or where capital transactions are modest, there may be little attention given to taking steps to maximize a corporation's CDA, since capital losses will hopefully be rare. However, in recessionary times, taking steps to ensure that a corporate client maximizes the use of its tax pools, including enabling its shareholders to access as much CDA as possible, could be a massive value-added service, strengthen client relationships, and in some cases, even make advisors seem like *heroes* to their clients.

In many cases all it will take is an understanding of the CDA and a little strategic planning.

CDA Basics

At the risk of oversimplifying the concept, the CDA is a notional corporate tax account that allows a corporation to make non-taxable dividend distributions of certain amounts that, if received by an individual, would have been taxed preferentially.

In the Series a CDA distribution, whether paid or payable and whether made by actual or deemed dividend, will often simply be referred to as a "CDA Dividend". The technical requirements to have a distribution treated as a CDA Dividend are described in Regulation 2101, which requires a prescribed form (T2054) to be filed with the Canada Revenue Agency ("CRA") together with:[14]

(1) A certified resolution of the director(s) declaring the CDA Dividend as required per Regulation 2101; and

(2) A calculation of the CDA of the particular corporation immediately prior to the declaration of the CDA Dividend.[15]

As set out in the CDA definition in subsection 89(1), there are many components or pools that aggregate together to form a corporation's CDA. For most corporations, the key pools include and tend to be derived from:

(1) net capital gains realized by a corporation over time ("NCG Pool");

(2) CDA Dividends from other entities; and

(3) insurance proceeds ("Insurance Pool").

The discussion in the Series will focus on the NCG Pool.

As with all CDA pools, the calculation of the NCG Pool is determined on a cumulative basis since 1971 or incorporation, whichever is later.[16] The NCG Pool is determined by:[17]

(1) adding the non-taxable portion (currently 50%)[18] of corporate capital gains to the NCG Pool; and

(2) subtracting the non-taxable portion (currently 50%) of corporate capital losses from the NCG Pool.

Even though realizing capital losses will not create a tax liability, doing so will reduce the balance of the NCG Pool, which will impair and possibly eliminate the ability to pay tax-free CDA Dividends out of the NCG Pool.

---

[14] Because it is often difficult to comply with the timelines in subsection 83(2) and because penalties for late filing Form T2054 are modest (subsection 83(4)), in my experience, it is relatively common for Form T2054 to be late-filed.

[15] While taxpayers may use SCHT289, my experience has been that many CDA election filings are made with Excel spreadsheets containing only relevant components of this schedule.

[16] Corporate reorganizations, including wind-ups and amalgamations, may make tracking CDA balances difficult.

[17] See paragraph (*a*) of the CDA definition. The actual calculation is more complex than described below.

[18] The non-taxable portion of corporate capital gains and capital losses has fluctuated from time to time.

Because most corporate clients will hold assets with a mixture of capital gains and capital losses, strategically timing the capital losses can often allow a corporation to generate material NCG Pools out of which to declare CDA Dividends. In particular, maximizing CDA Dividends can be accomplished by:

(1) selling some or all of the corporate holdings with unrealized capital gains;

(2) declaring a CDA Dividend; and

(3) realizing the capital losses[19]

(collectively, a "Strategic CDA Plan").

Strategic CDA Plan — A Simple Example

A simple numerical example can help to illustrate the value that can be unlocked with a Strategic CDA Plan. For now, let's assume that a corporate client, TL Investments Inc. ("Holdco"), has had no prior CDA activity and owns a portfolio of marketable securities that includes assets with $1,000,000 of unrealized capital gains and $1,000,000 of unrealized capital losses.

For whatever reason, the controlling shareholder of Holdco, Mr. Wise, wants liquidity and wants to sell loss positions or perhaps liquidate the entire portfolio. Regardless of the reasons, on these facts the sale transactions should not give rise to any net tax liability in Holdco. However, assuming that Mr. Wise wanted $500,000 personally and Holdco is only able to pay ordinary taxable dividends, then removing these funds from Holdco could cost Mr. Wise nearly $250,000.[20]

If a Strategic CDA Plan had instead been implemented, the $1,000,000 capital gain would have generated an addition to the NCG Pool of Holdco of $500,000, which on the basis of Holdco's facts would also be the available CDA balance. Assuming that $500,000 of CDA Dividends are paid to Mr. Wise, taking these simple steps could have saved him nearly $250,000 of taxes. In a recession, or really at any time, this strategic planning could make a huge difference.

While all of this may seem very basic to most readers, it may not be basic to the people who are actually making the decisions to realize the capital losses. For instance, without education, clients such as Mr. Wise and/or the investment advisors who make the decision to realize capital losses might not appreciate the importance of timing these steps and may miss out on the opportunity to maximize the benefits of the CDA with a Strategic CDA Plan.

As a result, the take-away from Part I of the Series is for us, as advisors, to try to reach these decision makers and educate them on the basics of Strategic CDA Planning before they realize material capital losses.

COVID-19 UPDATE

Bill C-20 Expands and Extends the CEWS

Bill C-20, An Act respecting further COVID-19 measures, received Royal Assent on July 27, 2020. The bill amended the rules for the Canada Emergency Wage Subsidy ("CEWS") in order to:

- Allow the extension of the CEWS until December 19, 2020, including redesigned program details until November 21, 2020.

---

[19] Best practice will involve complying with all of the CDA Dividend filing requirements noted above before realizing any capital losses.

[20] The liability would be nearly $200,000 if Holdco was able to declare eligible dividends.

The tax liability amounts noted in the Series are approximate amounts and are based on the assumption that Mr. Wise is a top rate Ontario taxpayer. The net tax cost also assumes that Holdco has no RDTOH accounts that would be refunded on the payment of taxable dividends. Other planning might be implemented to access the funds at lower potential tax cost than shown in the illustration.

- Make the subsidy accessible to a broader range of employers by including employers with a revenue decline of less than 30 per cent and providing a gradually decreasing base subsidy to all qualifying employers. This would help many struggling employers with less than a 30-per-cent revenue loss get support to keep and bring back workers, while also ensuring those who have previously benefited could still qualify, even if their revenues recover and no longer meet the 30 per cent revenue decline threshold.
- Introduce a top-up subsidy of up to an additional 25 per cent for employers that have been most adversely affected by the pandemic. This would be particularly helpful to employers in industries that are recovering more slowly.
- Provide certainty to employers that have already made business decisions for July and August by ensuring they would not receive a subsidy rate lower than they would have had under the previous rules.

Further, Bill C-20 addresses certain technical issues identified by stakeholders. These changes, which generally apply as of March 15, 2020, include:

- providing an appeal process based on the existing procedure for notices of determination that allows for an appeal to the Tax Court of Canada;
- providing continuity rules for the calculation of an employer's drop in revenues in certain circumstances where the employer purchased all or substantially all the assets used in carrying on business by the seller;
- allowing prescribed organizations that are registered charities or non-profit organizations to choose whether to include government-source revenue for the purpose of computing their reductions in qualifying revenue; and
- allowing entities that use the cash method of accounting to elect to use accrual based accounting to compute their revenues for the purpose of the CEWS.

In addition to the above changes, Bill C-20 enacted changes that had originally been included in Bill C-17. These include relieving changes for calculating pre-crisis "baseline" remuneration for corporations that have amalgamated and for eligible entities that use payroll service providers, and an amendment that aligns the treatment of trusts and corporations for the purposes of the CEWS.

Tax Payment Deadline Extended Again

On July 27, 2020, the CRA extended the payment deadline for income tax balances and instalments. The deadline with respect to current-year individual, corporate, and trust income tax returns is extended to September 30, 2020 — previously this deadline had been extended to September 1, 2020. Penalties and interest will not be charged if payments are made by September 30, 2020, which includes the late-filing penalty if the return is filed by September 30, 2020. The deadline for instalment payments is also extended to September 30, 2020.

The CRA is also waiving interest on existing tax debts for individual, corporate, and trust income tax returns from April 1, 2020, to September 30, 2020. Similarly, interest on existing GST/HST debts is waived from April 1, 2020, to June 30, 2020. Therefore, interest will not apply during these periods with respect to existing balances owing, but this does not cancel interest and penalties that had been assessed prior to these periods.

To align with the federal announcement, Revenu Québec announced that the deadline for the payment of tax balances, instalments, and other tax payments will also be extended again to September 30, 2020.

2020 Economic and Fiscal Snapshot

On July 8, 2020, Federal Finance Minister Bill Morneau delivered the *2020 Economic and Fiscal Snapshot*. The deficit for 2020-2021 is projected to increase to $343.2 billion — it was originally projected to be $34.4 billion. A large proportion of the spending is $212 billion in direct support to Canadians and businesses.

Also attributable to the increased deficit are projected declines in tax revenues. Personal income tax revenues are expected to decline to $146.3 billion in 2020-2021 from $170.9 billion in 2019-2020. Corporate income tax revenues are projected to decline to $38.3 billion in 2020-2021 from $49.2 billion in 2019-2020. Revenue from excise taxes and duties is projected to decrease to $46.4 billion in 2020-2021 from $55.6 billion in 2019-2020.

Though there are many COVID-19 response measures to contribute to the deficit, the biggest expenditures include:

- Canada Emergency Response Benefit: $80 billion;
- Canada Emergency Wage Subsidy: $82.3 billion;
- Safe Restart Agreement: $14 billion; and
- Canada Emergency Business Account: $13.75 billion.

Although the federal government's projected budget deficit has increased, the snapshot did not announce any tax changes in response to the significant change in the fiscal position. However, the snapshot reiterates the government's commitment to two previously proposed tax changes.

First, as economies reopen and business activity resumes, the government will soon announce changes to the CEWS to stimulate rehiring, provide support to businesses during reopening and help them adapt to the new normal. In anticipation of this forthcoming announcement, the government has set aside additional funding as part of the *2020 Economic and Fiscal Snapshot*.

Second, to encourage businesses to adopt zero-emission vehicles, the government proposes to provide a full tax write-off to business investments in: used on-road battery electric, plug-in hybrid (with a battery capacity of at least 7 kWh) or hydrogen fuel cell vehicles; and, new and used fully electric or hydrogen powered rail, aerial, marine or off-road zero emission automotive equipment and vehicles. The full tax write-off will apply to eligible vehicles purchased on or after March 2, 2020, and will be gradually phased out beginning January 1, 2023, and ending December 31, 2027.

Deferral Ends for GST/HST Payments and Returns

On June 29, 2020, the CRA confirmed that it will not extend the relief that was originally announced on March 27, 2020. This relief allowed all businesses to defer, until June 30, 2020, any GST/HST payments or remittances that became owing on or after March 27, 2020, and before July 2020. Also, though the deadline to file a GST/HST return was never deferred, the CRA promised to not impose penalties where a return is filed late provided that it is filed by June 30, 2020.

Therefore, businesses must make their payments and remittances and file their returns by June 30, 2020. Interest will begin to apply to outstanding remittances and payments, and penalties will begin to apply to outstanding returns, effective July 1, 2020.

Businesses that continue to have difficulty in making a GST/HST remittance or payment or filing a GST/HST return can contact the CRA to request a cancellation or waiver of penalties and interest, and/or for a flexible payment arrangement.

For additional information, see the CRA's FAQ, *Deferral of GST/HST Tax Remittances: CRA and COVID-19*.

Partnership Return Deadline Extended

On June 1, 2020, the CRA updated its website with new filing deadlines for the 2019 T5013 partnership information return. Prior to this change, the website solely stated that the deadline for the T5013 return had been extended to May 1, 2020. The updated deadlines are as follows:

- May 1, 2020 for partnerships that would normally have a March 31 filing deadline;

- June 1, 2020 for to partnerships that would normally have a filing deadline after March 31 and before May 31, 2020; and
- September 1, 2020 for to partnerships that normally have a filing deadline on May 31, or in June, July, or August 2020.

CRA Extends Filing Deadline for Corporations and Trusts

On May 22, 2020, the CRA extended the filing deadline for corporations and trusts. The CRA will allow all businesses to defer T2 corporation income tax returns otherwise due in June, July or August, to September 1, 2020. The deadlines for T3 trust returns that would otherwise be due in June, July or August, have also been extended to September 1, 2020.

Previously, the CRA extended the deadline to June 1, 2020 for corporations that would otherwise have a filing due date after March 18 and before June 1, 2020. Similarly, the date was extended to June 1, 2020 for trusts that would otherwise have a filing due date on March 31, or in April or May 2020. Also, the filing date was extended to May 1, 2020, for trusts that had a year end of December 31, 2019.

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.

COVID-19 – Deferred Salary Leave Plan

The situation the Canada Revenue Agency ("CRA") was asked to consider involved a deferred salary leave plan ("DSLP"), which allowed employees to defer their salary for funding a leave of absence from their employment, but only if they met certain conditions. One condition was that the deferral period could not exceed six years, with the leave period beginning immediately after the deferral period. Another condition was that the leave period had to be a continuous one of at least six consecutive months (or three months for certain educational leaves).

The COVID-19 pandemic has prevented, as follows, employees providing essential services and covered by a DSLP from meeting the above DSLP conditions:

- They were recalled from their leave period before having met the minimum leave period condition, but would resume their leave of absence following the end of the pandemic.
- They were unable to begin their leave of absence as scheduled, and would therefore contravene the maximum deferral period condition.

Under normal conditions, the DSLP would be terminated and all deferred salary would be paid to the employees and included in their income. However, the CRA confirmed that, because of the COVID-19 outbreak, the employers would not have to terminate the DSLPs for any failure to meet one of the above conditions. The administration position will remain applicable regardless of the reason for deferring the leave or returning to work. This administrative position will also accommodate employees who had planned to travel during their leave of absence, but could not do it or had to return early because of travel restrictions caused by the COVID-19 pandemic.

The above situation is currently under review by the Department of Finance.

— External Technical Interpretation, Financial Industries and Trusts Division, May 29, 2020, document number 2020-0849841E5

COVID-19 – Expiry of Unused Credits in Health Care Spending Account

The situation the Canada Revenue Agency ("CRA") was asked to consider involved credits allocated to an employee's health care spending account ("HCSA") which could not be used by the employee before their expiration because of the COVID-19 pandemic preventing the health care service providers from rendering their services. More specifically, the CRA was asked if those HCSA credits could be carried forward without affecting the private health services plan ("PHSP") status of the HCSA. The CRA confirmed that, because of the COVID-19 pandemic, an HCSA that already qualified as a PHSP and that had unused credits expiring between March 15, 2020 and December 31, 2020, could be carried forward for a reasonable period of time to enable the employee to access health care services otherwise restricted during the COVID-19 outbreak. The CRA added that a period of up to six months would be considered reasonable and would not disqualify the HCSA as a PHSP.

Note that the above interpretation would apply to the following three models of HCSAs:

- Use it or lose it model – HCSA does not permit the carry forward of unreimbursed eligible medical expenses or unused credits.
- Carry-forward of credits – HCSA permits the carry forward of unused credits to the next plan year (i.e., a period not exceeding 12 months).
- Carry-forward of expenses – HCSA permits the carry forward of unreimbursed eligible medical expenses to the next plan year (i.e., a period not exceeding 12 months).

— External Technical Interpretation, Business and Employment Division, May 25, 2020, document number 2020-0846751E5

Partnership Losses – Adjusted Stub Period Accrual Amount

The Canada Revenue Agency ("CRA") was asked to consider the following situation:

(1) The company Opco held (as a limited partner) an important interest in the P partnership, being entitled to 10% of its income or loss or 10% of its net assets if it ceased to exist.

(2) The taxation years for Opco and P ended on November 30 and December 31, respectively.

(3) In prior years, P allocated losses to Opco and a portion of the losses were deducted from Opco's income up to the "at risk amount" ("ARA") of Opco's interest in P.

(4) At the start of the year, Opco had a balance of many millions of dollars of deferred limited partner losses of P from prior years that were not deducted since the total amount of losses from prior years exceeded the ARA of Opco's interest in P for those years.

(5) For the current year, P would realize an income of hundreds of thousands of dollars that would be allocated to Opco and that would increase the ARA of Opco's interest under s. 96(2.2)(*b*) of the *Income Tax Act* (the "Act"). Opco would then deduct a portion of its losses as limited partner of P from its taxable income for the year up to its ARA under s. 111(1)(*e*) of the Act. At the end of the year, Opco would still have a large amount of losses as a limited partner of P that would not have been deducted.

(6) Furthermore, Opco would be required under s. 34.2 of the Act to calculate for the current year an "adjusted stub period accrual" ("ASPA") and include it in its income.

The CRA was asked if the limited partner losses could be considered to calculate the ASPA for Opco. The CRA relied on the definition of ASPA in s. 34.2(1) to confirm that those losses could not be taken into account to calculate Opco's ASPA for the purpose of reducing the amount to be added to its income. The only limited partner losses that could be

deducted by Opco would be limited to the ARA of Opco's interest in P.

— External Technical Interpretation, Reorganizations Division, June 12, 2020, document number 2018-0788161E5

Income from Securities Trading Business

The Canada Revenue Agency ("CRA") was asked to consider the following situation:

- A corporation carries on a securities trading business with one full-time employee.
- The trading business executes approximately 200 to 500 trades a year.
- It also receives a small amount of interest and dividends from holding securities.
- Most of its income consists of gains and losses from trading securities.

The CRA was asked:

(1) whether the gains/losses from trading securities (like speculative futures and option contracts on commodities) were on account of income or capital; and

(2) assuming they were on income account, whether the gains or losses from trading securities or interest or dividends from holding securities were considered to be active business income.

The CRA confirmed that the gains or losses could be considered on account of income (although this is primarily a question of fact) since the securities trading activities that are carried on by the corporation have many of the characteristics of a business. As noted in paragraph 11 of Interpretation Bulletin IT-479R, those characteristics are: frequency of transactions, period of ownership, and time spent studying the securities market. Relying on the definition of "active business" in s. 248(1) of the *Income Tax Act* and the fact that this business is not a "specified investment business" as this term is defined in s. 125(7), both the gains and losses derived from trading securities and the interest and dividends derived from holding securities should be treated as active business income for tax purposes.

— External Technical Interpretation, Business and Employment Division, February 13, 2020, document number 2019-0826051E5

Tax on Split Income (TOSI) – Excluded Share

The situation the CRA was asked to consider involved a corporation carrying on a business of producing and selling training videos on a variety of topics as digital downloads from its website. The CRA was asked if the income from the business would be considered income from providing services for the purpose of the definition of "excluded share" in s. 120.4(1) of the *Income Tax Act* (the "Act").

The CRA noted that it did not have enough facts to confirm with certainty that the corporation was engaged in the provision of services (which depended on the circumstances of the business) but confirmed that the payment for a right to download a digital product (that would traditionally have been sold to the customer as a tangible property) would usually be treated as a sale of intangible property and not as a provision of a service. The portion of the business income of a corporation for a taxation year that is generated by the following activities would likely be from the provision of a service not the provision of an intangible property for the purpose of the TOSI rules:

- Payments received as consideration for after-sales services.
- Payments for services rendered by a supplier under a guarantee.
- Payments for pure technical assistance.

The CRA finally noted that, where the "excluded share" safe harbour exclusion does not apply, the application of the TOSI rules is normally determined on the basis of whether the amount received meets another exclusion (see definition of "excluded amount" in s. 120.4(1) of the Act).

— External Technical Interpretation, Reorganizations Division, March 13, 2020, document number 2019-0833181E5

TOSI – "Excluded Shares" – Clarification of 2019-081943E5

The Canada Revenue Agency "CRA" provided clarification on some comments made previously in technical interpretation 2019-0819431E5, dated January 10, 2020. The scenario addressed was set out in detail in the previous interpretation and involved a corporation that initially both carried on a medical services business and earned income from a significant portfolio of investments which had been acquired with the earnings of the medial services business ("PC1"). The physician held all of the voting shares and the spouse and physician each held 50% of the non-voting shares. PC1 ceased carrying on the medical services business and a new corporation ("PC2") was incorporated for this purpose at the end of year 1, with the spouse acquiring 50% of the voting shares of PC1 from the physician for fair market value consideration.

The question addressed in 2019-0819431E5 was whether the shares of PC1 held by the spouse would qualify as "excluded shares" for years 1, 2, 3, and subsequent years. In respect of years 1 and 2, no clarification was required. However, the CRA's comments on the application of the "excluded share" definition as it may apply for year 3 and subsequent years (which were that the shares of PC1 held by the spouse would not qualify as "excluded shares", such that dividends paid on the shares to the spouse would be subject to TOSI, in part because they would be considered to be derived directly or indirectly from a "related business" carried on by PC2 (and not PC1) in year 2 and subsequent years) did require clarification since, in respect of those years, the CRA's published comments on "second generation" income as set out in 2018-0779981C6 and 2018-0768801C6 should have been specifically addressed.

Specifically, if the income of PC1 for year 2 and any subsequent year is income earned solely from its investment business (a question of fact), such income would not be considered to be derived directly or indirectly from the medical services business now carried on by PC2. This would be the case even though the historical retained earnings of PC1 that are used in PC1's investment business were originally derived from its former medical services business. Accordingly, in those circumstances, the CRA would consider all the conditions of the "excluded share" definition to be technically met for those years.

A caution was added that if it is determined that any transaction, either alone or as part of a series, has been undertaken primarily to obtain the "excluded amount" exemption under s. 120.4(1) in a manner that would frustrate the object, spirit, and purpose of s. 120.4, the CRA would seek to apply the general anti-avoidance rule.

— External Technical Interpretation, Reorganizations Division, April 8, 2020, document number 2020-0839581E5

TAX PLANNING FOR SMALL BUSINESS

Published quarterly by Wolters Kluwer Canada Limited. For subscription information, see your Wolters Kluwer Account Manager or call 1-800-268-4522 or (416) 224-2248 (Toronto).

For Wolters Kluwer Canada Limited

Email: cservice@wolterskluwer.com *Phone: 1-800-268-4522 or (416) 224-2248 (Toronto)*

© 2020, Wolters Kluwer Canada Limited

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

Wolters Kluwer