CCH Tax Notes – January 2012

What's New?

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Those of you who are regular readers of this newsletter may have noticed that I haven't done an article in the last few months. At the end of September 2011, a medical issue forced me to temporarily discontinue my writing.

As I left off,[1] I remember there being rather pressing issues: the CRA had given notice that it wasn't going to accept deferred year ends for joint ventures, but it offered little detail. Also, the Copthorne case, involving the "series of transactions" issue, had not been released, even though it was heard by the Supreme Court of Canada back in January 2011. But as I resumed reading tax releases, it seemed that, rather than dealing with these issues, the CRA was preoccupied with such matters as SIFT partnerships, as well as various nuances of the Canada–U.S. Tax Treaty. When I came across a CRA missive on asteroid mining, I figured I wasn't fully recovered; but it turned out that it was not a hallucination.[2]

Personal Services Business Rules

At the end of October 2011, the Department of Finance released some technical proposals.[3] Buried therein was a change to the personal services business provisions[4] — it seems that, for companies with taxation years beginning after October 31, 2011, personal services business income will no longer qualify for the corporate general rate reduction under subsection 123.[4] In effect, there will be a surtax of 13%[5] of personal services business income, compared to other forms of business income. This was the subject of a recent article in *Tax Topics* No. 2071, "Should I Be Taking It Personally?" by Jesse Brodlieb. As the article commented, if the personal services business rules apply, there will now be a serious degree of underintegration.[6] I find this curious—the government had recently taken steps to provide that integration occurs with all major forms of income. Now it seems there will be one notable exception.

So in effect, while income from the incorporation of a personal service business may enjoy a significant element of deferral, if the "personal services business" rules apply — basically, if an employer–employee relationship would exist but for the corporation— there will be serious penalties.[7] Thus, pre-existing arrangements that could trigger the new rules should be reconsidered; clients should understand the downside risks. In many cases, the applicability of the personal services business rules will be unclear, leading taxpayers and their advisers to avoid the downside risks—presumably that's the point of these harsh proposals. One may also expect a spate of CRA ruling requests.[8]

RRSPs and Bill C-13

Also during my hiatus, a further round of legislation to implement certain portions of the 2011 federal Budget[9] came out.[10] I commented on the changes that would apply to RRSPs in my last article.[11] By and large, there are few changes to the RRSP legislation. However, one notable change is the extension of the deadline for “swapping” RRSP investments that would otherwise trigger the new RRSP penalties under Part XI.01 of the Act (for example, trading personally held investments for prohibited RRSP investments that would trigger the advantage tax on income or gains). The deadline for such swaps has been extended from the end of 2012 to 2021.[12] In addition, if the investment was a prohibited investment on March 23, 2011, the tax break on transitional prohibitive investment benefits will likewise apply to income earned or gains realized to the end of 2021, rather than 2017 as was previously proposed.[13]

One word of warning: other than the limited exceptions, the process of swapping—trading personally held investments[14] with your RRSP—will bring about the confiscation of 100% of the increase in value of investments in your RRSP attributable to swap transactions.[15] I used to recommend swapping as an expeditious way to realign RRSP investments—for example, swapping high-tax personally held investments so that they are held by your RRSP, in return for low-tax investments from your RRSP (a recommendation still repeated on some Web sites). Unfortunately, this tax planning avenue is all but foreclosed—I guess because some bureaucrat or academic saw a ghost.

Also, as noted in my last article, it appears that certain changes to the Regulations indicate that, if a corporation ceases to be a “specified small business corporation”,[16] the investment will become a prohibited investment if it was acquired after March 22, 2011. In other words, this seems to mean that constant monitoring of the investment’s status[17] to make sure it is onside with the Regulations will be required. Since no changes have been made to the Regulations, this issue appears to be “live”. When private corporations were first allowed as qualified investments, a similar requirement had to be met, so that monitoring for qualified investment status was required. In many or most cases, this requirement jeopardized the viability of private corporations as investments in RRSPs—until the rules were liberalized some years later. It appears that we may be back to the future on this scenario.

Joint Ventures

But what about additional detail on the joint venture revisions? The release of the *Copthorne* case? In a document dated November 29, 2011,[18] the CRA released further details on the new administrative policy regarding deferred fiscal year ends for joint ventures. The release itself indicates that, for joint venturers with taxation years ending after March 22, 2011, it will be required that income from joint ventures be calculated for each participant taxpayer based on the fiscal period of that particular taxpayer—that is, deferred joint venture year ends will not be recognized. However, transitional relief similar to the partnership rules[19] will potentially apply, so that a deferral will be offered. The income that may generally apply for this transitional relief will be based on actual additional income for the stub period to the extent that the amount would not otherwise have been included in income (that is, under the pre-existing administrative policy) for the first taxation year that ends after March 22, 2011. The CRA goes on to observe that, like the partnership proposals, this transitional relief would generally result in no additional income being included for the first taxation year of the participant taxpayer. Instead, the participant taxpayer will bring in the additional income over the next five years.[20]

The release goes on to say that, in order to avail itself of this transitional relief for the first taxation year ending after March 22, 2011, a participant taxpayer will be required to file an election in writing, on or

before the filing due date for that taxation year, by attaching a letter to their return for that taxation year.[21] If a return has already been filed, or if the return is filed electronically, an eligible participant will be required to send a letter to their Taxation Centre indicating their election to benefit from this administrative policy. But a failure to report *all* of the accrued income in a participant's first taxation year that ends after March 22, 2011, in accordance with this administrative policy, will render the participant taxpayer ineligible for transitional relief. Note also that the release says that policies similar to the above will apply where a partnership is a participant in a joint venture.

This administrative policy raises some important questions. For one thing, it would be impractical, if not impossible, for many joint venturers (for example, minority participants with small interests) to calculate income based on the joint venturer's particular taxation year. The release makes no mention of doing an approximation based on principles similar to the new partnership rules (that is, estimating the current income based on the previous year's partnership income, subject to subsequent adjustments), even though in many cases there would be no practical alternative to using this method.[22] The release says that failure to report "all of the accrued income in a participant's first year that ends after March 22, 2011" will result in the taxpayer's ineligibility for transitional relief. If an approximation (for example, using principles similar to the proposed partnership rules) turns out to be an underestimation of this income, query whether the taxpayer will be ineligible for transitional relief.[23]

Copthorne

Finally, after months of waiting, the *Copthorne*[24] case has come out—nearly a year after it was heard by the Supreme Court. Based on recent experience, I find that the longer it takes for the top court to produce a judgment, the less favourable it is. *Copthorne* was no exception.

But I'm getting ahead of myself. *Copthorne* involved an offshore strip of paid-up capital ("PUC") facilitated by earlier "set up" transactions involving the conversion of a would-be vertical amalgamation of two corporations to a horizontal amalgamation, which had the effect of increasing PUC.[25] The later transactions (that is, the actual offshore strip) in fact had depended on unforeseen legislation at the time the transactions were set up, so that the set up transactions, which were observed to effect a "double count" of some $67 million in PUC, were "just in case". In effect, the CRA used hindsight to reassess the offshore strip transactions as *part of the series* of transactions—a prerequisite for applying GAAR. Many tax practitioners had come to view the case as a heroic campaign against the "empire" (as it were—no less a luminary than Richard Pound, of international Olympic fame, argued the case).

But those looking for new hope in the future of GAAR were, no doubt, disappointed: holding against the taxpayer, the Supreme Court affirmed the "series of transactions" interpretation, which included an expansive interpretation of subsection 248(10) that allows the CRA to "tack on" transactions "contemplated" by the taxpayer. More precisely, the Supreme Court affirmed that you can "contemplate backwards". That is, the CRA can assess subsequent transactions (in this case, offshore strip) as part of the series if they were undertaken "because of"[26] a pre-existing series,[27] even if the particulars of the subsequent transactions were unforeseen at the time of the original series.[28]

Because of previous cases, the *Copthorne* decision is not new law, although it does reinforce the "contemplating backwards" test, which gives the CRA authority to use hindsight to reassess transactions based on the "series" concept. Besides GAAR itself, will the CRA use this ammunition to attack, say, a purification transaction? For example, otherwise tax-exempt intercorporate distributions of excess assets can become taxable, per subsection 55(2) of the Act, if the series of transactions involving the purification includes a third-party sale. So is the subsequent sale part of the same series as the purification, even if its

particulars were unforeseen at the time of the purification?[29] The question may really be whether a specific victory in *Copthorne*—close to a case on point—will broaden the CRA's assessing activity.

I have dwelt on the "contemplating backwards" issue for a reason: years ago, in a discussion with a tax lawyer who I greatly respect, we concluded that you can't contemplate backwards—that is, the act of contemplating is a perspective concept. You are probably thinking the same thing, and at least one recent leading article holds the same view. But courtesy of scholarly dissertations, previously decided cases, and so on; the Supreme Court of Canada has decreed you can indeed contemplate backwards.

Some releases on the *Copthorne* case have put a favourable spin on it, focusing on its supposed restrictions and limitations on when GAAR will apply.[30] But I am struck by the simplicity of the fact situations in the last two cases to come before the Supreme Court—both of which the taxpayers lost. In *Copthorne*, rather than do a vertical amalgamation of two companies held by an offshore parent, the first-tier subsidiary transferred the second-tier subsidiary to the offshore parent, and the two companies in question were amalgamated horizontally, so as to attempt to preserve the second-tier subsidiary's PUC. The second case (*Lipson v. The Queen*, 2009 DTC 5015) involved a "spousal flip": a wife took out a loan to buy shares from her husband to get an interest deduction.[31] Both of these fact situations brought the wrath of the highest court in the land. The fact that some commentators find solace in the fine print gives me little comfort.

My Rick Perry Moment

A belated correction to my last article. I confused the date of the release of legislation in respect the spring federal Budget proposals (August 16, 2011) with the date of the foreign affiliate proposals (released on August 19, 2011). In the latter, there is a two-year repayment deadline before offside loans from foreign affiliates are subject to the new tax penalties outlined in the foreign affiliate proposals.[32] I mentioned that, for "pre-Budget" loans, the clock on the two-year period starts ticking on the date of the Budget. Obviously, the foreign affiliate rules were not in the Budget —they were in the August 19 release—so the two-year clock starts ticking on August 19, 2011.

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Notes:

[1] See "New Tax Proposals: Summer Overload" and "Partnership Anti-Deferral Rules—The Clock Is Ticking", *Tax Notes* No. 585, October 2011.

[2] See Doc. No. 2011-0407961E5, September 27, 2011.

[3] *Legislative Proposals Relating to Income Tax and Sales and Excise Taxes*, October 31, 2011.

[4] A "personal services business," defined in subsection 125(7), means a business of providing services in which an individual (the "incorporated employee") (a) is a specified shareholder of the corporation, (b) provides services on behalf of the corporation to another person, and (c) would reasonably be regarded as an officer or employee of the person or partnership to whom or to which the services were provided, but for the existence of the corporation. An exception exists if the corporation employs more than five full-time employees.

[5] Applicable to taxation years commencing January 1, 2011. To the extent that days in the corporation's taxation year fall before this date, the corporation will lose the benefit of an 11.5% general rate reduction.

[6] That is, a degree of "double taxation" will arise when corporate-level earnings are distributed as dividends, as compared to the tax rate that would apply if such income was directly earned at the personal level.

[7] Under pre-existing rules, a personal services business is ineligible for the small business deduction, and the expenses it can deduct for tax purposes are severely restricted, in general, to the salary and wages that it pays to an incorporated employee.

[8] The efficacy thereof may be another matter.

[9] Originally released on August 16, 2011.

[10] Bill C-13, which received Royal Assent on December 15, 2011.

[11] "New Tax Proposals: Summer Overload", *supra*.

[12] Previously, a swap transaction did not include the transfer of a prohibited investment from an RRSP where the annuitant was entitled to a refund under subsection 207.04(4) on the transfer—this refers to the refund of the 50% tax on non-qualifying or prohibited investments. Now this exclusion is extended to the transfer of a non-qualified investment as well.

[13] The consequence of having the status of a transitional prohibited investment benefit was changed slightly, from a tax rate of 43.9% to having the benefit included in income.

[14] Or those of non-arm's length entities, e.g., a corporation controlled by a family member.

[15] The CRA has the ability to waive the tax in certain circumstances.

[16] The difference between a "small business corporation" and a "specified small business corporation" is that, rather than requiring CCPC status, per the "small business corporation" definition, the corporation must be a Canadian corporation that is not directly or indirectly controlled by one or more non-residents.

[17] E.g., to ensure that "small business corporation" status is maintained, e.g., the corporation doesn't have "offside" assets.

[18] See Doc. No. 2011-0429581E5; the document appears to supplement a question in the 2011 CRA Round Table at the Canadian Tax Foundation on the same date. A similar notice, "Joint ventures—Elimination of fiscal period", has appeared on the CRA's Web site.

[19] I.e., the relief in section 34.2.

[20] I.e., in a manner similar to the reserve mechanism provided for under section 34.2.

[21] The letter should indicate that the participant taxpayer is including income from the joint venture for which it is seeking transitional relief.

[22] One recent article indicates that taxpayers with joint venture interests should consider carefully whether such structures are still manageable in light of this new policy. But for pre-existing joint ventures, query how one copes with the rules; for example, converting the joint venture into a partnership may have a number of complexities.

[23] In addition, as stated previously, if a return has already been filed, a letter will be required to be sent to the CRA indicating that the taxpayer elects to be eligible for the transitional relief. However, no deadline is indicated for this letter.

[24] *Copthorne Holdings Limited v. Canada*, 2011 SCC 63; released December 16, 2011.

[25] Offshore parent (Big City) held Sub 1 (Copthorne I), which in turn held Sub 2 (VHHC II), a company whose PUC far exceeded its value. Rather than merge Sub 1 and Sub 2 in a vertical amalgamation and lose Sub 2's high PUC of some $67 million, Sub 1 transferred Sub 2 to Offshore Parent, followed by a horizontal amalgamation of Sub 1 and Sub 2, a transaction which preserved both companies' PUC. The CRA reassessed the offshore strip on the grounds that the tax benefit was the avoidance of the withholding tax on the offshore strip (i.e., due to the high PUC), and that the avoidance transaction was the share transfer by Sub 2 to Offshore Parent, which allowed a horizontal amalgamation of Sub 1 and Sub 2 and preserved Sub 2's $67 million of PUC. This was an abuse of paragraph 87(3)(*a*) governing PUC on amalgamations, which specifically excludes, from the computation of the PUC of the amalgamated corporation, the PUC of a share (i.e., Sub 2) held by any other predecessor corporation (i.e., Sub 1). The transaction was aggressive in that it involved the double count of PUC. But it was also quite simple.

[26] In the sense that the earlier transaction was taken into account as a relevant consideration when the decision was made to undertake the later transaction.

[27] As to the degree of remoteness, the Court's remarks were limited; see para. 47, reproduced in footnote 11 of the following article.

[28] As the Supreme Court observed, that's the way the *Canada Trustco* (2005 SCC 54) case went (i.e., the case supports that subsection 248(10) may be applied both prospectively and retrospectively), and given this, the Court will not entertain lightly the reversing of a recent case (see para. 57).

[29] I.e., a spinout transaction of non-qualified assets to a transferee corporation may involve would-be deemed dividends (on the redemption of cross-shareholdings between the transferor and transferee corporations). If, however, this is part of a series of transaction involving the third-party sale of shares of the transferor corporation, deemed capital gains status will apply instead, under subsection 55(2). In the past, the CRA has stated that it would be difficult for a taxpayer to maintain that it had no intention of ever selling the purified shares at the time of a purification reorganization and, as a consequence, the deemed dividends realized on the purification transaction and an eventual sale of the Opco shares would not be part of the same series of transactions. The CRA's reasoning for this position was set out in Doc. No. 5-7939, June 30, 1989, quoted below: It is in our view unlikely that such a situation would occur, however, since in most situations a shareholder who causes a reorganization to be carried out for the purpose of causing shares to qualify as QSBC shares does so in order that a deduction under subsection 110.6(2.1) of the Act will be available to him upon a disposition of the shares. In such cases the shareholder would have some intention at the time of the reorganization of eventually selling the shares. Now, it appears open to use the *Copthorne* case to link (by contemplating backwards) the ultimate sale of the shares with the precedent spinout transaction.

[30] Several releases take comfort i[30]n the Court's statements, such as these: determining the rationale of the relevant provision in the Act should not be conflated with a value judgment of what is right or wrong, nor with theories about what tax law ought to be or ought to do (for example, in this case, the Supreme Court did not examine whether there was a general policy against surplus stripping in the Act); GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is clear; it is only when a reorganization is primarily for a tax purpose and is done in a manner found to circumvent a provision of the *Income Tax Act* that it may be found to abuse that provision; it is the obligation of the Minister who wishes to overcome the countervailing obligations of consistency and predictability to demonstrate clearly the abuse he alleges.

[31] In that simple situation, the attribution rules provide that the husband gets the deduction. The Supreme Court held that the attribution rules had been "misused and abused" so that GAAR applied.

[32] Note that this differs from subsection 15(2), in that the latter limitation period is based on two years from the end of the taxation year of the lender in which the loan was made.