TAX FOR THE Owner-Manager

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WIP Election Applies to New Partners

In a recent technical interpretation (TI 2017-0734381E5, March 26, 2018), the CRA clarified that a professional partnership's valid election to use billed-based accounting will apply to a new partner, even if he or she becomes a new partner during or after the partnership's fiscal period that straddles the elimination date for the election. As a result, a new partner can still elect to use billed-based accounting (that is, to exclude the value of work in progress [WIP] from income) over the five-year transitional relief period that starts with the first taxation year that begins after March 22, 2017. In the TI, the CRA clarified that for the WIP election to apply to the new partner, the partnership must have elected to exclude WIP for the taxation year that straddles March 22, 2017 (or an earlier year).

Generally, a professional or a professional corporation must include the value of WIP at the end of the year in its income for tax purposes to account for partly finished services that clients have not yet been billed for. A professional business's WIP is generally considered to be inventory and must be valued at the end of the year at the lower of its cost and FMV.

Previously, designated professionals (lawyers, accountants, dentists, doctors, veterinarians, and chiropractors) could effectively defer tax by electing, under paragraph 34(a), to exclude the value of their year-end WIP in their income for the year (that is, they could elect to use "billed-basis accounting"). After a professional makes an election, it remains effective for all subsequent taxation years unless the professional revokes the election with the concurrence of the CRA (paragraph 34(b)).

The 2017 federal budget eliminated this election for taxation years beginning after March 21, 2017. Now, professionals must include their end-of-year WIP in their business income for that year. Finance also introduced transitional relief under subsection 10(4.1). This relief phases in the WIP inclusion over five years, starting with the first taxation year beginning on or after March 22, 2017, by gradually increasing the inclusion (of the lesser of the WIP's cost and FMV) as follows:

- 20 percent in the first taxation year,
- 40 percent in the second taxation year,
- 60 percent in the third taxation year,
- 80 percent in the fourth taxation year, and
- 100 percent in the fifth taxation year.

Generally, when a profession is carried on by a partnership, a section 34 election must be made by an authorized partner on behalf of all the partners, under subsection 96(3). If such an election is made by the authorized partner, then the authorized partner and all other persons who were members of the partnership during the relevant fiscal period are deemed to have made a valid election.

In the TI, the CRA considered a Canadian partnership that carries on a business as a legal professional practice. The partnership has 10 individual partners, and its current fiscal period began on January 1, 2017 (that is, before March 22, 2017) and ends on December 31, 2017.

In 2017, an authorized partner elected to use billed-based accounting on behalf of all the other partners so that they do not have to include WIP in their income for 2017. One of the partners wants to hold their partnership interest in a professional corporation (Partnerco). Under the partnership agreement, a partner may incorporate (that is, transfer his or her interest to a corporation) on either December 31, 2017 or January 1, 2018.

At issue in the TI was whether the election can apply to Partnerco, so that it can use billed-based accounting in 2017 and subsequent years (subject to the transitional rules introduced in 2017) if it becomes a partner on the last day of the partnership's 2017 fiscal year.

The CRA was also asked to consider whether the election to use billed-basis accounting will apply to Partnerco in 2018 and subsequent years if it becomes a member of the partnership on January 1, 2018 instead of December 31, 2017.

In its response, the CRA noted that the partnership must make the section 34 election to exclude WIP for the taxation year that straddles March 22, 2017. The CRA confirmed that because the partnership made the election in 2017, all persons who are members of the partnership during that year will be deemed to have made the election under subsection 96(3).

In This Issue

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Therefore, if Partnerco becomes a member of the partnership on December 31, 2017, the election will be valid for Partnerco.

The CRA further stated that the partnership's 2017 election will apply to Partnerco in 2018 and subsequent years if Partnerco becomes a member of the partnership on January 1, 2018, which is the year after the year that the partnership elected to use billed-based accounting. In this situation, paragraph 34(b) will apply and Partnerco will be subject to the election made by the partnership in the previous taxation year.

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The Passive Income Rules: New Ways To Grind the SBD

Prior to the 2016 federal budget, two corporations that were deemed to be associated through a third corporation pursuant to subsection 256(2) had the ability to preserve their respective small business deductions (SBDs), provided that the third corporation filed an election to disassociate itself from the other two corporations, so that all three corporations were not associated. The 2016 federal budget amended this election to disassociate only the two corporations that were deemed to be associated; the third corporation remained associated with each of the two corporations for the purposes of the Act. Consequently, the small business limit reduction under subsection 125(5.1) took account of the taxable capital of the third corporation.

The 2018 federal budget did not amend subsection 256(2), but it did amend subsection 125(5.1) to include new paragraph (b), which reduced the small business limit subject to the combined adjusted aggregate investment income of each of the associated corporations from the preceding calendar year.

Assume, for example, that H and W are spouses. H wholly owns H Co and W wholly owns W Co. H and W each own 50 percent of Jointco. H Co and W Co are associated with Jointco pursuant to subsection 256(1), and H Co and W Co are deemed to be associated with each other pursuant to subsection 256(2). H Co, W Co, and Jointco all have a December 31 year-end. Jointco has $100,000 of passive income annually. Jointco elects under subparagraph 256(2)(b)(ii) to disassociate itself from H Co and W Co for the purposes of section 125.

Question: Does subparagraph 256(2)(b)(ii) allow Jointco to disassociate for the purposes of the passive income grind rules in paragraph 125(5.1)(b)?

Answer: For taxation years commencing after March 22, 2016, new subsection 256(2) states that H Co and W Co are associated with each other for all purposes of the Act, except that subparagraph 256(2)(b)(ii) will disassociate H Co and W Co for the purposes of section 125 while Jointco will still be associated with them and have a nil SBD. For all other purposes of the Act, however, Jointco remains associated with H Co and W Co respectively and independently.

A calculation of the annual adjusted aggregate investment income as defined in subsection 125(7) will have to be conducted for Jointco, H Co, and W Co for the years that end in the 2018 calendar year to determine the passive income grind in the 2019 tax years for both H Co and W Co as a result of the wording in variable E of paragraph 125(5.1)(b): "for each taxation year of the corporation, or associated corporation, as the case may be, that ended in the preceding calendar year." This means that Jointco's $100,000 of adjusted aggregate investment income commencing for its December 31, 2018 taxation year will reduce both H Co's and W Co's small business deduction starting for taxation years of the latter two corporations that begin after December 31, 2018.

Practitioners should carefully analyze the wording of variable E of paragraph 125(5.1)(b) to avoid potential pitfalls. Traditionally, the small business limit reduction was based on the taxable capital of the associated group for its last taxation year that ended in the preceding calendar year. If a corporation had multiple year-ends in the same calendar year, only the taxable capital of the last taxation year of the preceding calendar year was accounted for in the computation of the small business limit reduction.

Contrast that wording with the wording of variable E:

> is the total of all amounts each of which is the adjusted aggregate investment income of the corporation, or of any corporation with which it is associated at any time in the particular taxation year, for *each* taxation year of the corporation, or associated corporation, as the case may be, that ended in the preceding calendar year. [Emphasis added.]

Therefore, regardless of whether a corporation has had multiple year-ends, these new passive income rules will aggregate all of the adjusted aggregate investment income of all of the taxation years ending in the preceding calendar year to compute the small business limit reduction. Practitioners who rely on triggering short year-ends to avoid the application of paragraph 125(5.1)(b) will be frustrated by the wording of this provision, and may create unnecessary costs by triggering short year-ends.

Furthermore, paragraph 125(5.1)(b) should be considered in the context of the SBD assignment provisions in subsection 125(3.2). The CRA has said (in TI 2017-0709241E5, January 25, 2018) that

> [i]n our view, the use of the word "notwithstanding" in subsection 125(5.1) ensures that any assignment of a CCPC's business limit under subsection 125(3.2) can only occur after its business limit under subsection (2), (3) or (4) is first reduced by subsection 125(5.1).

Therefore, according to the CRA, a corporation's business limit must be reduced on the basis of both the taxable capital and the adjusted aggregate investment income (by inference,

since the TI was issued prior to the enactment of paragraph 125(5.1)(b)) and before the associated group assigned the small business limit under subsection 125(3.2).

The new rules for passive income will add complexity to an already complicated regime for CCPCs—in particular, when one is calculating the SBD. Practitioners must carefully monitor corporate structures that involve or create associated status. Unintended consequences may arise when reorganizations or acquisitions result in associated corporation status for one or more members of the corporate group.

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Judicial Review Allowed: FCA Extends Application of Subsection 220(2.1)

The FCA's decision in *Bonnybrook Industrial Park Development Co. Ltd. v. Canada (National Revenue)* (2018 FCA 136) represents a rare instance of success on judicial review in respect of the application of the taxpayer relief provisions to the deadline for claiming dividend refunds.

The taxpayer (Bonnybrook) failed to file its tax return for many years due to its principal's ongoing medical problems. Although a voluntary disclosure was made (and accepted) with respect to the taxpayer's unreported income, the dividend refunds claimed as part of the disclosure were denied because the taxpayer failed to meet the condition that a tax return be made within three years of the taxation year in which the refund was claimed.

Since the dividend refunds were denied as part of the voluntary disclosure, the taxpayer sought to claim the dividend refunds through the Act's taxpayer relief provisions. Of particular note, pursuant to subsection 220(3), Bonnybrook sought an extension of the three-year deadline to file its tax returns for the purpose of claiming its dividend refunds; pursuant to subsection 220(2.1), it sought a waiver of the dividend refund requirement to file corporate tax returns within three years.

The minister denied Bonnybrook's requests for relief and stated the following:

> *Denied Dividend Refund:*
> You have requested under subsection 220(3) that the Minister exercise discretionary powers to waive or extend the requirement to file the corporation's tax returns within three years for the purposes of dividend refund. Subsection 220(3) states, "The Minister may at any time extend the time for making a return under this Act." Filing requirements and refund of overpayment of tax are governed by two different section[s] of the Act. Subsection 150(1) of the Act sets out the tax return requirements and filing deadlines for taxpayers and Subsection 164(1) of the Act provides rules governing the refunds of overpayments of tax. It is our position that Subsection 220(3) is only applicable to the provisions of Subsection 150(1) and has no application to Subsection 164(1). [Italics omitted.]

Bonnybrook applied for judicial review of the minister's decision (2017 FC 642); the FC dismissed the application, except to grant some relief for interest on the consent of the parties.

On appeal, the FCA considered whether the minister had erred in concluding that she had no authority to exercise the discretion requested. The court held that the minister's decision was both "unreasonable and incorrect," and it noted two obvious errors. First, the minister's decision indicated that subsection 220(3) has no application to subsection 164(1); instead, the reference should have been to subsection 129(1). Second, the minister attempted to address only the timing request for the filing requirement (under subsection 220(3)), not the request for a waiver of the filing requirement itself (under subsection 220(2.1)).

The minister's argument with respect to the timing requirement was principally that the taxpayer relief provisions could not apply to subsection 129(1), because the extension of time to file would not have the effect of eliminating the requirement that the taxpayer file the return within three years in order to claim the refund. The court said,

> The CRA's view . . . is that the taxpayer relief provisions cannot affect a filing requirement which restricts the issuance of a dividend refund. The problem with this reasoning is that this is exactly what the taxpayer relief provisions are intended to do—enable the Minister to provide relief from strict filing requirements.

Further, had Parliament intended that subsection 220(3) not apply to subsection 129(1), "it would have been an easy matter for Parliament to have provided for this explicitly."

The FCA therefore allowed the application for judicial review and referred the matter back to the minister to consider the taxpayer's application in accordance with the principles set out in the reasons.

In an unusually strongly worded dissent, Stratas J agreed that the minister's decision should be quashed, but he concluded that the matter should be remitted to the minister for "full consideration and decision" rather than for reconsideration in accordance with the court's reasons. Stratas J said that the role of "[a] reviewing court is to *review* the work of an administrator, not *do* the work of an administrator" (emphasis in original). In this case, the minister had asserted only a "bottom-line" position with respect to subsection 220(3) without adequately explaining how she arrived at it; thus, the court's ability to conduct a reasonableness review was "fatally hobbled."

As a result of this decision, it appears that extensions to the three-year filing deadline may be available. Whether the

filing requirement can be waived entirely is unclear, but the case certainly represents a precedent for taxpayers who may otherwise be out of time.

The case is also helpful because the minister was required to conduct her reconsideration in accordance with the court's reasons. There is always a risk that after a successful judicial review application, the minister will reach the same conclusion on reconsideration. However, this case may offer an effective means of mitigating that risk.

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Section 76 and the Taxation of Cash Purchase Tickets

Section 76 of the ITA addresses the recognition of income in situations where a security or debt is received in satisfaction, either in whole or in part, of a debt then payable. Generally speaking, when a taxpayer receives a security or some form of indebtedness (such as a postdated cheque) as consideration for the sale of property that is on account of income and that would otherwise be included in the taxpayer's income in the year, subsection 76(1) will generally deem the recipient to have received income at that time equal to the FMV of the security or debt received.

As it pertains to taxpayers who carry on a farming business, subsection 76(4) provides an exception to the general rule in subsection 76(1). More specifically, when a taxpayer receives a cash purchase ticket from a licensed grain elevator operator in respect of the sale of a listed grain (discussed below), the income resulting from the sale is not included in the taxpayer's income until the taxation year immediately following the taxation year in which the grain was delivered, provided that

1) the ticket is received by a taxpayer (see *Dixon v. The Queen*, 2003 TCC 102, where a partnership was not able to utilize the cash purchase ticket rules because it was not a "taxpayer");
2) the ticket is not payable until after the end of the current taxation year;
3) the ticket does not bear interest;
4) the ticket is issued by a "primary elevator" or "process elevator"; and
5) the taxpayer received the ticket in consideration for a delivery of "grain."

The final requirement may seem straightforward on its face, but the definition of "grain" is in fact somewhat limited in its scope. The definition of "grain" in the Canada Grain Act (RSC 1985, c. G-10, as amended; herein referred to as "the CGA") includes 20 different types of crops; subsection 76(5), however, includes only 7 types of crops (wheat, oats, barley, rye, flaxseed, rapeseed, and canola).

Anyone familiar with modern agriculture in Canada will know that the list of crops in subsection 76(5) does not accurately capture many of the more common types of crops grown by farmers in this country. Access to foreign markets, climate change, and scientific advancements in crop varieties have led to greater diversity in the types of crops being planted. (For example, improved access to foreign markets has greatly increased the growing of pulses such as lentils and chickpeas.)

Because pulses (among other crops) are not included in the definition of "grain" in subsection 76(5), the receipt by the farmer of a cash purchase ticket, postdated cheque, or other deferred instrument in full or partial satisfaction of the sale price of such a crop is not eligible for deferral by virtue of subsection 76(4). Instead, if the farmer had the legal ability to receive the cash purchase price at the time of sale, but instead chose to receive some form of deferred payment (which is often the case), it is likely that subsection 76(1) will require the amount to be included in income in the year that the crop was delivered, not in the immediately following taxation year. It should also be noted that subsection 76(2) probably will not be of assistance in avoiding the impact of subsection 76(1), since the grain elevator operator typically pays the purchase price to the farmer at the time of delivery by means of a cash purchase ticket; it is only the deeming rule in subsection 76(4) that allows for this income to be included in the immediately following taxation year. Arguably, if the postdating of the cash purchase ticket were sufficient to postpone the recognition of income until the following taxation year, subsections 76(4) and 76(5) would be superfluous.

Another notable difference between the ITA and the CGA is that subsection 76(4) provides that grain is to be delivered to a "primary elevator" or "process elevator"; however, the definition of "cash purchase ticket" in the CGA provides that the ticket can be issued in respect of grain delivered to a "primary elevator, process elevator *or grain dealer*" (emphasis added). Thus, although a grain dealer can issue a cash purchase ticket under the CGA, arguably a farmer will be eligible for income deferral under subsection 76(4) only if such a delivery is made to a "primary elevator" or "process elevator" (as those terms are defined in the CGA).

It is not clear why the definition of "grain" in the ITA differs from that in the CGA. When subsection 76(5) was amended in 2012 to include canola, the Department of Finance could have either included additional crops or simply incorporated the definition of "grain" from the CGA (as was done with other terms, such as "primary elevator" and "process elevator"). However, the exclusion of those crops appears to have been a deliberate choice by Parliament.

Since the Department of Finance chose to maintain the income tax deferral benefits currently afforded to cash purchase tickets (rather than eliminate them, which was one of the measures proposed but ultimately abandoned in the 2017 federal budget), and since there does not appear to be any

compelling policy reason for the differences between the ITA and the CGA noted above, it is our view that subsections 76(4) and 76(5) should be harmonized with the provisions of the CGA to ensure equal and consistent treatment under the ITA for farmers of all crops characterized as "grain" under the CGA.

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Specified Investment Business Income Does Not Include Royalties

Subsection 125(7) defines an "active business carried on by a corporation" to mean any business other than, among other things, a "specified investment business" (SIB). In *Rocco Gagliese Productions Inc. v. The Queen* (2018 TCC 136), the TCC held that a music-composing business is not a SIB even if it primarily received royalty income. This decision, which is extremely important for composers, may also apply to taxpayers who receive royalties in other industries.

Background

As defined, a SIB is a business carried on by a corporation, the principal purpose of which is to earn income from property, unless the corporation meets certain employee-related exceptions. Parliament enacted the exception to limit the availability of the small business deduction (SBD) in subsection 125(1). When determining the principal purpose of a business, the Canadian tax courts have established that the most important factors are (1) what a taxpayer actually does and (2) what the taxpayer's sources of income are.

In the 1990s, the CRA confirmed that if the taxpayer's royalty income was related to an active business or if the taxpayer was in the business of dealing in or originating property from which royalties are received, such income would be from an active business. For example, the CRA confirmed that if a company is in the business of composing music, the income from the copyrighted music generally will be active business income (TI 9722915, September 26, 1997). The CRA provided other examples of royalty income from an active business, such as royalties from licensing computer software, from licensing a product for manufacturing, and from selling a product under a trade name (TI 9301657, April 28, 1993).

More recently, however, the CRA adopted a stricter interpretation of the SIB definition and focused on whether the income itself is a royalty. The result was the denial of the SBD to businesses such as music composing, as demonstrated by the facts in *Rocco Gagliese Productions Inc.*

Rocco Gagliese Productions Inc.: Facts

Rocco Gagliese is an award-winning music composer who was the only shareholder, director, officer, and employee of Rocco Gagliese Productions Inc. (RGPI). During the 2011, 2012, and 2013 taxation years, RGPI was a member of the Society of Composers, Authors and Music Publishers of Canada (SOCAN). Generally, Canadian music composers receive their revenue as royalties from SOCAN, which can make the royalty payable to a corporation at the composer's direction. SOCAN, not the composer's clients, pays royalties directly to its members. Before SOCAN existed, clients would pay the composer directly. Mr. Gagliese carried out his music-writing activities as an employee of RGPI. He composed approximately 22,000 music tracks that were used in television shows. Mr. Gagliese testified that "if you take away his daily writing activities, [RGPI] earned little or no income."

During the taxation years in issue, RGPI received between $127,000 and $151,000 from its music writing and composing business, and it included those amounts in computing its SBD. The CRA reassessed the taxation years on the basis that RGPI's music-writing business was a SIB, and therefore those amounts could not be included in computing RGPI's SBD. RGPI also received rent from a rental property during the taxation years, but it did not deduct the SBD in respect of that rent.

The TCC's Analysis and Conclusion

On the basis of the evidence, D'Arcy J concluded that the principal purpose of RGPI's business was to earn income from writing and recording music, not to earn income from property. The fact that the majority of RGPI's income was from Mr. Gagliese's activities influenced his decision. Having found that RGPI carried on an active business, he then concluded that all of RGPI's income, except the rent received from certain rental properties, was from the music-composing business.

The CRA argued that the "legal character" of the income determines whether a business is a SIB. In other words, if a corporation receives mostly royalty income, the corporation is carrying on a SIB regardless of what it did to earn the royalty income. The CRA based this argument on *Weaver v. Canada* (2008 FCA 238), in which the FCA stated that the SIB definition asks about the legal character of the income that the business is principally intended to earn. However, D'Arcy J disagreed: he stated that RGPI was receiving royalty income because of SOCAN's existence. Before SOCAN was created, the income received by a composer was active business income.

Active Businesses and Royalties in Other Industries

The CRA has applied a similar strict interpretation to other businesses that receive royalty income. For example, incorporated oil and gas consultants often receive a gross overriding royalty (GORR) as compensation from property owners. GORR usually is computed as a percentage of the production from particular oil and gas properties that the consultant works on. These taxpayers use their specialized skills and spend considerable time and resources to increase production from

those properties, resulting in greater GORR income. Taxpayers may include GORR as income from an active business in computing the SBD. In my experience, however, the CRA reassesses on the basis that because a GORR payment is a royalty, the taxpayer is carrying on a SIB.

In light of *Rocco Gagliese Productions*, the CRA's position likely is not correct because the incorporated consultant is not carrying on a SIB. The purpose of the taxpayer's business is to earn income from its oil and gas consulting activities, not to earn income from property, even though the business receives royalty income. The taxpayer's activities will lead to greater production, which in turn will lead to greater royalty income in the future.

The TCC arrived at a similar conclusion in *R.W. Switzer v. Canada* ([1995] 1 CTC 2928), in which a consultant received GORR income and treated that amount as business income in computing his earned income for RRSP purposes. The TCC agreed that such income is income from business, not property income; it distinguished Mr. Switzer from a taxpayer who buys a passive investment and receives interest income.

Conclusion

Rocco Gagliese Productions is a welcome clarification of the SIB definition, and it is consistent with previous income tax case law. The decision reinforces the principle that a SIB is based on what the taxpayer actually does, not just on the form of the income received by the taxpayer.

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Paragraph 12(1)(x) and the Taxation of Incentive and Inducement Payments

In *Ritchie v. The Queen* (2018 TCC 113), the issue in dispute was the tax treatment of certain signing bonuses reported on the appellant's personal tax return. The facts of the case were relatively straightforward. The appellant rented land that he owned to his corporation, which farmed the land on his behalf. In 2007, Enbridge Pipelines Inc. was engaged in a project to install pipelines across Alberta, Saskatchewan, and Manitoba. The appellant's land was situated on the pipeline route that Enbridge was building.

In 2008, pursuant to a settlement agreement between the appellant and Enbridge, the appellant received funds totalling $441,595 from Enbridge. The funds represented payments in respect of the granting of easements, disturbance damages, insurance, temporary workspace rights, and most importantly a signing bonus. The appellant's corporation reported the money received in respect of the insurance, disturbance damages, and temporary workspace as income; the appellant reported money received in respect of an easement and the signing bonus as a capital receipt.

The minister reassessed the appellant on the basis that the signing bonus was income to the appellant and not a capital receipt. The minister argued (1) that the signing bonus was paid in the course of the appellant's farming business and did not relate to the disposition of capital property; and (2) that even if the signing bonus was not received as part of the farming business, it was includible under paragraph 12(1)(x) as an incentive or inducement for the early signing of the settlement agreement and that the exclusion in subparagraph 12(1)(x)(viii) did not apply because the payment was an inducement granted in consideration of a contractual obligation. The appellant argued that the signing bonus was a non-taxable windfall or, in the alternative, a capital receipt.

The TCC first turned to the minister's argument that the signing bonus was received as part of the appellant's farming business. It rejected this argument, holding that the appellant's corporation and not the appellant carried on the farming business; thus, the signing bonus was not received as income from the appellant's business because the appellant did not carry on a farming business.

The court then turned to the application of paragraph 12(1)(x), which in general terms includes in income amounts received as inducements. D'Arcy J rejected the application of paragraph 12(1)(x) because of the exclusion in subparagraph 12(1)(x)(viii), which applies when the inducement—in this case, the signing bonus—may reasonably be considered "to be a payment made in respect of the acquisition by the payer . . . of an interest in the taxpayer . . . or an interest in . . . the taxpayer's property." The TCC then turned to the question whether the signing bonus was in respect of Enbridge's acquisition of an interest in the appellant's land (the easement).

D'Arcy J cited *Nowegijick v. The Queen* (1983 CanLII 18 (SCC)), in which the SCC held that the words "in respect of"

> are, in my opinion, words of the widest possible scope. They import such meanings as "in relation to," "with reference to" or "in connection with." The phrase "in respect of" is probably the widest of any expression intended to convey some connection between two related subject matters.

The TCC noted that Enbridge had paid the signing bonus as an incentive for the early granting of the easement. Thus, it was paid in connection with the appellant's granting of the easement, and therefore in respect of the acquisition of an interest in the appellant's property. Consequently, because of the exclusion in subparagraph 12(1)(x)(viii), the signing bonus was not taxable under paragraph 12(1)(x).

The TCC also held that because the signing bonus was in respect of a disposition by the appellant of a capital asset—namely, an interest in land—it was a capital receipt to the appellant. Further, the signing bonus was part of the proceeds of disposition of an interest in land, and Enbridge had agreed to pay a higher sale price for the easement if it was granted before a certain date. As a result, the TCC allowed the appeal

and held that the signing bonus must be included for the purpose of determining the appellant's capital gain under subsection 39(1) from the disposition of an interest in land. The TCC rejected the appellant's contention that the signing bonus was a non-taxable windfall because that argument was based on facts that were not before the court.

This case does not break new law. However, it is a helpful reminder to practitioners that when one is dealing with a payment whose character is arguably ambiguous, it may be advantageous to document the underlying transaction that gives rise to the payment in a way that clearly reflects the character that results in the desired tax treatment.

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Surplus Stripping: A New Approach?

Although the FCA's decision in *Pomerleau v. Canada* (2018 FCA 129) confirms that the use of the capital gains deduction (CGD) for the sole purpose of stripping one's own management company of its surplus constitutes an abuse of section 84.1, it also suggests that the indirect use of the CGD in the context of a non-arm's-length business transfer might be acceptable. More broadly, the decision directly addresses the issue of surplus stripping on the basis of *Copthorne Holdings* (2011 SCC 63). By concluding that the purpose of section 84.1 "is to prevent amounts which have not been subject to tax" from being returned tax-free to shareholders, Noël CJ appears to go further than the TCC's interpretation of the purpose of this provision (2016 TCC 228), as I discuss below.

The tax planning undertaken by Pomerleau was essentially aimed at withdrawing money tax-free from his management company through the indirect use of the CGD. (For a more detailed summary of the facts and the TCC's decision, see "GAAR: Abuse of Section 84.1," *Tax for the Owner-Manager*, January 2017.) He held crystallized preferred shares in his management company, the ACB of which had been calculated by reference to his, his sister's, and his mother's CGD. The shares had been acquired in a series of complex transactions.

First, Pomerleau caused his management company to redeem its preferred shares, resulting in a deemed dividend of $994,628 that was subject to tax. At the same time, the redemption resulted in an equivalent capital loss, deemed to be nil under subsection 40(3.6). That subsection and paragraph 53(1)(f.2) then added the amount of the capital loss to the ACB of his common shares in the same company. The resulting increase in the ACB is the key point: the ACB of the crystallized preferred shares, initially deemed "soft" for the purposes of section 84.1 due to their CGD origin, became "hard" when transferred to the common shares by reason of subsection 40(3.6).

With the ACB of his management company's common shares hardened, Pomerleau transferred those shares to a second company that he controlled. He received as consideration preferred shares whose redemption value, ACB, and PUC all corresponded to the amount of the hard ACB of the common shares without triggering the application of section 84.1. All that was left to do was to redeem the new preferred shares for cash of almost $1 million, which he did without paying any personal income tax.

Noël CJ upheld the TCC's decision by confirming the abuse of section 84.1 and the application of GAAR. The decision is particularly interesting because of its analysis of the object and purpose of section 84.1, which is likely to influence the courts' and tax authorities' future approach to surplus stripping.

The FCA's decision is based on the fact that the concepts of PUC and ACB fundamentally reflect "amounts that have been subject to tax" and that the provisions of the Act that relate to the calculation of those amounts are essentially intended to subtract non-taxable amounts when PUC and ACB are being calculated.

Citing the SCC's decision in *Copthorne*, Noël CJ said that the PUC "essentially represents a shareholder's investment in a corporation, calculated in monetary terms," and that the Act, including section 84.1, modifies its calculation to exclude "any amount that has not been subject to tax." He also said that the ACB "is composed of amounts that have been subject to tax" and that the changes to its calculation under section 53 are directly related to taxable transactions or events. In two exceptional instances, the ACB of shares includes amounts that are not subject to tax—namely, amounts attributable to the valuation-day value of the shares and amounts attributable to the CGD. Paragraph 84.1(2)(a.1) specifically reduces the calculation of the ACB of those shares by the amount by which the FMV on valuation day exceeds the actual cost of the shares, or the amount by which a non-arm's-length party from whom the shares were acquired enjoyed the benefit of the CGD, as the case may be. In either case, the amounts so described were not "amounts that have been subject to tax."

According to the FCA, it is in this context that section 84.1 applies: its purpose is "to prevent amounts which have not been subject to tax from being used in order to allow shareholders to withdraw corporate surpluses on a tax-free basis." The court cited as an example a sale of shares of a corporation by an individual to another corporation with which the individual does not deal at arm's length that would be covered by section 84.1. In such a case, it prevents the amount of the capital gain realized on the transaction from being added to the PUC of the shares issued in consideration by the purchasing corporation. Without this adjustment, the PUC of the newly issued shares would be the FMV of the shares sold,

"even though only half of the accrued value would have been subject to tax." Thus, the FCA equated the non-taxable portion of the capital gain realized in these circumstances to an amount that was not subject to tax.

This approach raises several questions, particularly with respect to previous TCC decisions. Is this determination of the object of section 84.1 broader than that previously proposed by the TCC? In the trial decision, as well as in *Descarries v. The Queen* (2014 TCC 75) and *1245989 Alberta Ltd. v. The Queen* (2017 TCC 51), the TCC held that section 84.1 is intended to prevent the stripping of surpluses "tax-free through the use of a tax-exempt margin or a capital gain exemption" (*Descarries*, at paragraph 53). But in *Pomerleau*, the FCA speaks more broadly of preventing the withdrawal of "amounts that were not subject to tax," which seems to include any non-taxable portion of capital gains, whether or not the tax-exempt margin or the CGD was used.

Will this new approach have an impact on the surplus-stripping operations currently accepted by the tax authorities or validated by the courts that involve, directly or indirectly, capital gains? Examples include two-step pipeline transactions, either post mortem or inter vivos, for the purpose of distributing a corporation's surplus through the realization of a taxable capital gain (sale of shares to an individual to trigger a taxable capital gain before a subsequent sale to a corporation), and gains such as those realized in *Gwartz v. The Queen* (2013 TCC 86).

The FCA also refused to recognize the taxpayer's argument that the surplus distribution took place in the context of the transfer of a family business and therefore did not constitute an abuse of the Act. The court noted, however, that section 84.1 has a punitive effect when an intergenerational business is transferred to a corporation controlled by an heir (which was not the case in *Pomerleau*) by converting a capital gain into a dividend: "This particular situation, if it arose in the context of an analysis under the GAAR, could possibly give rise to a construction of section 84.1 which would prevent this punitive result."

The CRA reached the same conclusion in an advance ruling (2005-0134731R3, released March 30, 2007), which allowed a father to indirectly cash in the amount of his CGD, tax-free, when transferring his business to his children. The CRA withdrew this advance ruling in 2016 (2016-0633351E5, May 2, 2016), after the decision in *Descarries*, which applied GAAR to a surplus distribution using similar transactions but outside the context of a business transfer. One hopes that what Noël CJ said will prompt the CRA to reconsider its 2016 decision and to accept once again the indirect use of the CGD for family business transfers.

Almost a year after the minister of finance's tax reform project, the FCA is now taking part in the debate on surplus stripping and intergenerational business transfers. It is not at all clear how this issue will play out, but it does seem likely that more cases will be decided on this point before it is resolved.

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RRSP Overcontributions: CRA Continues To Punish When It Should Assist

"Very complex [RRSP] legislation should not be used to penalize the innocent and the uninformed." Despite this clear statement from the judiciary in *McNamee v. The Queen* (2009 TCC 630, at paragraph 13), the CRA continues to take the position that taxpayers should know everything about the complex calculations that underlie the RRSP deduction limit. In cases of non-compliance, the penalties and interest may be reduced only if the CRA provides discretionary administrative relief or the court allows a motion for judicial review. Ultimately, taxpayers are expected to be aware of the complexities of the law governing the RRSP deduction limit; and if they are not, they must accept the penalties unless the CRA agrees to provide administrative relief. *Pouchet v. Canada (Attorney General)* (2018 FC 473) is a recent example of a taxpayer unknowingly contributing an excess amount to her RRSP.

In 2007, while transferring her accounts from one bank to another, the taxpayer transferred $17,000 from her bank account to an RRSP account. However, her unused RRSP deduction limit was only $1,514. She heard nothing from the CRA for seven years until 2014, when the CRA informed her that she *may* have made excess RRSP contributions during the 2007 and subsequent taxation years, and that she had not filed a T1-OVP return to report and pay tax on the excess contribution. Unfortunately, she did not reply to this correspondence, and in April 2015 she was issued a notice of assessment for the 2007 to 2013 taxation years regarding her excess contributions. She immediately withdrew amounts from her RRSP to eliminate the excess RRSP contribution. (It should be noted that from 2007 to 2014, Ms. Pouchet's annual income never exceeded $6,242, and the RRSP contributions in question would have resulted in no tax benefit to her.)

In May 2015, Ms. Pouchet requested taxpayer relief under subsection 220(2.1) for the 2007-2015 taxation years and provided an unsigned 2014 T1-OVP return with the request. Once again, a CRA representative wrote to her, notifying her that she *may* have had excess RRSP contributions during the 2015 taxation year, and that she had not filed the T1-OVP return. After she received this letter, she filed a signed T1-OVP for the 2015 taxation year.

In February 2016, the CRA rendered its first decision, providing no relief. It stated, inter alia, that

(c) Each year, CRA provided the Applicant with a notice of assessment, which notably mentioned that if her amount B (unused contributions) is higher than amount A (maximum for the following taxation year), she can be subject to a tax liability regarding her excess contributions;

(d) It is an individual responsibility to ensure that his or her accountant prepared correctly his or her income tax returns.

Ms. Pouchet confirmed that in every notice of assessment that she received, there was a mention that she could *possibly* be in violation of the RRSP contribution rules. Accompanying the notice was the formula for evaluating the contribution room. However, if a taxpayer is to understand the formula, several key terms may need further explanation. If a taxpayer were to use the CRA publication "RRSP and Other Registered Plans for Retirement," he or she would be met with language that shows how convoluted the calculation can be. For example, in calculating the "unused RRSP deduction room" for the previous year, the CRA instructs the reader to

> [s]ubtract the total RRSP, PRPP and/or SPP contributions, that you deducted on line 208 (do not include amounts you deducted for transfers of payments or benefits to an RRSP, or the excess amount you withdrew from your RRSP in connection with the certification of a provisional PSPA that you re-contributed to your RRSP in 2016), from your RRSP deduction limit for 2016 and the total 2016 employer PRPP contributions reported on line 205.

Other terms that the taxpayer must interpret include "pension adjustment," "earned income," "net past service pension adjustment," and "pension adjustment reversal." The problem, of course, is that most taxpayers have no clear sense of what these words mean, even if they can figure out which ones might apply in their circumstances. Consequently, at best they are left uncertain about whether they are actually in violation of the rules until they are assessed a penalty.

The TCC in *Pouchet* dismissed the taxpayer's appeal, stating that the taxpayer "never contacted the CRA to verify whether the amounts she was contributing were reasonable." Nonetheless, the court agreed "that the consequences visited on the Applicant are harsh and out of proportion with any error in over contributing to her RRSP," and stated that

> the Court repeats its concerns stated in *Connolly v. Canada (National Revenue)*, 2017 FC 1006 (CanLII) in concluding that contributions to RRSPs can represent a hidden trap for many unsuspecting taxpayers such as the Applicant. It urges the Minister to take steps to find the appropriate means to provide conspicuous warnings to taxpayers not to make any contributions to their RRSP plans unless aware of their contribution limits because of the harsh penalties that may accrue from over contributions.

In today's world of ever more complex tax legislation, even in matters touching the average taxpayer (for example, the new tax on split income rules), the CRA's approach to issues of innocent non-compliance is troubling. No significant tax was avoided in *Pouchet*; the main effect of the CRA's assessments was to burden the taxpayer with disproportionate penalties and interest. Most taxpayers want to follow the rules and be compliant, but the CRA has to help them do so if Canada is to have a truly fair and functional tax system.

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When Is a Forward Contract a Hedge?

In *Canada v. MacDonald* (2018 FCA 128), the issue was whether an agreement between the taxpayer and the Toronto-Dominion Bank (TD) was to be treated as a hedge for tax purposes. The taxpayer owned 165,000 shares of the Bank of Nova Scotia (BNS), which he anticipated would decline in value due to the recession. The shares were a capital asset to him. He entered into a forward contract and a related financing facility with TD under which the shares were pledged to the bank as security for the financing. Under the forward contract, the taxpayer agreed to pay the bank the amount by which the forward share price exceeded $68.43 on the settlement date, and the bank agreed to pay the taxpayer a corresponding amount on that date if the value declined. The credit facility offered by TD required the taxpayer to pledge a certain number of his BNS shares and assign any payment to which he became entitled pursuant to the forward contract as collateral for the loan. The forward contract remained in place after the loan was repaid. The value of the forward contract shares did not decrease, and the taxpayer was required to make cash settlement payments to TD. He claimed the payments as non-capital losses on the basis that he entered into the forward contract for speculative purposes, not to hedge the value of the BNS shares. The minister reassessed and treated the loss as a capital loss on the basis that the taxpayer entered into the forward contract in order to hedge his investment in the BNS shares. Therefore, the tax consequences of the hedge were to be determined by reference to the character of the underlying asset, which was agreed to be a capital asset of the taxpayer.

The TCC ruled in favour of the taxpayer (2017 TCC 157). According to the TCC, the taxpayer entered into the forward contract as a speculation, not as a hedge of the value of the BNS shares. It held that the taxpayer was not exposed to the risk of market fluctuation, since he never intended to sell the BNS shares. Specifically, the TCC disregarded *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)* (2006 SCC 20) because it concerned transaction risk, whereas *MacDonald* dealt with ownership risk. Furthermore, the TCC held that the required link between the forward contract and the underlying asset was not present because the BNS shares were not the delivery asset under the forward contract. In short, the TCC's decision

demonstrated that intention was critical to the question whether the forward contract was a hedge: the taxpayer must have an intention to hedge or eliminate a risk associated with an underlying asset and must have entered into the contract with the intention to hedge. The intention to hedge is separate and distinct from an intention to profit.

The FCA concluded that the TCC erred in law by failing to apply the proper test in characterizing the nature of the forward contract. The FCA said that the issue to be decided was whether the forward contract was a "hedging instrument." The answer to this question did not start with an analysis of whether the forward contract was in itself an adventure or concern in the nature of trade. The FCA stressed that the taxpayer's intention is not a condition precedent for a hedge, whereas foresight of an impending risk is a necessary element of a hedging exercise. In addition, citing *Placer Dome* and *George Weston Limited v. The Queen* (2015 TCC 42), the FCA clarified that a hedging instrument exists as long as it has the effect of neutralizing or mitigating the risk to which the underlying asset is exposed. Furthermore, a transaction to sell the underlying assets is not required for a hedge to exist, and the form of settlement is irrelevant in determining whether a derivative contract constitutes a hedge.

Specifically, the FCA commented that "an intention to hedge is not a condition precedent for hedging," and "the Forward Contract is a hedging instrument if it neutralizes or mitigates risk to which the underlying asset is exposed." The FCA's emphasis on the mere existence of a hedging effect clearly changes the hedging test from subjective to objective. Its decision will have consequences for taxpayers who genuinely speculate on a capital asset through derivative transactions.

It is of interest that the FCA seemed to ignore Mr. MacDonald's specific circumstances in deciding that the forward contract here operated as a hedge. He acquired the BNS shares long before he entered into the forward contract, and he intended to hold on to the shares after the forward contract was settled. Granted, a person can neither gain nor lose by entering into a derivative instrument while owning assets whose value is protected by the instrument; but that is true only for the years covered by the forward contract. Mr. MacDonald intended to hold, and actually held, the BNS shares long after the forward contract was settled. Ownership risk exists if the underlying property is not sold and an intention never to sell is wholly consistent with the existence of ownership risk. But is the taxpayer's behaviour here consistent with mitigating such a risk? If Mr. MacDonald wanted to effectively hedge his risk of holding a long-term asset, why did he enter into a forward contract with a five-year term and extend the contract only to 2006? Why not enter into a contract with whatever longer term was available in the market? Was there even a hedging effect in this particular case?

Disregarding the taxpayer's particular circumstances in cases involving derivative contracts suggests that the courts now favour a one-size-fits-all approach. There are many reasons why a taxpayer might engage in a derivative transaction, and hedging the value of an underlying asset is only one of them. Given the approach taken by the court in this case, taxpayers who enter into forward contracts that can be linked to the mere ownership of assets owned at the time that the contract is made will have to be careful in reporting any gain or loss when the forward contract is closed out.

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