Canadian Tax Highlights

Editor: Vivien Morgan, JD

Volume 24, Number 10, October 2016

BEPS Cash Box Inconsistent with Canadian Tax Rules

The BEPS project's new transfer-pricing notion of "cash box" appears to be inconsistent both with commercial reality and with longstanding Canadian outbound international tax policy.

In 1976, Canada adopted the policy of facilitating management (reduction) of the foreign tax obligations of Canada's multinational enterprises (MNEs) via group financing and licensing arrangements, carving those obligations out of the FAPI system. The primary mechanism of this carve-out was and remains subparagraph 95(2)(a)(ii), which converts passive inter-FA interest or royalty payments out of the payer FA's ABI into the recipient FA's ABI. This system survived an indirect challenge in 2007, when the anti-double-dipping rule in section 18.2 was enacted (but repealed in 2009, before its effective date), and it was strongly endorsed by the 2008 government-appointed Advisory Panel on Canada's System of International Taxation.

The integrity and effectiveness of subparagraph 95(2)(a)(ii) may now be coming under another indirect attack, a result of the OECD's BEPS transfer-pricing theory for so-called cash boxes and the consequent taxation of income of a group financing or licensing company (or, more accurately, taxation of the sharing of the income among multinational group members). This article explains the BEPS cash-box theory, why it is invalid, and why it should therefore not apply in Canada.

The BEPS cash box disregards commercial reality. Actions 8-10 of the BEPS report, which make up the transfer-pricing approach, contain a cash-box notion: the stated purpose of that report is to align transfer-pricing outcomes with value creation while retaining and working within the confines of the arm's-length principle. The OECD defines cash boxes as "shell companies with few if any employees and little or no economic activity, which seek to take advantage of low or no-tax jurisdictions"; the cash box thus contemplates a group member that simply provides capital, such as funding or intangibles, for use by an operating company and that itself has limited activities. The OECD asserts that "[i]f the capital-rich member does not in fact control the financial risks associated with its funding, then it will be entitled to no more than a risk-free return, or less if, for example, the transaction is not commercially rational and therefore the guidance on non-recognition applies," and it similarly says, with respect to intangibles, that "[l]egal ownership of intangibles by an associated enterprise alone does not determine entitlement to returns from the exploitation of intangibles."

These OECD statements essentially suggest that economic returns in excess of a risk-free return are (or should be) attributable to labour and not to capital; furthermore, they suggest that excess economic returns are only allocable to an entity if its own employees perform the specific economic functions and it does not outsource functions to other group entities or external providers. The OECD statements are not supported by the arm's-length principle and are inconsistent with economic theory and practice.

According to the cash-box notion, the allocation of the risk from loans and licences between group members of MNEs—and hence the related profit—must be made on a factual basis and not a contractual basis. That process is said to have two actors: the party that has the "control over the risk" and the party that has the financial capacity to bear the risk of the loan. The first party's control appears to mean merely the decision-making authority to make a loan, but investors may routinely hire professionals to perform the task. Can the second party be other than the lender that puts up its money to make the loan? In any event, it is difficult to interpret those factors in such a way as to arrive at the OECD's conclusion that the lion's share of the profit from the intercompany loan or licence is allocable to group members as a whole and not to the group lender or licensor, which is allocated only "risk-free returns" (that is, three-month treasury bill rates). Thus, according to the OECD, if the lender or licensor does not employ persons to make and manage its investments but turns to group members to help out, it may not be entitled to the main portion of the income from the loan or licence.

Economic theory and practice arrive at a different conclusion. As a matter of practice, passive investors routinely

In This Issue

BEPS Cash Box Inconsistent with Canadian Tax Rules	1
Proposed Regs May Limit US Estate Plan	2
Partnerships and ASPA on Acquisition of Control	3
US Estate Tax: Partnership Investing in US Realty	5
T1135: Right to Amounts Under Foreign Retirement Plan Must Be Reported	6
Arranging for Financial Services	7
September 2016 FA Proposals	8
Owner-Manager Year-End Tips, Part 1	9
CRA: Accrued Simple Interest Not Debt for Thin Cap	11
Tax Under Appeal Not Debt in Bankruptcy	11

CTF FCF
CANADIAN TAX FOUNDATION
FONDATION CANADIENNE DE FISCALITÉ

©2016, Canadian Tax Foundation

engage financial advisers and asset managers, but they do not merely keep a risk-free return for themselves and pay the balance to the advisers. For example, the best-paid private equity fund managers receive no more than 20 percent of the income earned by the totally passive money-owning investors. The cash-box notion does not reflect that reality and is inconsistent with transfer-pricing policy, which is intended to mirror economic and business reality whenever possible.

In summary, the OECD's changes to its BEPS transfer-pricing guidelines seek to erode the arm's-length principle by promoting inconsistent exceptions, such as for cash boxes. The OECD's focus on labour appears to adopt a formulary apportionment that is based on salaries and wages. Therefore, it is not surprising that, last year, Justice Frank J. Pizzitelli of the TCC described the OECD's final package on BEPS as a step toward formulary profit attribution principles, and he said that the trend was likely to continue. In our view, the BEPS approach is also inconsistent with the Canadian policy reflected in subparagraph 95(2)(a)(ii).

In Canada's 2016 budget, Finance took the unusual step of saying that the CRA was then applying the revised OECD guidance on transfer pricing, which "provides an improved interpretation of the arm's-length principle." Significantly, however, Finance also said that the CRA would not adjust its administrative practices at that time in the two most controversial areas of the OECD's BEPS-related transfer-pricing work: the proposed simplified approach to low value-adding services and the treatment of cash boxes. Canada will decide on a course of action with regard to these measures after the OECD completes its followup work.

It should be reiterated that in the seminal transfer-pricing case of *GlaxoSmithKline* (2012 SCC 52), the SCC said that the OECD's transfer-pricing guidelines "are not controlling as if they were a Canadian statute and the test of any set of transactions or prices ultimately must be determined according to [Canada's transfer-pricing legislation] rather than any particular methodology or commentary set out in the *Guidelines*." The Canadian arm's-length principle is legislated in section 247 and thus any inconsistent OECD pronouncements—even those adopted as CRA administrative practice—are likely to fail in proceedings before a Canadian court.

The CRA and Finance should reject the notion of the cash box's relevance to Canadian tax law. However, comments made by Michelle Levac (transfer-pricing specialist at the CRA) at a transfer-pricing conference held in Toronto on August 30, 2016 appear to be inconclusive. Levac, who previously served as chair of the OECD's Working Party 6, said that the OECD transfer-pricing report recognizes the importance of funding "and the contributions of cash or capital." Levac went on to say, however, that there had been no "sea change" in the BEPS limitations attached to a cash box that funds intangible development but whose only economically relevant activities result in a risk-free return.

Nathan Boidman and Michael Kandev
Davies Ward Phillips & Vineberg LLP, Montreal

Proposed Regs May Limit US Estate Plan

On August 2, 2016, the US Treasury issued long-awaited proposed regulations under Code section 2704 that make comprehensive and very significant changes to the valuation of interests in many family-controlled entities for US estate, gift, and generation-skipping transfer tax purposes. US tax practitioners have been anticipating these proposals since 2003, when the project began to appear annually in the "IRS Priority Guidance Plan." No specific date has yet been set for the proposed regulations' becoming effective.

Congress enacted section 2704 in 1990 to limit valuation discounts for gift and estate tax purposes applicable to intrafamily transfers of interests in family-owned and closely held corporations and partnerships. If an individual and his or her family hold voting or liquidation control over a corporation or partnership, section 2704(a) generally provides that the lapse of a voting or liquidation right is taxed as a transfer subject to gift or estate tax. Section 2704(b)(4) authorizes the Treasury to issue regulations that similarly disregard other restrictions in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family, if that restriction effectively reduces the value of the transferred interest for transfer tax purposes but not ultimately for the transferee.

Under current law, a taxpayer can transfer interests in a closely held business to family members (generally, children and grandchildren) at a discounted value. Usually, the recipient is given a non-voting, minority (less than 50 percent) interest, and his or her ability to dispose of that interest is restricted (usually by transfer restrictions in the business's governance documents). These minority and lack-of-marketability discounts, which can reduce the value of the transferred interest by as much as 40 percent, are designed to reflect the economic reality that an arm's-length buyer would not pay $10,000 for a 10 percent interest in a $100,000 family business because, as a minority owner, the third party (1) cannot control business decisions and (2) cannot easily sell or otherwise liquidate the business interest because of transfer and liquidation restrictions and the small market for selling closely held business interests.

The proposed regulations limit the existing regulatory exceptions to transfer taxes upon the lapse of a voting or liquidation restriction. The proposals also further restrict

valuation discounts for transfers between family members of interests in family-controlled corporations, partnerships, limited liability companies, and other business entities or arrangements, both domestic and foreign. More specifically, the proposed regulations

- treat as an additional transfer the lapse of voting and liquidation rights for transfers of interests in a family-controlled entity made within three years of death (discounts reflecting lack-of-control and minority interests that are typically taken in these transactions are thus substantially limited or eliminated);
- disregard the ability of most non-family-member owners to block the removal of covered restrictions unless the non-family member has held the interest for more than three years, owns a substantial interest in the entity, and has the right, upon six months' notice, to be redeemed or bought out for cash or property;
- disregard restrictions on liquidation that are not mandated by federal or state law in determining the transferred interest's FMV; and
- clarify the description of entities covered to include limited liability companies and other entities and business arrangements, in addition to corporations and partnerships.

US tax practitioners have long speculated about whether these proposed regulations would focus solely on closely held entities holding passive investment assets or whether active trade or business operations would also be affected. The proposed regulations, as currently drafted, apply similarly to both types of entities.

Planning opportunities still exist, because the proposed regulations are not yet effective. Proposed regulations may be useful indicators of the Treasury's position and interpretation of the law, but they are generally not binding either on the Treasury or on taxpayers. Currently, we are in the midst of a 90-day public comment period for the proposed regulations, and interested parties may submit written comments; a public hearing is scheduled for December 1, 2016. Any final regulations, if adopted, may be substantially different from the proposed regulations and are only effective on, at the earliest, the publication date of the Treasury decision to adopt them as final. Even for less controversial projects, the finalization of regulations is typically a multi-year process. However, some commentators are of the view that the IRS may make the project a high priority, and thus an effective date in mid-2017 is possible.

Republican members of Congress have already introduced three bills calling for the Treasury's effective withdrawal of the regulations. The latest bill, introduced on September 29, 2016 by Senators Marco Rubio, Jerry Moran, and Jeff Flake, highlights the impediments that the regulations create for the effective transition of ownership of family-owned businesses and farms to the next generation.

Final regulations that are similar to the proposed regulations will cause the disappearance of a significant estate-planning technique and will increase, accordingly, the tax cost of transferring interests in family-owned entities. Not only will lack-of-control discounts be affected to the taxpayer's detriment, but undoubtedly appraisal costs will substantially increase in order to comply with the regulatory mandate.

Leslie R. Kellogg
Hodgson Russ LLP, Buffalo

Partnerships and ASPA on Acquisition of Control

The adjusted stub period accrual (ASPA) rules can generate interesting results on an acquisition of control of a corporate partner. When private corporation shares are sold, the buyer and the seller often agree that the seller bears the cost of taxes that arise before the acquisition of control—a division of responsibilities that may highlight the need to be aware of the timing of partnership income inclusions. If the corporation owns an interest in a partnership, the partnership has no deemed year-end on the acquisition of control, but the corporation's taxable income may be adjusted as required by section 34.2.

Assume that Partnership AB has a limited partner (ACo) whose wholly owned subsidiary (BCo) is the general partner. ACo's shares are acquired by a third party. Assuming that no exception in subsection 256(7) applies, an acquisition of control of ACo and BCo occurs because de jure control of ACo has been acquired. The consequences to ACo and BCo of the acquisition of control may include a deemed year-end immediately before acquisition of control and a new taxation year beginning at the time of acquisition of control; accrued losses recognized on non-depreciable capital property, depreciable capital property, eligible capital property, doubtful debts, and inventory; and restrictions on the future use of ACo's and BCo's losses. However, the acquisition-of-control rules do not apply to partnerships, and thus the fiscal period of a partnership is not deemed to end when a corporate partner's acquisition of control occurs.

What if the partnership and a corporate partner have a different fiscal period and taxation years, respectively? Assume that ACo has a December 31 year-end, the partnership has a January 31 fiscal period-end, and acquisition of control of ACo occurs on April 1, 2016 (creating a deemed year-end on March 31, 2016). If there was no acquisition of control, subsection 34.2(2) requires that ACo include an ASPA in computing its income; thus, for ACo's January 1 to December 31, 2016 taxation year, it would include in income

- its share of Partnership AB's income for the fiscal period ending January 31, 2016; plus
- an ASPA adjustment for the 11 months of Partnership AB from February 1, 2016 to December 31, 2016; less
- the prior year's ASPA income inclusion, under subsection 34.2(4).

Subsection 34.2(2) applies if the corporation is not a professional corporation and if (a) the corporation has a significant interest in the partnership at the end of the partnership's last fiscal period that ends in the year; (b) another fiscal period of the partnership begins in the year and ends after the year; and (c) at the end of the year, the corporation is entitled to a share of an income, loss, taxable capital gain, or allowable capital loss of the partnership for the fiscal period referred to in paragraph (b).

However, the example assumes that an acquisition of control occurred and a deemed year-end occurred on March 31, 2016. ACo includes in income

- its share of Partnership AB's income for the fiscal period ending January 31, 2016; plus
- an adjustment for ASPA for the two months of Partnership AB from February 1, 2016 to March 31, 2016; less
- the prior year's ASPA income inclusion (for ACo's December 31, 2015 taxation year, and that covers Partnership AB's stub period of February 1, 2015 to December 31, 2015).

An ASPA income inclusion is required because Partnership AB has a fiscal period that begins in ACo's taxation year (February 1, 2016) and ends after that year (January 31, 2017).

Assume that ACo then chooses a December 31, 2016 post-acquisition-of-control year-end: there is no income pickup from Partnership AB for the period of April 1, 2016 to December 31, 2016. Pursuant to paragraph 34.2(2)(a), ACo still has a significant interest in Partnership AB, but paragraph 34.2(2)(b) requires a fiscal period of the partnership to begin in the year and end after the year. Partnership AB's fiscal period runs from February 1, 2016 to January 31, 2017, and ACo's taxation year runs from April 1, 2016 to December 31, 2016. Thus, no fiscal period of the partnership begins in ACo's taxation year, and therefore ACo does not include any of Partnership AB's income in its December 31, 2016 taxation year. (In the context of a short taxation year ending on an amalgamation, this was confirmed in CRA technical interpretation 2014-0539191E5, November 4, 2014.) However, the ASPA adjustment included in ACo's income for the stub period from February 1, 2016 to March 31, 2016 is then deducted in the computing of ACo's income for its April 1, 2016 to December 31, 2016 taxation year. ACo's share of Partnership AB's income for the February 1, 2016 to January 31, 2017 fiscal period is then included in ACo's income in the following year (its 2017 calendar taxation year). Assume that ACo's share of Partnership AB's income is $1,200 for the fiscal periods ending January 31, 2015 and January 31, 2016, and $1,500 for the fiscal period ending January 31, 2017. The following summarizes ACo's approximate share of Partnership AB's income for calendar years 2016 and 2017.

ACo's Partnership Income for Calendar 2016 and 2017

January 1, 2016 to March 31, 2016	
Income from partnership (February 1, 2015 to January 31, 2016)	1,200
ASPA inclusion (February 1, 2016 to March 31, 2016)	200
ASPA deduction (February 1, 2015 to December 31, 2015)	−1,100
	300
April 1, 2016 to December 31, 2016	
Income from partnership	—
ASPA inclusion	—
ASPA deduction (February 1, 2016 to March 31, 2016)	− 200
	− 200
January 1, 2017 to December 31, 2017	
Income from partnership (February 1, 2016 to January 31, 2017)	1,500
ASPA inclusion (February 1, 2017 to December 31, 2017)	1,375
ASPA deduction	—
	2,875
Total income from January 1, 2016 to December 31, 2017	2,975

In the example above, ACo's income for the February 1, 2016 to March 31, 2016 partnership period (the stub period before acquisition of control) is based on the income of Partnership AB in the prior period—which may be lower than the actual partnership income for the stub period. Also, the example demonstrates that notwithstanding the ASPA rules, some stub periods may not include partnership income: here, the stub period following the acquisition of control has no partnership income inclusion; in other scenarios, however, the stub period before the acquisition of control may not have a partnership income inclusion. Thus, if the acquisition of control in the example had occurred in January 2016, the pre-acquisition-of-control stub period would not have a partnership income inclusion. Accordingly, in a sale transaction where one party is responsible for the tax liabilities arising before the acquisition of control and another is responsible for tax liabilities arising after the acquisition of control, it may be necessary to consider the amount of partnership income that is taxed in the pre-acquisition-of-control period compared with the amount taxed in the post-acquisition-of-control period.

Janette Pantry and Robyn Campbell
Ernst & Young LLP, Vancouver

US Estate Tax: Partnership Investing in US Realty

The choice of structure for US real property investment should include an assessment of the structure's US estate tax impact. The effect of the US check-the-box (entity classification) election on US real estate is of particular interest. Multi-tiered partnerships may also be considered.

Canada does not tax a partnership, but it calculates the partnership's taxable income as if the partnership were a taxpayer; after that calculation, the taxable income is allocated proportionately to its partners. The partners are subject to tax on their proportionate share of the partnership's income and gain from investments, and they must file both Canadian and US returns to report that income. A Canadian partnership (as defined in the Act) may also qualify for a rollover of property from the partners to the partnership and for a rollover on dissolution (if conditions pertaining to a proportionate distribution of undivided interests are met).

A partnership is useful for US real property investments, whether direct investments in real property or investments in another partnership that holds real property. (This article does not consider a partnership that invests in a US limited liability company [LLC] that in turn owns real property.) One prime reason for preferring a partnership vehicle is that it gives access to the favourable 20 percent rate on an individual's long-term US capital gains and to limited liability (provided that the partnership is a limited partnership and not a general partnership).

A limited partnership also provides the business purposes that are necessary before an election can be made to treat the partnership as a corporation. Any foreign partner is subject to US withholding tax on effectively connected and allocable taxable income, but a Canadian foreign tax credit may be available to such a partner.

US estate tax may be imposed on both a US resident and a US citizen; if the decedent was not a US person or a resident alien, US estate tax is imposed only on US-situs assets. US-situs assets include real property interests, shares of a US corporation, and tangible property located in the United States; shares of a foreign corporation do not constitute US-situs property. Whether a partnership interest constitutes US-situs property is unclear; technical IRS guidance on the issue is unpersuasive and outdated. However, a partnership that elects (checks the box) to be treated as a non-resident corporation should be exempt from US estate tax.

A check-the-box election essentially classifies an entity as a different entity. Only eligible entities can make the election. US Treasury regulation 301.7701-2(b) lists non-eligible entities (or per se corporations) that are treated as corporations and therefore cannot make the election. In contrast, a Canadian partnership or an unlimited liability company can check the box and elect to be treated as a corporation for US tax purposes.

A check-the-box election is available only to a business entity. A partnership that holds US real property only for personal use does not clearly qualify as a business entity: consideration may be given to the partnership's use for multiple investments or for other business activities, although the real property investment may be available to creditors of that other business.

Given the uncertainty surrounding the status of a partnership interest for US estate tax purposes, checking the box is important for estate tax planning when US property is held through a partnership. As a result of the election, the partnership is treated as an interest in a foreign corporation, which is not US-situs property for US estate tax purposes. However, this also means that the US real property is owned by a foreign corporation from the time of the election: the entity is thus taxed on gains from the property at the higher capital gains tax rate applicable to a corporation. Thus, protection from US estate tax results in the loss of an income tax benefit.

The tension between US income tax and US estate tax has long been a concern to tax planners. On one hand, a partnership allows for limited liability (a limited partnership) and yet preserves the favourable long-term capital gains tax rate. On the other hand, the partnership does not adequately protect against US estate tax; a check-the-box election does afford this protection, but the partnership—now treated as a corporation—is subject to a higher capital gains rate. Further planning is required.

A planning step that is often overlooked is to consider the potential income and estate tax liabilities. If estate tax exposure is expected to be insignificant, ideally the partnership should not elect to be treated as a corporation. However, if the expected property gain is insignificant or the estate tax liability is potentially large, an election to be a corporation is advisable. Nonetheless, planning for a tax liability many years in advance may not be possible, and thus the timing of the election itself may become relevant.

A check-the-box election immediately after the partnership's formation is no different from the use, at the outset, of a Canco to hold the US real property. Thus, an immediate election is not beneficial. In contrast, a future check-the-box election may trigger capital gains tax on the property's deemed disposition from a partnership into a corporation. Triggering a lower capital gains tax rate is beneficial, as is planning against the estate tax, but the election's timing may mean that the capital gains tax is paid too far in advance of the investor's death. Moreover, a timing mismatch may arise between US and Canadian recognition of the tax liability, because Canada does not view the election as triggering a disposition.

An election immediately after the partner's death—the election can be retroactive by 75 days—allows the executors and tax planners to compute the otherwise applicable estate

and capital gains taxes. Whether such an election is valid is uncertain, even though case law in other contexts accepts the retroactive election in tax planning. A retroactive election for a partnership that holds US realty may be the most effective and flexible solution from a planning perspective, but the (perhaps remote) possibility of an IRS challenge to the election always exists.

An alternative and underused strategy is a gifting of partnership interests, immediately before death, to multiple family members in order to further reduce estate tax. A partnership interest is an intangible, and thus its gifting by a non-resident alien should not attract US gift tax.

A foreign corporation and a foreign partnership are each subject to US withholding tax. For example, the foreign partners of a partnership (US or foreign) may be subject to withholding tax under Code section 1446 on effectively connected taxable income of the partnership that is allocable to those partners. Each individual partner must make US income tax filings.

US tax compliance issues may be simplified through the use of a multi-tiered partnership in which the bottom-tier partnership is a US limited partnership whose limited partner is a Canadian limited partnership with individual partners. (The use of such a multi-tiered partnership does not affect the results or concerns discussed above.) The Canadian limited partnership can check the box to be a corporation. This structure is beneficial: a US limited partnership (1) allows greater flexibility to choose a jurisdiction that grants the most limitation on liability, (2) ensures the choice of a jurisdiction that allows the limited partnership's business purpose, and (3) provides greater comfort to potential partners because it is a domestic entity. The benefit of the check-the-box regime continues to be available to the Canadian limited partnership. Compliance flexibility is maximized because tax filings are made solely by the Canadian limited partnership: individual (and multiple) partners do not make US filings. The Canadian partnership should also be able to receive a foreign tax credit in Canada on any Code section 1446 withholding tax on effectively connected taxable income.

Ron Choudhury
Miller Thomson LLP, Toronto

T1135: Right to Amounts Under Foreign Retirement Plan Must Be Reported

A recent TI (2015-0595461E5, April 12, 2016) says that a Canadian-resident individual who has an interest in a foreign pension fund trust must report the interest's cost amount on form T1135 ("Foreign Income Verification Statement"). The CRA says that the cost amount is the amount that the individual is legally entitled to receive from the pension, even if it will be received in the future. The CRA also notes that if it is not possible to determine the cost amount, the taxpayer must make a "reasonable estimate" thereof.

The CRA also provides a technical overview of why the interest in the foreign pension fund trust (in this case, an Australian superannuation fund) is not excluded from the definition of specified foreign property. Falling within that definition triggers the form T1135 reporting requirement.

Generally, if a specified foreign property's total cost amount is greater than $100,000 at any time in the year, a specified Canadian entity must report the property on form T1135. A "specified Canadian entity" includes most Canadian-resident taxpayers and certain partnerships. "Specified foreign property" is, inter alia, an interest in a non-resident trust under paragraph (d) of subsection 233.3(1), unless it meets one of the listed exclusions, which include (1) an interest in a non-resident trust that is an FA of the person or partnership for the purpose of the T1134 FA reporting rules in section 233.4 (paragraph (l)); (2) an interest in a non-resident trust that was not acquired for consideration (paragraph (m)); and (3) an interest in a trust described in paragraph (a) or (b) of the definition of "exempt trust" in subsection 233.2(1) (paragraph (n)).

Under subsection 233.2(1), an exempt trust includes under paragraph (a) a trust that is governed by a "foreign retirement arrangement" and under paragraph (b) a trust that is (i) resident in a country that imposes income tax; (ii) exempt under the laws of that country from the payment of income tax; (iii) established for the principal purpose of administering or providing benefits under a superannuation, pension, or retirement fund or plan, or under any fund or plan established to provide employee benefits; and (iv) either maintained primarily for the benefit of non-resident individuals or governed by an employee profit-sharing plan. A "foreign retirement arrangement" is a US IRA as defined in regulation 6803.

The TI describes a situation in which a Canadian individual taxpayer (Ms. X) is a member of, and contributed to, a regulated Australian superannuation fund, which operates as a trust. The fund receives concessional tax treatment in Australia and is funded by compulsory and voluntary contributions from employers and individuals over the individuals' working lives, and it is held until their retirement. Under the concessional tax treatment, all investment earnings are taxed at 15 percent, except for capital gains, which receive a 33 percent discount.

The TI says that the fund was classified in Australia as both a retail fund and a public offer fund (a classification that includes master trusts, in which a large number of unconnected individuals or companies operate their superannuation arrangements under a single common trust deed). Ms. X's interest in the fund was valued at over $100,000 when she became a Canadian resident. Ms. X has made no contributions since moving to Canada, and she cannot withdraw funds until she reaches age 60.

The principal issues in this TI are (1) whether the fund is considered "specified foreign property" and must therefore be reported by Ms. X on form T1135; and (2) if the fund is not required to be reported, whether Ms. X must report the property when she starts to draw benefits from the fund.

The CRA concludes in the TI that the interest in the fund is considered to be specified foreign property under paragraph (d) of the definition and that none of the exclusions apply. The CRA assumes that the fund is a non-resident trust for Canadian tax purposes and is not deemed to be resident in Canada by subsection 94(3).

According to the CRA, none of the relevant exclusions in paragraphs (l) through (n) in the definition of "specified foreign property" apply. The CRA assumes that section 94.2 does not apply to deem the non-resident trust to be an FA of Ms. X for the purposes of the FA reporting rules in section 233.4. In addition, the CRA notes that the employees' contribution to the fund constitutes consideration to acquire an interest in the fund. Moreover, the CRA notes that the fund does not fit into paragraph (a) or (b) of the definition of exempt trust: it is not a "foreign retirement arrangement," which exempts only certain US IRAs, and it is not a fund that is tax-exempt—the fund is subject to income tax in Australia.

The CRA concludes that if the cost amount of Ms. X's interest in the fund is greater than $100,000, she must report the property on form T1135 whether or not she is drawing benefits from the fund. The CRA says that if the fund is both a pension and an employee benefit plan, the cost amount of the interest is the amount that Ms. X has a legal right to receive from the fund, including amounts to be received in the future.

The CRA further notes that in the unlikely event that it is not possible to determine the cost amount, a taxpayer must make an estimate and be prepared to demonstrate its reasonableness to the CRA.

Georgina Tollstam
KPMG LLP, Toronto

Arranging for Financial Services

The TCC concluded in *Rojas* (2016 TCC 177) that the taxpayer's mortgage-related services were exempt from HST as financial services under ETA subsection 123(1) and not taxable as administrative services provided to a brokerage firm.

The taxpayer was a real estate agent and also assisted clients in obtaining mortgages on the properties that they wanted to purchase. Because she provided mortgage services, Ontario required her to be licensed as a mortgage broker and also to obtain registration under the umbrella of a mortgage brokerage firm.

The taxpayer's mortgage work involved determining the borrowing needs of her client; receiving a written mortgage application from her client; using an online computer program available only to mortgage brokers to determine client qualification and to find willing lenders; explaining available mortgage products to a client working with her brokerage firm in order to obtain a lending commitment from the chosen lender; receiving 75 percent of the commission paid by the lender (the balance was paid to the brokerage firm); and dealing with any subsequent issues between her client and the lender.

On reassessment, the minister said that the taxpayer's mortgage services were in the nature of an administrative service, primarily the collection of information for a mortgage brokerage firm; thus, related commissions that she received were not HST-exempt. On appeal, the taxpayer argued that her services constituted arranging for the lending of money and were thus exempt as a financial service under paragraph (l) of the definition in subsection 123(1).

In the definition of "financial service" in subsection 123(1), paragraphs (a) to (t) fall into two categories: paragraphs (a) to (m) describe supplies that qualify as a financial service, and paragraphs (n) to (t) describe supplies that are excluded from the definition of a financial service. Paragraph (r.4) excludes from the definition of "financial service" a supply that is an administrative service that is either preparatory to a financial service or provided in conjunction with a financial service.

Jurisprudence concerning the definition of "financial service" has established that the assessment of whether a supply is a financial service requires a two-step test: first, determine the essential character of the supply provided (*Great-West Life Assurance Company*, 2015 TCC 225); and, second, determine which paragraph in the definition best describes the supply.

The TCC concluded that the taxpayer (1) provided a single supply and facilitated the entire lending process (the court noted that she was a licensed mortgage broker); (2) determined the borrowing qualification of each affected client; (3) identified lenders and their terms; (4) took steps to obtain lending commitments from the lenders; and (5) completed the lending process by obtaining applicable forms from the borrower and providing them to the lender.

The court concluded in the taxpayer's favour, because an administrative service is excluded from the meaning of "financial service" only if it is preparatory to or in conjunction with the provision of a financial service. Moreover, that administrative service must be supplied separately from a financial service. The taxpayer provided what the court said was a single supply, and therefore her services could not be characterized as merely preparatory to or provided in conjunction with the lending of money. Thus, the exclusion in paragraph (r.4) did not apply. The court emphasized that this conclusion was consistent with that in *Global Cash Access (Canada) Inc.* (2013 FCA 269), which found that the exclusion of an administrative service under paragraph (r.4) did not apply to a single supply of a financial service as described in paragraph (g).

Rojas highlights the court's view that a compound supply is "a supply where there are a number of constituent elements which, if supplied separately, some would have been taxed and some not" (*Great-West Life Assurance Company*, 2015 TCC 225). Thus, the non-essential elements of the supply, its subordinate or ancillary parts, are ignored for the purposes of determining whether the supply is a financial service.

Rojas also deals with the definition of "financial service," which contains inclusionary and exclusionary paragraphs. The case follows previous jurisprudence, interpreting the test implicit in the definition to require a pith and substance analysis to determine the supply's essential character, followed by an assessment of which of paragraphs (a) to (t) best describes the supply. The definition is thus understood as not involving an inclusion step followed by an exclusion step, but rather that inclusion or exclusion is determined in the light of the supply's essential character.

Rojas also concerns the relationship between the inclusionary paragraph (l), which describes as a financial service a supply that arranges for a supply described in paragraphs (a) to (k); and the exclusionary paragraph (r.4), which excludes a service that is preparatory to or in conjunction with a supply described in paragraphs (a) to (m). However, the legislation does not explain how the "arranging for" described in paragraph (l) does or does not fall under the paragraph (r.4) exclusion of a service that is preparatory to a financial service or a service that is provided in conjunction with a financial service.

Kathryn Walker
Millar Kreklewetz LLP, Toronto

September 2016 FA Proposals

The September 16, 2016 draft legislation contains a number of FA proposals that are relieving in nature and for the most part codify Finance comfort letters or CRA administrative positions. This article highlights key changes in the package.

Upstream loans. New subsections 90(6.1) and (6.11) provide a continuity rule for certain upstream loans, to prevent multiple income inclusions under subsection 90(6) or the denial of a deduction under subsection 90(9) or (14). The new rule applies if an amount receivable or payable under a loan is assigned to or assumed by a different entity as a result of an amalgamation, merger, windup, or liquidation and dissolution that involves the creditor or debtor. For example, if an FA creditor is merged or liquidated into another FA or the Canco debtor is amalgamated or liquidated into another Canco, the new creditor or debtor is deemed to be a continuation of the old creditor or debtor for the purposes of the upstream loan rules. The FA-to-FA liquidation or merger was the subject of TI 2013-0499121E5 (November 14, 2013) in which the CRA applied subsection 248(28) to prevent a double income inclusion (see *Canadian Tax Highlights*, "Upstream Loans: CRA Update," December 2013).

The new rule also applies to a situation where a taxpayer that is subject to a subsection 90(6) inclusion ceases to exist or merges into one or more corporations to form a new corporation. For example, assume that Canco 1 wholly owns Canco 2, which wholly owns FA, and that an upstream loan from FA to Canco 1 is included in Canco 2's income: under subsection 90(9), there is no available deduction room for the inclusion. Under current law, if Canco 2 liquidates or amalgamates into Canco 1, no deduction is available to Canco 1 under subsection 90(14) when the loan is subsequently repaid.

It is unclear why Finance did not extend the continuity rule to other common transactions in which a loan receivable is assigned to another FA through, for example, a sale or distribution in kind. Absent a legislative change and the CRA's administrative position, a taxpayer is left to rely on a legal novation when a debt's transfer gives rise to a repayment. The novation may cause a foreign tax issue, and the taxpayer must, in any event, defend against an attack that the repayment is considered to be part of a series of loans or other transactions and repayments.

The new rule applies to transactions that occur on or after September 16, 2016; it may apply as of August 20, 2011 if an election is filed before 2017. A taxpayer who has relied on the CRA's administrative position in TI 2013-0499121E5 should consider filing the election to avoid dealing with an unreceptive auditor.

Stub period FAPI. The July 2013 proposed rules in subsections 91(1.1) to (1.2) are replaced by new subsections 91(1.1) to (1.5). The redrafted proposals address many deficiencies identified in the previous draft proposals. The new draft still uses surplus entitlement percentage (SEP) as a determining factor in the measurement of a taxpayer's dilution when the taxpayer's CFA triggers a stub year-end. Exceptions are available for certain group transactions—for example, if (1) a taxpayer's SEP decrease is offset by an SEP increase for non-arm's-length Cancos, (2) an SEP decrease results from an amalgamation of Cancos, or (3) the total of all of the taxpayer's SEP decreases less the total of all of its SEP increases arising from arm's-length acquisitions in a given year is less than 5 percent.

If the exceptions do not apply, the CFA has a deemed stub year-end in respect of the taxpayer and a corporation or a partnership that is connected to the taxpayer. A corporation is connected if it is non-arm's-length with the taxpayer; a partnership is connected with the taxpayer if it or a non-arm's-length corporation is directly or indirectly a partnership member. This rule prevents the stub period FAPI from being included in the income of a connected person whose SEP in the CFA

has increased. For a non-connected taxpayer (including arm's-length persons) with increased SEP of whom the CFA was an FA before the SEP change, a proposed subsection 91(1.5) election can be made that deems the CFA to have a stub period year-end.

Because the deemed year-end extends only to connected corporations and partnerships, double income inclusion may still arise in certain cases. Assume that a Canco disposes of a CFA to a non-arm's-length Canadian individual who does not own the CFA before the transfer and who continues to own the CFA at the end of its normal year-end. In this case, the stub period FAPI is included twice: in the hands of both the Canco and the individual. Similar anomalies arise if the transferor is another individual instead of a Canco, or if the transferee is a trust, or if a partnership with non-corporate members is involved.

The draft stub period rules are in force on July 12, 2013.

Melanie Huynh
PricewaterhouseCoopers LLP, Toronto

Paul Barnicke
Toronto

Owner-Manager Year-End Tips, Part 1

An owner-manager should start to focus on year-end remuneration strategies. The following items relate to the optimal salary-dividend mix.

- Determine the optimal salary-dividend mix for the owner-manager and family members to minimize overall taxes. Consider their marginal tax rates, the corporation's tax rate, provincial health and/or payroll taxes, RRSP contribution room (in 2016, $144,500 of earned income is required to maximize the 2017 RRSP contribution), CPP contributions, and other deductions and credits (such as donations and child-care expenses). If an owner-manager earns dividends (especially eligible dividends), alternative minimum tax (AMT) exposure may increase.
- Establish the deductibility of salaries and bonuses by ensuring that they are reasonable, and that they either have been paid at the business's year-end or were accrued and properly documented as being legally payable and then paid within 179 days of the business's year-end. Remit appropriate source deductions and payroll taxes on time. It may be beneficial to pay a reasonable salary to a spouse or child who provides services to the business and is in a lower tax bracket; the reasonableness of the salary is generally determined in relation to the value of the services performed. This also allows family members to have earned income for the purposes of CPP, RRSP, and child-care expenses.
- Consider dividend distributions in the following order: (1) eligible dividends that trigger a refundable dividend tax on hand (RDTOH) refund; (2) non-eligible dividends that trigger an RDTOH refund; (3) eligible dividends that do not trigger an RDTOH refund; and (4) non-eligible dividends that do not trigger an RDTOH refund. Depending on the province or territory of residence, the payment of non-taxable capital dividends is the first, second, or third preference. Be aware that distributing dividends that trigger an RDTOH refund will not be a cash-positive transaction if the owner-manager's marginal personal tax rate on the dividend is greater than or equal to the dividend refund rate (38⅓ percent).
- A CCPC can designate and pay eligible dividends only to the extent that it has a positive general rate income pool (GRIP) at the end of the year of payment. Generally, a CCPC's GRIP is the portion of its taxable income that has not benefited from any preferential corporate tax rates: taxable income taxed at small business or investment income rates is excluded. A dividend must be designated as eligible when or before it is paid. A dividend paid and inadvertently designated as eligible (because the CCPC had insufficient GRIP) attracts part III.1 tax to the payer on the excess designation; an election to treat all or part of the excess designation as a separate non-eligible dividend should be considered.
- An owner-manager should consider paying dividends to adult family members who are shareholders in his or her company and in a lower tax bracket. Individuals with no other income can receive up to about $50,000 of eligible dividends (or up to about $30,000 of non-eligible dividends) without triggering any tax, depending on the individual's province or territory of residence and the ability of the company to pay eligible (or non-eligible) dividends.
- An owner-manager in Alberta should consider accelerating discretionary non-eligible dividends to 2016 to take advantage of lower non-eligible dividend tax rates in 2016. This strategy accelerates the payment of tax and may increase an owner-manager's AMT exposure in 2016.
- An owner-manager in New Brunswick should consider: (1) deferring discretionary eligible dividends to 2017 to take advantage of lower eligible dividend tax rates in 2017; and (2) accelerating discretionary non-eligible dividends to 2016 to take advantage of lower non-eligible dividend tax rates in 2016. This strategy may accelerate the payment of tax and may increase an owner-manager's AMT exposure in 2016.
- An owner-manager in Newfoundland and Labrador should ensure that his or her remuneration strategies contemplate Newfoundland and Labrador's (1) personal income tax rate increases at all income levels in 2017 and (2) temporary deficit-reduction levy that is payable by an individual whose taxable income exceeds $50,000, starting July 1, 2016 (the

maximum levy is $900 in 2016 [$1,800 thereafter] if taxable income is $601,000 or more) and that will be phased out over three years starting in 2018. The owner-manager should consider accelerating taxable bonuses and discretionary dividends to 2016 to avoid the higher tax rates after 2016. This strategy accelerates the payment of tax and may increase an owner-manager's AMT exposure in 2016.

- An owner-manager in Nova Scotia should be aware that if the province tables a budget surplus in its 2017-18 fiscal year, in 2017 the province will eliminate the top $150,000 personal tax bracket and 21 percent rate and reinstate the 10 percent surtax on personal provincial income tax that exceeds $10,000. Thus, in the event of a provincial budget surplus next year, an owner-manager should anticipate a potential personal tax rate decrease in 2017 and make appropriate adjustments to his or her strategy for the payment of salary and/or dividends.
- Forgoing bonus payments and/or dividend distributions out of excess cash may create doubt about the status of a CCPC's shares as qualified small business corporation (QSBC) shares: if substantially all of the CCPC's assets are not used in an active business, the shareholder's claim to the $824,176 (indexed after 2016) lifetime capital gains exemption (LCGE) on the sale of the shares is jeopardized. The ratio of a CCPC's redundant or investment assets to total assets should be monitored. The LCGE is $1 million for the disposition of qualified farm or fishing properties.
- Forgoing bonus payments in 2016 may cause a CCPC's taxable income in 2016 to exceed $500,000 on an associated basis, which in 2017 may cause a CCPC's SR & ED investment tax credits (ITCs) to be non-refundable and attract the lower ITC rate. If ITCs are non-refundable, consider other planning to create a federal corporate income tax liability that is sufficient to use those ITCs in 2017.
- If the owner-manager does not need to extract cash, consider whether the retention of income by the corporation ultimately yields a tax saving (or cost) when the after-tax corporate income is paid out as a dividend. Retaining income in the corporation defers tax if the corporation's tax rate is less than the individual shareholder-employee's rate. The table shows (1) the income tax deferral associated with the retention of active business income (ABI) in a corporation that is not paid out as salary to the shareholder-employee, and (2) the tax saving (or cost) when the corporation pays a dividend out of after-tax income (ATI).

Determining the Optimal Salary-Dividend Mix (Based on a December 31, 2016 Year-End and $10,000 ABI)[a]

	Eligible for small business deduction[b]		Not eligible for small business deduction[c]	
	Deferral	Saving/ (cost)	Deferral	Saving/ (cost)
Alberta[d]	3,450	(31)	2,100	(215)
British Columbia	3,470	(63)	2,170	(146)
Manitoba	4,094	nil	2,444	(314)
New Brunswick	3,918	(16)	2,480	35
Newfoundland and Labrador	3,728[e]	107[e]	2,078	(760)
Northwest Territories	3,455	401	2,255	173
Nova Scotia	4,050	(13)	2,300	(569)
Nunavut	3,200	92	1,950	(465)
Ontario[f]				
General	3,942	91	2,792	(100)
M&P	3,942	91	2,942	(9)
Prince Edward Island	3,637	(92)	2,037	(324)
Quebec				
General	3,672	99	2,832	(80)
M & P	4,072[g]	324[g]	2,832	(80)
Saskatchewan				
General	3,550	58	2,100	(114)
M & P	3,550	58	2,300	25
Yukon[h]				
General	3,450	(25)	1,800	63
M & P	3,600	65	3,050	1,003

[a] The individual is assumed to be taxed at the top marginal income tax rate. Only federal, provincial, and territorial income tax; the employer portion of provincial health tax; and the employee portion of payroll tax (for Northwest Territories and Nunavut) are considered. Different results may arise in special circumstances, such as for credit unions.

[b] The federal small business threshold of $500,000 applies in all provinces and territories, except for Manitoba (threshold of $450,000) and Nova Scotia (threshold of $350,000).

[c] When there is no SBD, the after-tax corporate income is assumed to be paid out as an eligible dividend.

[d] For Alberta, the figures in the table assume that the individual is taxed at Alberta's personal income tax rate on income over $300,000. For income over $200,000 and up to and including $300,000, the figures are as follows: Eligible for SBD: deferral 3,350, cost (30); no SBD: deferral 2,000, cost (214).

[e] For Newfoundland and Labrador, the figures assume that the non-eligible dividend is received after June 30, 2016. If the non-eligible dividend is received before July 1, 2016, the figures are as follows: Eligible for SBD: deferral 3,728, saving 168.

[f] For Ontario, the figures in the table assume that the individual is taxed at Ontario's personal income tax rate on income over $220,000. For income over $200,000 and up to and including $220,000, the figures are as follows: Eligible for SBD: deferral 3,789, saving 93; no SBD: general—deferral 2,639, cost (95); M & P—deferral 2,789, cost nil.

[g] For Quebec, the figures in the table assume that the corporation's small business income is eligible for Quebec's M & P rate of 4% for 2016; this is the case if 50% or more

of the corporation's activities are attributable to M & P (based on M & P assets and labour). If this percentage is under 50% and more than 25%, the M & P rate increases proportionately (straight line) from 4% to 8% for 2016.

[h] For Yukon, the figures assume that the individual is taxed at Yukon's personal income tax rate on income over $500,000. For income over $200,000 and up to and including $500,000, the figures are as follows: Eligible for SBD: no M & P—deferral 3,230, cost (23); M & P—deferral 3,380, saving 71. No SBD: general—deferral 1,580, saving 56; M & P—deferral 2,830, saving 1,033. The figures assume that the combined federal/Yukon eligible dividend tax rate is 21.777% (federal of 24.813% plus Yukon of –3.036%), and that the taxpayer has other income that can be sheltered by Yukon's negative eligible dividend tax rate. If the taxpayer has no other income, the combined federal/Yukon eligible dividend tax rate is 24.813% (federal of 24.813% plus nil for Yukon).

Luigi F. De Rose
PricewaterhouseCoopers LLP, Toronto

Giancarlo Di Maio
PricewaterhouseCoopers LLP, Windsor

CRA: Accrued Simple Interest Not Debt for Thin Cap

A TI (2016-0626841E5, March 4, 2016) says that a corporation's accrued simple interest is not included in "outstanding debts to specified non-residents" for the purposes of the thin capitalization rules because the compound interest on the accrued simple interest was not deductible. The compound interest had not been paid and therefore was not deductible under paragraph 20(1)(d).

The thin capitalization rules in subsections 18(4) to (8) generally limit a corporation's deduction for interest paid or payable on outstanding debts to specified non-residents. The deduction for that interest is generally limited if the outstanding debts to specified non-residents exceed a 1.5:1 debt-to-equity ratio. If this ratio is exceeded, some (or all) of the interest paid on the loan is denied as a deduction and is treated instead as a dividend paid to the non-resident. This dividend is subject to Canadian withholding tax.

A corporation's "outstanding debts to specified non-residents" in a taxation year are generally defined to include a debt payable to a specified non-resident shareholder (or to a non-resident person not at arm's length with a specified shareholder) on which interest paid or payable by the corporation is—absent the thin capitalization rules—deductible in the computing of the corporation's income for the year.

A "specified non-resident shareholder" is generally defined as a non-resident that, either alone or with non-arm's-length persons, owns shares of the corporation that have at least 25 percent of the voting rights in the corporation or that have an FMV of at least 25 percent of the FMV of all of the corporation's issued and outstanding shares.

A taxpayer may deduct compound interest in computing its income for a taxation year only if the taxpayer has paid the compound interest in the year (see paragraph 20(1)(d)). This deduction differs from the interest deduction under subparagraph 20(1)(c)(i) that is available for interest paid or payable on borrowed money used for the purpose of earning income from a business or property.

The CRA was presented with a situation in which a Canadian corporation (Canco) has an outstanding interest-bearing loan owing to a specified non-resident shareholder. Simple interest has accrued on the loan, and compound interest has accrued on the balance of the unpaid simple interest. The simple and compound interest balances were unpaid at the end of the taxation year in question.

In the TI, the CRA considers whether Canco's outstanding debts to specified non-residents for the particular taxation year include Canco's liability for the accrued simple interest on the loan. The CRA concludes that, in computing its income for that taxation year, Canco cannot deduct the compound interest on the accrued simple interest because the compound interest remains unpaid at the end of the taxation year. As a result, the accrued simple interest does not meet subsection 18(5)'s definition of "outstanding debts to specified non-residents," and Canco's liability for the accrued simple interest is not an outstanding debt to a non-resident for the particular taxation year.

Marlene Cepparo
KPMG LLP, Toronto

Tax Under Appeal Not Debt in Bankruptcy

Under section 69(1) of the Bankruptcy and Insolvency Act (BIA), all creditors (including the CRA) must stay all recovery activities. Under the BIA, personal tax debts may be released on a bankruptcy discharge. (In contrast, section 523 of the American Bankruptcy Code excepts a tax debt from discharge.) In *Schnier* (2016 ONCA 5), only $71,179.04 of over $4 million assessed was a personal tax debt for bankruptcy discharge purposes. (See "Appeal by an Undischarged Bankrupt," *Canadian Tax Highlights*, September 2015: the TCC dismissed the minister's motion to quash the appeal of the undischarged bankrupt, Schnier [2015 TCC 160].)

Under the BIA, a tax debt may be discharged on a bankruptcy proceeding, but restrictions on discharge apply to a tax-motivated bankruptcy. Section 172.1 governs the discharge proceedings of a bankrupt who has $200,000 or more of personal income tax debt that represents 75 percent or more of the bankrupt's total unsecured proven claims. In a number of respects, a bankruptcy discharge is more difficult to obtain under section 172.1 than it is in a standard bankruptcy:

- In a standard personal bankruptcy, the passage of time may result in automatic discharge, but under section 172.1, a court application must be made.

- In a standard personal bankruptcy, the court may grant an absolute order of discharge, but that order is not available if section 172.1 applies.
- If a court suspends the discharge in a section 172.1 bankruptcy, the bankrupt must monthly file income and expense statements with the trustee.
- A court on a section 172.1 discharge application must take into account (1) the circumstances of the bankrupt at the time the personal income tax debt was incurred; (2) the efforts, if any, made by the bankrupt to pay the personal income tax debt; (3) whether the bankrupt made payments in respect of other debts while failing to make reasonable efforts to pay the personal income tax debt; and (4) the bankrupt's financial prospects.

The restrictive regime in section 172.1 recognizes the important social impact of tax debts. In *Koch* (2012 QCCA 2207), the Quebec Court of Appeal confirmed that section 172.1 was implemented to ensure that personal income tax debtors were discouraged from paying non-government creditors first and thus from treating income tax debt as lower in priority than other debt. Industry Canada set out the rationale for the provision:

> [The new provision] specifies the types of orders that the court may make on the hearing of a bankrupt's application for discharge. The options available to the court include: refusing the discharge; suspending the discharge; requiring the bankrupt to perform any acts, pay any moneys, consent to any judgements or comply with any other terms that the court may direct [subsection 172.1(3)].
>
> Subsection (4) sets out the factors the court shall take into account when making a decision with respect to the bankrupt's discharge. The onus is on the bankrupt to justify the relief requested of the court. . . .
>
> Subsection (8) defines "personal income tax" in the context of the *Income Tax Act* [and] includes [similar tax] under any provincial legislation . . . [and] interest, penalties or fines.

In *Koch*, the QCCA noted that high-tax debtors are ineligible for automatic discharge or for an absolute order of discharge upon application (section 108.1 and subsections 172.1(1) and (4)).

The bankrupt taxpayer in *Schnier* sought exclusion from section 172.1. Mr. Schnier, a tax lawyer, invested in two yacht shelters between 1985 and 1991 and, later, in four computer software shelters; he claimed related interest expense or business losses. Mr. Schnier received opinions from independent lawyers and accountants confirming that the tax shelter deductions were permissible.

Beginning in 1989, Mr. Schnier received reassessments, and he immediately filed objections: they were not dealt with by the CRA for over 20 years although Mr. Schnier repeatedly asked the CRA to do so. In October 2011, the minister confirmed the reassessments for the yacht shelters, assessing $1,278,519.62 in income tax plus penalties and interest, for a total of $4,478,703.19. Appeals were filed forthwith; ultimately, a proposal to Mr. Schnier's creditors under the BIA was rejected by the CRA, his largest creditor, and Mr. Schnier became bankrupt in January 2012.

At issue before the ONCA was whether appealed-from personal income tax was a claim in bankruptcy, making the taxpayer subject to section 172.1. In 2014, the trustee noted in his report that only $71,170.04 of the CRA's claim was included: the remaining $4,424,558.19 was a contingent claim. The trustee's approach would allow Mr. Schnier to seek a bankruptcy discharge under the regular BIA provisions. The court said that

> a creditor's inability to enforce a claim bears directly on the creditor's ability to prove its claim under the *BIA*. In order to be a provable claim within the meaning of *BIA* s. 121, a claim must be one recoverable by legal process . . . . The restraints placed by *ITA* s. 225.1 on the enforceability of an assessed amount of tax that is under appeal are strong indicators that a claim based on those amounts would not be provable in a bankruptcy.

The trustee must consider whether the debt claimed by a creditor is liquidated, future, or contingent. A contingent claim must be determined to be provable, and, if it is found to be so, it is valued under subsection 135(1.1). The SCC in *Newfoundland and Labrador v. AbitibiBowater* (2012 SCC 67) said that a contingent claim can be asserted if it is not "too remote or speculative."

Section 172.1(8) defines a personal income tax debt to mean "the amount payable" under subsection 223(1) of the Income Tax Act. The ONCA concluded that an income tax assessment is deemed to be valid and binding unless it is found otherwise on an appeal. Relying on ITA subsections 152(8) and 248(2), the court said that the minister can compel payment only when the appeal is concluded.

The ONCA contrasted Mr. Schnier's case with that in *Re Norris* (1989 CanLII 4079 (ONCA)), in which no objection was filed; although the trustee did not disagree with the amount proposed by the minister, no final determination was made, and the CRA's claim could not be valued. The court in *Schnier* warned against the potential abuse of the bankruptcy process by the CRA if the minister's argument was accepted: the minister could have sought an adjournment to allow for a decision in the appeal, which would have resolved the contingency and made the claim provable or not. Although the minister is concerned that the government might not be able to go after

The editor of *Canadian Tax Highlights* welcomes submissions of ideas or of written material that has not been published or submitted elsewhere. Please write to Vivien Morgan at vmorgan@ctf.ca.

Published monthly

Canadian Tax Foundation
595 Bay Street, Suite 1200
Toronto, ON M5G 2N5
Telephone: 416-599-0283
Fax: 416-599-9283
Internet: http://www.ctf.ca
ISSN 1496-4422 (Online)

the bankrupt's funds, the court wanted to prevent the CRA from obtaining "an unjustified advantage over other creditors in the bankruptcy proceeding" if the government was allowed to fully claim amounts that had not been proven in the courts.

Sunita Doobay
Taxchambers LLP, Toronto

Darcy MacPherson
University of Manitoba, Winnipeg

©2016, Canadian Tax Foundation. All rights reserved. Permission to reproduce or to copy, in any form or by any means, any part of this publication for distribution must be obtained in writing from Michael Gaughan, Permissions Editor, Canadian Tax Foundation, 595 Bay Street, Suite 1200, Toronto, Ontario M5G 2N5; **e-mail: mgaughan@ctf.ca**.

In publishing *Canadian Tax Highlights*, the Canadian Tax Foundation and Vivien Morgan are not engaged in rendering any professional service or advice. The comments presented herein represent the opinions of the individual writers and are not necessarily endorsed by the Canadian Tax Foundation or its members. Readers are urged to consult their professional advisers before taking any action on the basis of information in this publication.