# TAX FOR THE Owner-Manager

Editor: Thomas E. McDonnell, QC

Introductory Issue, October 2000

## A Note from the Editor

This is the introductory issue of *Tax for the Owner-Manager*, a quarterly newsletter aimed at owner-managers of private corporations and their advisers. Contributors from across Canada will report on tax developments (legislative, administrative, and judicial) of interest to readers, and on the accompanying planning traps and opportunities.

As business people and practitioners, we are often confronted with quirks in assessing practice or with the unexpected application of a court case or a legislative change. *Tax for the Owner-Manager* alerts readers to developments that might otherwise be overlooked. I encourage all of you to exchange views and information on the topics discussed in this newsletter. Post your comments, suggestions, and feedback on the Canadian Tax Foundation's "Talk Tax" message board at http://www.ctf.ca, or e-mail me directly at tmcdon@pathcom.com.

*Thomas E. McDonnell*
Editor

## Getting EnABILed

One practical disincentive to investing in a startup enterprise is the possibility that the business will fail. The deduction for an allowable business investment loss (ABIL) may provide some tax relief in the event of a failure, but the rules are technical and the CCRA often takes a restrictive approach in applying them.

An ABIL is triggered by the actual or deemed disposition of shares of a corporation, provided that the corporation qualified as a small business corporation (SBC) at any time in the 12-month period ending on the date of disposition. The rules in subsection 50(1) set out the conditions that must be met for a deemed disposition to occur. Generally, the SBC must be bankrupt or insolvent. In the case of an insolvency, additional tests apply: (1) the SBC must not be carrying on business; (2) it must be reasonable to expect that the SBC will be dissolved and will not commence to carry on any business; (3) the taxpayer must own the shares at the end of the taxation year; and (4) the shares must have no value. Slightly different rules apply to an investment in the form of debt. All technical requirements must be met if the ABIL is to be allowed.

Three recent cases highlight some of the issues that can arise in claiming an ABIL. In *Allen* (TCC 2000), the taxpayers made substantial cash advances to their company, which subsequently became insolvent. The TCC confirmed that an ABIL can be claimed only in respect of a debt incurred to earn income. The CCRA argued that there was no reasonable expectation of profit for the business and that therefore the debt did not meet this requirement. The record keeping was poor, and there was some evidence that personal and corporate funds were intermingled. The TCC accepted the taxpayers' assertion that they intended to carry on a business, and their accountant's explanation regarding the lack of records. The appeal was allowed.

In *Johnston* (TCC 2000), one issue was whether the company was carrying on an active business (another precondition to claiming an ABIL). After hearing the evidence, the TCC held that although the corporation was engaged in defrauding third parties, it was nonetheless carrying on a business; the criminal nature of that business did not prevent the investor from claiming his ABIL.

In *Turner* (FCA 2000), the issue was the year in which the ABIL should have been claimed. The taxpayer owned shares in an SBC that ceased to do business in 1984 because its licence to operate was revoked. The licence was subsequently restored in 1985, and the corporation was wound up in 1994. The FCA held that the revocation of the licence in 1984 did not necessarily mean that the ABIL arose in that year, as the CCRA had argued successfully in the TCC. It was also necessary that the SBC be dissolved and never carry on business in the future. The taxpayer was allowed to claim the ABIL in a subsequent year, when those conditions were satisfied.

The ability to deduct an ABIL is an important incentive designed to encourage investments in SBCs. To take full advantage of the available deduction, it is important to be aware of the rules. Keeping appropriate

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records of the investment will go a long way in persuading the CCRA to accept the claim if the investment goes bad.

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## A Reasonable Bonus

Whether the amount of a bonus paid to a shareholder is reasonable is a question of fact. As a matter of administrative practice, the CCRA does not challenge the reasonableness of salaries and bonuses paid out of active business income to resident principal shareholder-managers of a corporation when (1) the general practice of the corporation is to distribute the profits of the company to its shareholder-managers in the form of bonuses or additional salaries, or (2) the corporation has a policy of declaring bonuses to shareholders to remunerate them for the profits earned that are attributable to their special knowhow, connections, or entrepreneurial skills.

In a recent technical interpretation (no. 2000-0013085, "Reasonableness of Manager Bonuses," April 10, 2000), the CCRA states that its general policy does not apply to a bonus paid to a corporate rather than an individual shareholder. To be deductible, such bonuses must meet the reasonableness test: what would an arm's-length person in similar circumstances pay for similar services?

The example given in the technical interpretation deals with a CCPC that was ultimately controlled by three individuals. Two of them (A and B) held their shares through holdcos and family trusts. Each holdco was paid a bonus equal to the respective family's equity in the CCPC.

The CCRA said that because A and B were not principal shareholder-managers, the bonuses paid to A and B were subject to the normal test of reasonableness. This involved a consideration of the duties performed by each individual and the time spent in carrying out those duties. The CCRA suggested that the amounts of the bonuses should be compared with the remuneration paid to employees who performed similar services for corporations of similar size engaged in similar businesses in similar circumstances.

The CCRA does not say why a direct shareholding is a prerequisite to the application of its general policy regarding bonuses. Presumably it is concerned with the opportunity for income splitting where the recipient is a corporation. Because the non-deductibility of a bonus can result in double or triple taxation, it is important to be aware of CCRA policy when considering the payment of bonuses to corporate shareholders.

The CCRA has said elsewhere that where a holdco is interposed between an individual and an opco, management fees paid by the opco to the holdco must be reasonable in the context of the services rendered by the holdco through its employees.

These administrative positions should be considered in light of the recent decision in *Safety Boss Ltd.* (TCC 2000). This case involved the payment of large bonuses to a non-resident individual shareholder and to a non-resident holdco owned by him. The minister reassessed the payer corporation on the grounds that the large bonuses were not reasonable. The TCC ruled that they were reasonable owing to the special knowhow, expertise, and reputation of the individual. Effectively, all of the opco's earnings were attributable to his efforts.

The Income Tax Rulings and Interpretations Directorate has confirmed in a discussion that the CCRA still applies its historic policy of not challenging bonuses paid out of active business income to individual shareholder-managers who are resident in Canada. In other situations, however, taxpayers may expect the CCRA to review the deductibility of substantial bonuses based on the reasonableness test. Care should be exercised in bonusing large amounts to a holdco to reduce an opco's income to the business limit.

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## Estate Freeze Chilled

Advisers involved in estate freezes should pay close attention to the decision in *Romkey* (FCA 1999), which may have extended the reasoning in *Kieboom* (FCA 1992) with respect to the meaning of "a transfer of property."

In *Kieboom*, additional common shares were issued to new shareholders at a time when the common shares had substantial value. This gave the new shareholders instant value. In *Romkey*, there was a reorganization of capital of an inactive business at a time when the business had no value. Before the reorganization, two brothers owned the only shares (common) in the company. After the change, their common shares became voting class A shares with no fixed dividend entitlement. Non-voting class B participating shares were issued to family members, including trusts for minor children of the brothers. It was established that neither class of shares had any material value at the issue date. Nevertheless, the FCA, affirming the decision of the TCC, held that by issuing class B shares the taxpayers effectively forwent the right to receive future dividends, and that this resulted in a "transfer of property" to which subsection 74.1(2) applied.

This decision raises serious questions about the efficacy of garden-variety estate freezes. If the old shares have a dividend entitlement, for example, must the freeze shares also be entitled to dividends to avoid attribution? Generally, advisers have focused on a dividend entitlement to ensure that the freeze shares are worth the full value of the old shares on the implementation date. One reading of this decision is that it is necessary to go further and ask whether any change in a dividend entitlement constitutes a transfer in and of itself, regardless of the amount paid for the new shares.

If the reasoning in *Romkey* is generally applicable, estate freezes not otherwise within the technical application of the attribution rules can nonetheless be challenged on the basis of an alleged change of "economic interest" with respect to future income entitlements. It is arguable that the decision does not go this far and should be limited to its specific facts. Note especially that the court was not satisfied that the trusts acquired their shares with their own funds. As well, dividends paid to the trusts and allocated to the minor beneficiaries were immediately paid into the bank accounts of the children's parents and mingled with their personal funds.

The idea that any change in economic interest results in a transfer of property goes well beyond the existing jurisprudence. Until now, a transfer was thought to involve a giving up of an existing right, not the surrender of some future (and perhaps indefinite) interest. This view prevailed in *Shepp* (TCC 1999), but that decision may now be in doubt in light of *Romkey.*

It is to be hoped that *Romkey* will prove distinguishable on its facts. In the FCA, the minister conceded that if the taxpayers had established that the shares had been fully paid for, subsection 74.1(2) would not apply because no "property" would have been "transferred" to the trusts. This suggests that *Romkey* should not be of general application. Nonetheless, careful planners will note again the absolute importance of effective implementation when executing a tax-planning transaction.

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## Matters of Interest: 1

An individual with income-producing assets and personal-use debt may take steps to make the interest on the debt deductible. The conflicting case law raises questions about the sort of planning that will be effective here. The SCC's recent decision to hear appeals of two cases that touch on interest deductibility raises hope that the uncertainty is about to be resolved. In the meantime, planners should be careful to avoid obvious pitfalls in restructuring assets to create tax-deductible interest.

Conventional wisdom suggests that the individual sell the income-producing assets and use the proceeds to pay down the personal-use debt. The personal-use property (a home, say) can then be remortgaged and the proceeds used to replace the income-producing assets. In theory, the borrowed money is now used to earn income and the interest on the debt is therefore deductible. The CCRA has taken two approaches in challenging the interest deduction in such cases.

The first is based on a passage in *Bronfman Trust* (SCC 1987), which seems to say that the restructuring is to be disregarded as a sham. This was the CCRA's approach in *Singleton* (FCA 1999), where a partner drew down his capital in a law firm to acquire a home. He immediately borrowed against the property to recontribute capital to the firm. The FCA rejected the "sham" argument: it said that each step in the planning was to be viewed independently and accepted if legally implemented. The purpose of the restructuring—to create deductible interest—was irrelevant; what mattered was the actual use of the borrowed funds. In *Ludmer* (FCA 1999), the taxpayer borrowed to invest in participating shares of a foreign corporation. The FCA agreed with the minister's argument that the real purpose of the borrowing was to make a capital gain on the redemption of the shares, not to earn dividend income. This was not an eligible use for paragraph 20(1)(c) purposes, and the interest was not deductible. In April 2000, the SCC granted leave to appeal in both cases.

The CCRA's second line of attack is also based on the direct use requirement. A taxpayer with income-producing assets borrows against them and uses the proceeds for a non-qualifying use. The interest is deducted on the basis that the borrowing preserves the income-producing base. This is what happened in *Meggitt* (TCC 1999) and *Cascone* (TCC 1999). In both cases, the court upheld assessments disallowing the interest deduction.

It is hard to argue with the minister's position when the borrowed funds are not used directly for an income-producing purpose, as required by paragraph 20(1)(c).

Readers are invited to submit ideas or written material to *Tax for the Owner-Manager*. Please write to Thomas E. McDonnell in care of the Canadian Tax Foundation.

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Taxpayers who ignore this reality should expect to be reassessed. It may be inconvenient to sell the income-producing asset and then borrow to replace it, but this is an essential element of the planning. Equally important, all steps must be fully documented and legally effective.

This leaves open the possible application of the "sham" doctrine. It may not be too much to expect that the SCC will affirm the FCA's decision in *Singleton* and hold that the doctrine has no application to cases of this kind. But until the appeals in *Singleton* and *Ludmer* are heard, careful planners will continue to caution clients about a possible challenge to a restructuring of assets for interest-deductibility purposes, even where all the steps are properly implemented.

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## Matters of Interest: 2

Generally, when a person transfers income-producing property to a spouse, income from the property remains taxable in the hands of the transferor. In defined circumstances (generally, a sale for fair market value under section 74.5), income from the transferred property is not attributed to the transferor.

Interest paid on money borrowed to acquire income-producing property is generally deductible. Suppose that a person borrows money to acquire shares in circumstances in which the interest on the money borrowed is deductible. If the shares are subsequently gifted to the person's spouse, dividends on the shares are taxable in the hands of the transferor. Does it follow that the transferor may continue to deduct the interest expense on the borrowed money?

Not necessarily, according to CCRA Opinion no. 2000-0005125, "Interest Expense Attribution," May 16, 2000. The right to deduct the interest is governed by the general rule in paragraph 20(1)(c). One condition is that the taxpayer use the borrowed money for the purpose of earning income in the year. Once the shares are gifted, the transferor no longer owns property in respect of which the deduction may be claimed. Notwithstanding that the transferor remains liable for tax on the income from the property by reason of the attribution rules, he no longer owns property that meets the "used to earn income" test.

There is no obvious way to avoid this result. The opinion notes that in certain circumstances section 20.1 may allow the transferor of property acquired with borrowed funds to continue to deduct interest on the money borrowed to make the initial investment following a disposition of the property. The key requirement is that the taxpayer dispose of the shares for proceeds not less than their fair market value at the time of transfer. Thus, where an investment has declined in value and is sold at the then fair market value, the taxpayer may continue to deduct the interest until the loan is repaid.

In the situation discussed in the CCRA opinion, the taxpayer gifted the shares to his spouse. Assuming that the shares were worth something more than the transferor's original cost on the transfer date, unless the parties elect out of section 73, the transfer is deemed to take place at the transferor's ACB of the shares. This deemed transfer price effectively denies the transferor the benefits of section 20.1.

If the spouses elect out of section 73 to take advantage of section 20.1, the transferor is deemed to receive proceeds equal to FMV on the transfer date. Although making the election would ensure the transferor's right to a continued interest deduction, it comes at the cost of recognizing a gain on the transfer. The facts of the individual case will dictate whether it is worth paying tax on the gain to preserve the right to the interest deduction. Even assuming that the shares are likely to appreciate in value in the hands of the transferee spouse, the transferor is taxed on any capital gain subsequently realized by the transferee. Consider whether it might be attractive in some circumstances to have the transferee spouse purchase the shares at FMV in consideration of a promissory note payable when the shares are subsequently sold. In such a case, the interest payment requirements of subparagraph 74.5(1)(b)(i) must be met in order to avoid attribution on the subsequent sale.

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