T A X FOR THE Owner-Manager

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Kiddie Tax: The Income-Splitting Dance

With the introduction of the "kiddie tax" rules in section 120.4, effective for taxation years after 1999, many practitioners are searching for ways to continue to use family trusts to flow amounts out to family members for expenditures such as private school tuition fees. While there still may be some small benefit in certain provinces, such as British Columbia, in continuing to run dividends through the trust, the big tax savings of pre-2000 taxation year dividends are now just a fond memory.

There are many ways to nibble around the edge of the meaning of "split income," but one interesting possibility has nothing to do with "split income" as such. Because capital gains are not included in the definition of "split income," a plan that creates capital gains in a trust is arguably very attractive. The following is one such plan that, subject to various attacks under anti-avoidance provisions, appears to accomplish this result.

■ **Step 1:** A family company pays a stock dividend to a trust. The stock dividend share is a preferred share with $0.01 paid-up capital and a redemption amount of $500.00. (Check the applicable corporate law to ensure that high-low shares may be created.) The "amount" of the stock dividend, as defined in subsection 248(1), is the increase in paid-up capital of the share. Therefore, only $0.01 is subject to the application of section 120.4. Pursuant to subsection 52(3), the cost of the preferred share to the trust is also $0.01.

■ **Step 2:** The trust enters into an agreement to sell the preferred share to an individual at its $500.00 redemption price. This sale should trigger a $499.99 capital gain to the trust. The gain is allocated among the beneficiaries to utilize their low marginal rates of tax.

■ **Step 3:** The individual who purchased the preferred share enters into an agreement to sell the preferred share to a corporation for $500.00 cash. Generally, the transferee corporation will be "connected," as that term is defined in subsection 186(4), with the corporation that paid the stock dividend. The individual transferor will have proceeds and an adjusted cost base (ACB) of $500.00 with respect to the preferred share, so no gain or loss will result. Assuming that a connected corporation is used, section 84.1 will apply to this transaction. However, the ACB adjustments in subsection 84.1(2) should not apply to reduce the transferor's ACB from the $500.00 amount.

■ **Step 4:** Finally, the corporation paying the stock dividend redeems the share, the corporate recipient pays $500.00 to the individual, and the individual pays $500.00 to the trust where it is available to be distributed to, or on behalf of, the beneficiaries.

This series of transactions presents three primary risks.

First, if the trust holds one of a number of classes of shares in the company, as in a traditional dividend-sprinkling structure, the potential application of subsection 15(1.1) has to be considered. While commentary on *Wu* (FCA 1998), the leading decision in this area, is somewhat mixed as to how this section should be interpreted, clearly the CCRA could attempt to apply subsection 15(1.1) to the receipt of the stock dividend by the trust so that the whole $500.00, rather than just $0.01, is treated as a dividend.

Second, this type of planning could be subject to attack under the general anti-avoidance rule in subsection 245(2). The CCRA might argue that the planning creates a misuse of certain provisions or is an abuse of the Act read as a whole.

In This Issue

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Finally, practitioners must remember that when section 120.4 was introduced, the Department of Finance indicated that the initial legislation was narrowly drafted (in the department's view) and that appropriate action would be taken if new income-splitting techniques were developed to avoid its application.

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What Time Is It? SIDT

The definition of "safe-income determination time" (SIDT) was introduced in 1998, applicable to dividends received after June 20, 1996. Originally, subsection 55(2) referred to the time "before the dividend was received" as the cutoff point for the calculation of safe income (SI). In the early 1980s, administrative practice evolved to prevent income earned or realized before the payment of a dividend, but after the transaction or event or commencement of the series, from being included in the SI calculation, even though that income might have contributed to the gain realized on the shares. This took account of earn-out clauses and participating preferred shares issued by an acquiror, the value of which depended on future earnings. Hence, such future earnings could comprise SI with respect to the preferred shares at the time they were redeemed. Finance introduced the new definition to clarify and refine the cutoff point for the SI calculation and to make the calculation fairer.

Recent administrative developments are beginning to limit the scope of the SIDT definition and raise important interpretive and policy issues with respect to the wording of the definition. In a ruling released on September 1, 2000 (2000-0003253), the CCRA stated that the definition in subsection 55(1) contemplates only one SIDT for the entire series of transactions. The CCRA was dealing with the question whether each of several dividend recipients could have a different SIDT for the purposes of subsection 55(2) where the proposed dividend payments to each recipient were part of the same series that included the proposed transactions. Although the CCRA's position confirms a previous position and appears to be supported by the literal wording of the definition of SIDT, this strict interpretation of the definition hardly meets the underlying policy objective of subsection 55(2), which is intended to apply on a recipient-by-recipient basis.

The CCRA is quietly restoring a more restrictive approach to the calculation of SI, which could have inappropriate results. Indeed, stopping the calculation of SI for a particular shareholder would do the same for other shareholders even if they were unaware of the particular shareholder's fact-specific situation or tax-planning transactions. Practitioners should be aware of this, and should be especially vigilant when implementing any pre-sale planning steps involving SI. In particular, caution is required if a sale occurs when Opco is generating significant amounts of income. If the SIDT is triggered for one shareholder, it will stop the SI calculation for other shareholders, which may undermine the commercial viability of the sale.

Consider an example. Holdco A and Holdco B own 60 percent and 40 percent, respectively, of all the outstanding shares of Opco. Holdco A wishes to effect a dropdown of Opco's net assets, at fair market value, to a Newco. It is proposed that Opco will pay dividends out of the proceeds of the fair market sale. Because Holdco B is unrelated to Newco, the disposition by Opco to Newco of its net assets will trigger the SIDT and thus prevent both holding corporations from treating the dividends as having been paid out of SI simply because Holdco B and Newco are unrelated persons for the purposes of subparagraphs 55(3)(a)(i) and (ii).

Such a result seems inappropriate. While the CCRA may be applying the Act in a technically correct way, it is not applying a balanced interpretation that offsets the risks of potential abuse with the need for fairness among taxpayers. The balancing of these risks and benefits should be part of the SI determination process. Is Finance ready to make amendments?

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Subsection 18(2): Easily Overlooked

Subsection 18(2) limits the deduction of expenses for interest and property tax payable in respect of vacant land to the amount of the taxpayer's income from the land and, if the corporation is a principal-business real property corporation, the corporation's "base level deduction" (BLD) for the year. The BLD is defined in subsection 18(2.2) as $1,000,000 times the prescribed rate (subject to the associated-corporation rules). No BLD is available for partnerships. Similar rules apply under subsection 18(3.1) in relation to construction-period soft costs for non-principal-business corporations.

Because principal-business corporations obtain some relief from the rules under the BLD, the potential application of the interest-limitation rules is potentially of more concern to ordinary businesses that acquire land than to real estate businesses.

No doubt most practitioners are aware that these rules apply when a client arranges a financing specifically to acquire vacant land. However, consider the implications of borrowing for general corporate purposes, not for the acquisition of vacant land. If a business acquires vacant land during the year and at the same time incurs general purpose debt, is there a subsection 18(2) issue?

The question arises because of the expansive definition of "interest on debt relating to the acquisition of land" in paragraph 18(3)(a), which includes "interest . . . that cannot be identified with particular land but that may nonetheless reasonably be considered (having regard to all the circumstances) as interest on borrowed money used in respect of or for the acquisition of land." Similar language is used in subsection 18(3.2) relating to soft costs associated with a building during the construction period.

The 1982 explanatory notes to subsection 18(3.2) state that "where a corporation uses available cash to fund the construction of a building and borrows money to finance its trade receivables, a portion of the interest paid in respect of the money borrowed would fall within . . . [paragraph 18(3.2)(a)]." Paragraph (b) in both subsections traces money borrowed to lend (1) to a non-arm's-length person, (2) to a corporation of which the taxpayer is a specified shareholder, or (3) to a partnership of which the taxpayer is a specified member to its ultimate use for acquiring land or constructing a building. Some commentary suggests that paragraph (a) of each provision applies where the same taxpayer does the borrowing and uses the funds, while paragraph (b) applies where one taxpayer does the borrowing but another uses the funds (for example, a subsidiary: see *Anstel Holdings* (TCC 1991)). However, it is not clear from the wording of the provisions that they are meant to be mutually exclusive. For example, if a parent company borrows money and makes a loan to its subsidiary to finance its trade receivables and at the same time the subsidiary acquires vacant land for cash, is the parent's interest deductible?

The jurisprudence to date has not dealt with any of these borderline issues under the current legislation (the previous version of subsection 18(2) applied to land held on capital account). IT-153R3 takes a familiar interpretive stance, indicating that "the relationship between the borrowing of funds and the acquisition of land is a question of fact to be determined from the circumstances of each particular case." Consequently, it is not clear how far the CCRA will go with these rules in any particular case. What is clear is the desirability of keeping vacant land and debt as far apart as possible.

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Interest Deductible Notwithstanding Form of Contract

An interest expense incurred on money borrowed to earn income is deductible under paragraph 20(1)(c). In *Shell* (SCC 1999), the Supreme Court held that amounts specified to be payments of interest in enforceable legal contracts were to be taxed as such, notwithstanding that in terms of economic substance part of the payments could be regarded as being on account of principal. In the recent decision of the Cour du Québec in *Vanier* (Que. Ct. 2000), the court looked through the legal form of a contract that provided for a series of monthly payments described as an annuity and allowed the taxpayer to deduct a portion of each payment as interest. The issue was decided under the Quebec Taxation Act.

In 1987, Mr. Vanier contracted to buy a parcel of land from his father for use in his business. The purchase price was $538,000, the fair market value (FMV) of the property. The son made an initial payment of $1 and agreed to make monthly payments of $2,000 for 25 years, to a total of $600,000. The difference between the $600,000 and the FMV ($62,000) was considered by the parties to be interest. However, in his tax return for 1990 the father included an amount of $21,090 as interest from Canadian sources. This sum was paid by the son in addition to his $2,000 monthly payments in order to reflect the interest rates prevailing at that time (between 9 and 12 percent), since the $62,000 was not sufficient to cover the interest on the $538,000 value of the land. The son deducted the same amount for the same reason. Revenue Quebec rejected the deduction on the grounds that the contract between the parties was not a loan and did not create a legal obligation to pay interest.

The Quebec court stated that a taxpayer may deduct an amount as interest in two circumstances: (1) where a "reasonable amount" is actually paid as interest in the year, and (2) where an amount paid is not specified to be interest, but should be regarded as on account of interest. The court ruled that a "reasonable amount" was to be considered from the point of view of the payee. When a person reasonably considers an amount received to be interest and includes it in income, the amount should also be regarded as interest paid by the payer and deductible by him in computing income.

Revenue Quebec argued that in this case there was no obligation to pay interest, but rather an obligation to pay an annuity in return for the transfer of the land for $1. This argument was rejected. The ruling is interesting because it recharacterizes the contract in favour of the taxpayer. (Contrast *Shell* in this regard.) The court stated that the son's obligation included an obligation to pay interest, even though the contract did not expressly provide for it. This was a contract of sale on deferred payment terms, not a contract for the purchase of an annuity. The court concluded that the fact that the size of a payment may vary depending upon circumstances (interest rates or even conditions in the contract) does not in itself change the character of the payment as interest, even though those circumstances may affect the amount of interest, as here. The amount is considered interest so long as it is reasonable.

An interesting feature of this case is the fact that it was the taxpayer, not the fisc, who asserted that the payments included an interest component. Usually it is the taxation authority that looks through the form to identify, and tax, an amount as interest. (See section 120 of the Quebec Taxation Act and subsection 16(1) of the Income Tax Act.)

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Employee Versus Independent Contractor

The characterization of a person as an employee or as an independent contractor has many tax implications. In *Wiebe Door* (FCA 1987), the court established four criteria for determining the existence of an employment relationship:

- To what extent does the "employer" control the "employee"? Generally, an employer has the right to determine how an employee performs a task, whereas an independent contractor undertakes to produce a specified result and determines the manner of carrying out the work.
- An independent contractor generally supplies his or her own tools.
- From the perspective of the "employee," is the "employee" integrated into the "employer's" business?
- Does the "employee" have an opportunity for profit and a risk of loss?

In applying the criteria, the courts will examine the *extent* to which these tests have been met. One or more factors may be present, but only in a superficial way; the mere existence of a factor is not determinative.

Two recent cases involving commissioned salespersons highlight the fact that even in cases with similar facts, the weight given to one or another of the criteria can lead to different results.

In *Klassen* (TCC 2000), a commissioned salesman was held to be an independent contractor. The court observed that Klassen's "employer" did not pay him wages, did not provide support services other than voice mail, did not provide an office, and did not pay any of his expenses. The court further observed that Klassen set his own hours and, when travelling on business, stayed where he wanted to.

In *O'Brien* (TCC 2001), the court found that a commissioned salesman was an employee. O'Brien worked for two corporations of which he was the president and a shareholder. He provided executive services to both companies without compensation but earned commissions on sales he made. He was required to pay all related expenses such as advertising, promotion, and cell phone costs. The court gave little weight to the fact that O'Brien set his own schedule and supplied his own tools—a car, a cell phone, and a home office. The degree to which he was integrated into the "employer's" enterprise was the decisive factor.

The employee-independent contractor distinction is also important in determining whether a corporation is carrying on a "personal services business" (PSB). A PSB is not eligible for the small business deduction, is restricted in its expense deductions, and cannot deduct remuneration accrued in favour of the owner-manager.

A PSB is defined in subsection 125(7) to mean a business carried on by a corporation where an individual (or a related person) who performs services on behalf of the service corporation is a "specified shareholder" (generally, a person who owns more than 10 percent of the shares of any class of the corporation) and would reasonably be regarded as an employee of the entity to which the services are provided if the service corporation did not exist. The *Wiebe Door* tests can be applied to determine whether the specified shareholder should be regarded as an employee, subject to two statutory exceptions. The service corporation is exempt from these rules if it employs more than five full-time employees in the service business throughout the year, or if it receives the service fee from an associated corporation.

In *Healy Financial Corporation* (TCC 1994), the court held that the service company was not earning PSB income even though Healy, the shareholder, was the president and a director (and therefore an employee) of the corporation that was the recipient of the services. The service corporation was involved in several other ventures. Healy was apparently not involved in the day-to-day operations of the recipient corporation and had no offices on its premises. The court felt that the services provided were not those that would have been provided by an employee.

In a number of cases a corporation has been held to be carrying on a PSB. Each case is decided on its own particular facts. *Crestglen* (TCC 1993) is an example of a winner; *Placements Marcel Lapointe* (TCC 1993) is an example of a loser.

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Rollover for Eligible SBC Shares

In his 2000 federal budget, the minister of finance proposed new rollover rules for investors in qualifying small business corporation shares. The incentive is designed to encourage venture capital investment in high-tech company shares, but is not specifically limited to such shares. Draft legislation was released on December 21, 2000; this article is based on that draft.

The new rules will add section 44.1 to the Act. Essentially, they will allow an individual (other than a trust) to defer the capital gain arising on qualifying sales of eligible small business corporation shares (ESBCSs) where the sale proceeds are reinvested in other ESBCSs within a specified time. There is a deferral limit of $2 million, based on a formula that takes account of the ACB of the original shares and the amount of the reinvested proceeds. The amount of the deferred gain reduces the ACB of the new shares.

For shares to qualify as ESBCSs, the following tests must be met: (1) The shares must be common shares, acquired from treasury or from certain related individuals. (2) At the time the shares are issued, the corporation must be an eligible small business corporation (ESBC)—that is, a Canadian-controlled private corporation, all or substantially all of the assets of which (measured by fair market value) are used in an active business carried on primarily in Canada, and/or shares or debt of other related ESBCs. (3) The total carrying value of the assets of the corporation and related corporations immediately before and immediately after the issuance of the shares must not exceed $50 million.

Professional corporations, specified financial institutions, and real estate corporations are excluded, as is any corporation where real estate represents more than 50 percent of total asset value.

Two further tests apply when the ESBCSs are sold: (1) The shares must have been owned by the individual for at least 185 days prior to the sale. (2) Throughout the time the individual owned the shares, the corporation must have been an active business corporation. To qualify as such, it must have continuously met the tests for an ESBC, with only two exceptions: it is not necessary that it remain private, and the requirement to carry on business primarily in Canada is lifted, in effect, after two years.

As indicated above, these new rules are intended generally to spark new investment in high-tech companies. The rollover qualifications are likely to make it difficult for the typical owner-manager to take advantage of the deferral on the sale of an established business. For example, an individual must establish that while the shares were owned, they qualified as shares of an active business corporation. This will require going back through the entire history of the corporation from the time the shares were acquired to ensure that it has met the "all or substantially all" test throughout the ownership period. Contrast this restriction with that of the capital gains exemption, which specifies only a 50 percent asset test for the 24-month period prior to the sale of shares. Furthermore, any business that owns real estate (a manufacturing enterprise, for example) must establish that the value of its land and building did not represent more than 50 percent of the total asset value at any time throughout the period.

For the fortunate owner-manager who happens to fit the criteria, sales and reinvestments do not have to meet any arm's-length standard. This allows for valuable planning strategies that should not be overlooked. For example, an individual with two existing businesses can sell one and reinvest the proceeds in the other, thereby benefiting from the deferral.

The new rules are complicated, and the range of planning opportunities and pitfalls is not immediately obvious. Careful study will be required to take maximum advantage of this new rollover.

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Capital Gains and Losses in the Year of Death

Subsection 111(2) allows the estate of a deceased individual to deduct net capital losses against other income in the year of death and the immediately preceding year. This deduction is reduced if there are taxable capital gains in the year and if a capital gains deduction has been claimed in prior years under section 110.6. The changes in the capital gains inclusion rate from 75 percent to 66⅔ percent to 50 percent, and the corresponding changes in the capital gains deduction from $375,000 to $333,333 to $250,000, may produce unexpected results in the terminal return.

If the inclusion rate for the net capital losses is the same as the rate for the capital gains deduction, the system seems to work equitably (see example 1 below). However, if the inclusion rate for the net capital losses is greater than the rate for the capital gains deduction, an additional deduction is available on the terminal return (example 2). If the inclusion rate for the net capital losses is less than the rate for the capital gains deduction, there should be no additional deduction available on the terminal return (example 3).

Note that a similar analysis applies if the estate has net capital losses in its first year which are carried back to the terminal year under subsection 164(6).

Example 1

The inclusion rate for net capital losses is 75 percent; the inclusion rate for the capital gains deduction is 75 percent. Assume that the individual dies in 2002. Net capital losses of $75,000 (on a capital loss of $100,000) arose when the inclusion rate was 75 percent. No capital gains were realized in the year of death or in the previous year. A capital gains deduction of $75,000 (on a capital gain of $100,000) was claimed when the inclusion rate was 75 percent.

Net capital losses	$75,000
Less: Capital gains deduction	(75,000)
Available to claim against other income	$ 0

Example 2

The inclusion rate for net capital losses is 75 percent; the inclusion rate for the capital gains deduction is 50 percent. Assume that the individual dies in 2002. Net capital losses of $75,000 (on a capital loss of $100,000) arose when the inclusion rate was 75 percent. No capital gains were realized in the year of death or in the previous year. A capital gains deduction of $50,000 (on a capital gain of $100,000) was claimed when the inclusion rate was 50 percent.

Net capital losses	$75,000
Less: Capital gains deduction	(50,000)
Available to claim against other income	$25,000

The change in the capital gains inclusion rate results in a $25,000 deduction against other income even though the capital gain and the capital losses are both $100,000.

EXAMPLE 3

The inclusion rate for net capital losses is 50 percent; the inclusion rate for the capital gains deduction is 75 percent. Assume that the individual dies in 2002. Net capital losses of $50,000 (on a capital loss of $100,000) arose when the inclusion rate was 50 percent. No capital gains were realized in the year of death or in the previous year. A capital gains deduction of $75,000 (on a capital gain of $100,000) was claimed when the inclusion rate was 75 percent.

Net capital losses	$50,000
Less: Capital gains deduction	(75,000)
Available to claim against other income	$ 0

The larger capital gains deduction will merely offset the net capital losses. The excess will not offset other income.

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SECTION 85 ROLLOVER: THE CCRA RECONSIDERS "CONSIDERATION"

At the Canadian Tax Foundation's 2000 Annual Conference, the CCRA announced a change in its position on paragraph 85(1)(b). Previously, the CCRA did not consider that paragraph to apply to a transfer of property with liabilities in excess of cost amount where the excess was assumed by the purchaser in consideration for the delivery by the vendor of a promissory note. The CCRA now considers that paragraph 85(1)(b) will apply to increase the agreed amount by the amount of the excess.

In the CCRA's example, Sellco has capital property with a mortgage in excess of cost. Sellco transfers the property to Buyco pursuant to section 85 (electing at cost) and issues Buyco a note for the excess mortgage. Buyco assumes liabilities up to the cost of the property, issues shares to Sellco for the balance of the value of the transferred property, and in consideration for the Sellco note assumes the excess mortgage liability. Effectively, Sellco has paid Buyco to assume the excess mortgage liability. Subsequently, Buyco redeems the shares and surrenders the note to Sellco as consideration. These transactions place the property and the mortgage in Buyco. For transactions after December 31, 2000, the CCRA considers the entire mortgage to have been assumed as consideration for the transferred property, and paragraph 85(1)(b) increases the agreed amount to the amount of the mortgage.

In the other examples, the CCRA assumes the same facts, but alters the transactions so that Buyco simply redeems preferred shares issued on the rollover in consideration for the assumption of the mortgage or the parties enter into a series of transactions that involve Buyco injecting capital into Sellco. The CCRA again takes the position that transactions designed to move the excess mortgage into Buyco result in the application of paragraph 85(1)(b).

It is submitted that this new CCRA position is not supported by the plain meaning of the wording of paragraph 85(1)(b), which simply refers to consideration received by the taxpayer and not to consideration that may "reasonably be regarded" as having been received by the taxpayer in respect of the property. In our view, the CCRA would have to invoke GAAR to enforce this new position. Given the current development of the jurisprudence, it is questionable whether the CCRA would be successful.

The CCRA did confirm that paragraph 85(1)(b) does not apply if the non-share consideration given (including the assumption of debt by the purchaser) is allocated among several properties, transferred to the purchaser, and *retained* by the purchaser, provided that the amount allocated to each asset is not greater than the amount elected in respect of each asset. The reference to the property being retained by the purchaser is troubling; it suggests that a purchaser cannot dispose of property transferred to it as part of the series of transactions without triggering the application of paragraph 85(1)(b). In a similar comment at the October 2000 APFF meeting, the CCRA did not refer to the property being "retained" by the purchaser. The CCRA should clarify this point.

Finally, the tax implications of the redemptions and the deductibility of interest expense by the purchaser must be reviewed when considering the types of transactions described by the CCRA.

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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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TAX PLANNING FOR THE OWNER-MANAGER: MAY 5-9, NIAGARA FALLS

The Canadian Tax Foundation is offering a five-day course designed for advisers to small business and private corporations. As a refresher for experienced practitioners or as a learning opportunity, the course covers critical tax issues affecting business organization, financing, expansion, and succession. Leading practitioners will share their expertise and guide participants through the maze of small business tax and planning issues. Course enrolment is limited to 120 prepaid registrants.

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- Non-arm's-length transactions: recent cases, GAAR, shareholder agreements
- Civil penalties: what the rules mean to tax advisers and preparers, the draft information circular, recent cases
- Owner-manager remuneration: shareholder versus employee, salaries, bonuses, and fees, dividend distributions, subsection 15(1) benefits, subsection 15(2) loans
- Personal service, executive management, and professional corporations: current rules, benefits and tax-planning opportunities, qualifying for the small business deduction, the CCRA's administrative position
- Methods of transferring share ownership: stock option and share purchase plans, buy-sell arrangements, using holding companies
- Transferring assets to and from a private corporation: creating a checklist, the stop-loss rules, the impact of section 84.1, non-income-tax legislation, windups, intercorporate dividends, the paragraph 55(3)(a) exemption, butterfly reorganizations
- Purchase and sale of a business: property transfers and share-for-share exchanges, windups and amalgamations, the QSBC rules, financing of acquisitions, timing and valuation issues
- Cross-border tax issues: non-resident acquirors, regulation 105 waivers, thin capitalization
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