TAX FOR THE Owner-Manager

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RIP for REOP?

In two unanimous decisions, the Supreme Court of Canada has clarified the interpretation and application of the "reasonable expectation of profit" (REOP) test. In *Stewart v. The Queen* (2002 SCC 46) and *The Queen v. Walls* (2002 SCC 47) the minister denied business losses that had been claimed by the taxpayer on the basis that the taxpayer had no reasonable expectation of profit and therefore no source of income for the purposes of section 9 of the Income Tax Act.

In *Stewart*, the taxpayer had acquired four condominium units from which he earned rental income. The transactions were highly leveraged, and the taxpayer claimed losses as a result of the significant interest expense on money borrowed to acquire the units. In *Walls*, the taxpayers were limited partners in a partnership that acquired a mini-warehouse as a going concern. The partnership was required to pay service charges, management fees, and 24 percent interest per annum on the purchase price, as well as 50 percent of the net operating profit of the business. The partnership generated losses on the mini-warehouse, and the taxpayers deducted their proportionate share.

The REOP test originated in the *Moldowan* case ([1978] SCR 480), where Mr. Justice Dickson stated in obiter that to have a "source of income" the taxpayer must have profit or a reasonable expectation of profit. He then went on to list a number of criteria necessary to make an objective determination. These included profit and loss experience in past years, the taxpayer's training, the taxpayer's intended course of action, and the ability of the venture as capitalized to show a profit after claiming capital cost allowance.

Since *Moldowan*, the REOP test has been applied by the minister and the courts in a variety of situations to determine whether a taxpayer has a source of income, either business or property. In *Stewart*, the Supreme Court briefly reviewed some of the most important post-*Moldowan* cases. The court noted that the REOP test has not been applied in a consistent manner. At one end of the spectrum are the decisions that consider REOP to be the test by which the viability of the taxpayer's business plan is assessed, whatever the activity in question happens to be, in order to determine whether the activity deserves to be considered a "source of income." At the other end of the spectrum are the cases that use the REOP analysis only when the activity in question contains a personal or hobby element, and then only as a factor in determining whether this activity is sufficiently commercial to be labelled a "source of income."

In *Stewart*, the Supreme Court concluded that REOP is not a stand-alone source test: the court noted the distinction between judicial interpretation and judicial rule making, and found that the REOP test has been applied independently of the provisions of the Act to second-guess bona fide commercial decisions of the taxpayer. The test therefore runs afoul of the principle that courts should avoid judicial rule making in tax law. The court said that the determination of source must be grounded in the words and scheme of the Act, and then outlined a two-stage approach to the source question:

- Is the activity of the taxpayer undertaken in pursuit of profit, or is it a personal endeavour?
- If it is not a personal endeavour, is the source of the income a business or property?

The first stage of the test answers the general question whether a source of income exists; the second stage categorizes the source as either business or property. By developing and applying this two-stage approach, the court has restricted the application of the REOP test as enunciated in *Moldowan*.

The court emphasized that the "pursuit of profit" test requires analysis only in situations where there is some personal or hobby element to the activity in question. Where the nature of the activity is clearly commercial, there is no need to analyze the taxpayer's business decisions. Such

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endeavours necessarily involve the pursuit of profit; therefore, a source of income by definition exists, and there is no need to take the inquiry any further. If there is some personal element to the activity, the taxpayer is required to establish that his or her predominant intention is to make a profit from the activity and that the activity has been carried out in accordance with objective standards of businesslike behaviour. The factors listed by Mr. Justice Dickson in *Moldowan* could be used to make this determination. The court further emphasized that although REOP is a factor to be considered in the first stage of the test, it is not the only factor, nor is it conclusive. Moreover, it is the commercial nature of the taxpayer's activity that must be evaluated, not his or her business acumen. The court in *Stewart* then held that the taxpayer was engaged in property-rental activities that had no personal element: the activities were clearly commercial, and the appeal was allowed.

After that finding, however, the court made two additional remarks. First, the appellant's hope of realizing a capital gain on a disposition of the units did not detract from the commercial nature of his rental operations. The motivation of capital gains accords with the ordinary business person's understanding of "pursuit of profit" and may be taken into account in determining whether the taxpayer's activity is commercial. Second, referring to the decisions in *Ludco* (2001 SCR 1082) and *Neumann* ([1998] 1 SCR 770), the court cautioned the minister against using deduction provisions such as paragraph 20(1)(c) as an anti-avoidance mechanism, since specific anti-avoidance provisions already exist in the Act.

The Supreme Court in *Walls* applied the two-stage approach in *Stewart* and reached a similar conclusion, dismissing the minister's appeal. In addition, the court reiterated that a tax motivation does not affect the validity of transactions for tax purposes. It also distinguished cases, such as *Moloney* (92 DTC 6570), that involve a sham.

The decisions in *Stewart* and *Walls* are welcome news for taxpayers, not only for the direction they provide but also for their commonsense approach to investment. The REOP test will still have some application to those who operate hobby farms, maintain antique collections, or rent portions of the basements of their homes. But it will not apply to rental property losses, restaurant businesses, law practices, or legitimate tax shelters. The decisions will provide no assistance to taxpayers who are involved in a sham. Taxpayers who are currently engaged in the assessment process should protect their rights by filing notices of objection or notices of appeal to the Tax Court where applicable.

One can only hope that CCRA gets the message and that we are spared the ordeal of another *Neumann*-like followup case that forces the Supreme Court to say to the minister, "How many times do we have to tell you?"

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Shareholder Loans to Employees

Subsection 15(2) of the Income Tax Act is designed to prevent a corporation from distributing its funds tax-free to a shareholder by means of a loan to the shareholder. When a shareholder receives a loan from or becomes indebted to a corporation, the amount of the loan or indebtedness is included in the shareholder's income in the year that the loan arises. There are a number of exceptions to the subsection 15(2) income inclusion—most notably in subsection 15(2.4), for certain types of loans that are received by shareholders who are also employees of the corporation. Such loans may include a loan to an employee who is not a specified employee of the corporation (that is, he or she generally holds less than 10 percent of the shares); a loan to enable an employee to acquire a dwelling; a loan to enable an employee to acquire a motor vehicle; and a loan to enable an employee to acquire previously unissued shares of capital stock of the corporation. For these exceptions to apply, however, it must be reasonable to conclude that the employee received the loan because of his or her employment and not because of "any person's share-holdings." In addition, at the time the loan was made, bona fide arrangements must have been made for repayment of the loan or debt within a reasonable time.

Whether or not a loan made by a corporation to an employee is considered to have been received by the employee because of his or her employment and not because of "any person's share-holdings" is a question of fact. In a recent technical interpretation (document no. 2002-0118495, dated February 19, 2002), the CCRA considered a situation in which an arm's-length employee received a loan from a closely held private corporation to acquire shares of the corporation from the controlling shareholder. In the CCRA's view, a loan made at the direction of the controlling shareholder to enable an employee to buy shares from such a shareholder is received by the employee because of "any person's shareholdings"—in this case, because of the controlling shareholder's shareholdings—and as a result is not exempt from inclusion in the employee's income.

The CCRA's position may make it difficult for a controlling shareholder of a closely held corporation to tie a key employee's compensation to the corporation's performance or to encourage long-term retention of a key employee by allowing him or her to purchase shares from the controlling shareholder with an employee loan from the same corporation. In light of the CCRA's position, an alternative would be to arrange the affairs of the corporation so that the key employee can acquire previously unissued treasury shares of the corporation. However, it must still be reasonable to conclude that the employee has received the loan as a result of his or her

employment relationship with the corporation, not because of "any person's share-holdings."

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Bonuses to Shareholders Attract Increased Audit Scrutiny

The release of *Technical News* no. 22, dated January 11, 2002, and certain recent technical interpretations (2000-0013085, 2000-0016035, 2001-0064055, and 2001-0074115) has created renewed interest in the CCRA's longstanding administrative position on the reasonableness of salaries and bonuses paid to principal shareholder-managers. From a number of recent assessments we have seen, it appears that auditors are now applying the CCRA's administrative position with greater scrutiny on audit and questioning the quantum of salaries and bonuses paid to shareholders when the administrative position is determined not to apply. If a salary or bonus is paid to a shareholder and included in the shareholder's income, the denial of the corresponding deduction at the corporate level results in double taxation.

For a corporation to deduct a salary or bonus paid to a shareholder, the payment of the salary or bonus must meet the business-purpose test found in paragraph 18(1)(a) of the Income Tax Act, and the amount of the salary or bonus must be reasonable within the meaning of section 67.

Pursuant to paragraph 18(1)(a), a salary or bonus paid to a shareholder must be "made or incurred by the taxpayer for the purpose of gaining or producing income from the business" if it is to be deductible. The question whether an expense is incurred by a corporation for the purpose of gaining or producing income, though always a question of fact, is typically resolved in favour of the corporation if the expense relates to its business. The jurisprudence that directly addresses this issue establishes a relatively low standard for meeting the test in paragraph 18(1)(a). For example, in *La Compagnie Idéal Body Inc.* (89 DTC 5450), the FCTD found that the test was met by a widow who inherited control of a corporation from her late husband's estate and had minimal involvement in the day-to-day activity of the business. Similarly, in *Grant Babcock Limited* (85 DTC 518), the TCC found that such activities as "comparison shopping" and "discussions at home" with her husband were relevant in determining whether the business-purpose test was met in respect of a payment to a principal shareholder's wife. A review of the relevant jurisprudence suggests that the test in paragraph 18(1)(a) will be met if a shareholder has provided bona fide services to a corporation, even when those services are minimal.

If the test in paragraph 18(1)(a) is met, one must consider whether the salary or bonus was "reasonable in the circumstances" within the meaning of section 67. The CCRA's administrative position, originally outlined at the 1981 Revenue Canada Round Table, is that the reasonableness of salaries or bonuses paid to principal shareholder-managers of a corporation will not be questioned if the corporation has a practice of distributing its profits to its shareholder-managers in the form of bonuses or additional salaries, or of declaring bonuses to remunerate shareholders for the corporate profits attributable to the "special knowhow, connections, or entrepreneurial skills" of the shareholders.

Technical News no. 22 incorporates further subsequent restrictions and clarifies that the administrative position applies only to shareholders who "are Canadian residents, and are actively involved in the day-to-day operations of the company. The key is that the Canadian resident recipients must be active in the operating business and contribute to the income-producing activities from which the remuneration is paid."

All or part of a salary or bonus that does not fall within the CCRA's administrative position may still be deductible to the extent that the amount is "reasonable in the circumstances" within the meaning of section 67. The determination of reasonableness is a question of fact. While the CCRA has said that it will generally apply an arm's-length test to determine whether an amount paid to a shareholder is reasonable, the TCC's decision in *Safety Boss* (2000 DTC 1767) indicates that the test of reasonableness may be met if a salary or bonus is reasonable in relation to the profits of a corporation. In *Safety Boss*, an owner-manager was paid a $3 million bonus by his wholly owned corporation. The CCRA denied a portion of the bonus on the basis that it was unreasonable. The TCC held that the amount was reasonable based on the manner in and degree to which the duties, expertise, and reputation of the taxpayer contributed to the corporation's profits. Thus, it now appears that a bonus equal to the profits realized by a corporation may be reasonable if those profits are the result of the shareholder's contacts, skills, or efforts. However, because *Safety Boss* has not yet been considered by the courts in any later decisions, its subsequent interpretation remains uncertain.

Given that the CCRA's recent statements seem to have resulted in greater scrutiny of salaries and bonuses paid to shareholders, advisers should carefully consider (1) the deductibility of a salary or bonus paid to a shareholder under the business-purpose test in paragraph 18(1)(a), (2) the CCRA's administrative position, and (3) section 67. Generally, the business-purpose test in paragraph 18(1)(a) will be met if a shareholder has performed services for the corporation. However, if a shareholder's salary or bonus does not fall within the CCRA's administrative position, the CCRA may question the reasonableness of the amount.

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Estate Planning, Family Businesses, and Butterflies: 2

In the April 2002 issue, we discussed a strategy whereby a parent whose major asset is shares of a corporation (Holdco) could effectively arrange to leave a business controlled by Holdco to one child and investments owned by Holdco to another child. This strategy requires the use of the non-arm's-length butterfly provisions of paragraph 55(3)(a) before the parent's death. (For a discussion of the technical issues, see "Purification Transactions," *Tax for the Owner-Manager*, October 2001, and "Estate Planning, Family Businesses, and Butterflies," *Tax for the Owner-Manager*, April 2002.) In this issue we explore a method by which a parent can equalize the value of the inheritances even if there are no significant assets outside Holdco with which to effect such equalization, and/or the equalization cannot be achieved by a disproportionate assumption of liabilities.

Assume that Holdco's assets are shares of Opco (FMV $100,000) and investments (FMV $50,000). (All assets have cost amounts for tax purposes that are substantially less than FMV.) Assume further that the parent wants child 1 to inherit the shares of Opco and child 2 to inherit the investments, but that the parent also wants to leave assets of equal value to each child. One approach to resolving the dilemma is described below; keep in mind that, for the reasons discussed in the earlier articles, the solution involves taking major planning steps while the parent is still alive.

1) Parent incorporates Investco and uses the rollover provisions of subsection 85(1) to transfer 50 percent of his or her shares of Holdco (FMV $75,000) to Investco in exchange for additional common shares of Investco. Holdco then uses subsection 85(1) to transfer the investments (FMV $50,000) to Investco in exchange for $50,000 worth of retractable preferred shares of Investco. At this point, Holdco owns $50,000 worth of shares of Investco and Investco owns $75,000 worth of shares of Holdco.

2) Holdco purchases for cancellation its $75,000 worth of shares of Investco in return for a non-interest-bearing demand promissory note (note 1) in the amount of $75,000. Investco redeems its $50,000 worth of preferred shares held by Holdco in return for a non-interest-bearing demand promissory note (note 2) in the amount of $50,000. Investco pays Holdco $50,000 to retire its obligation under note 2. Holdco uses those funds to pay note 1 down from $75,000 to $25,000.

The result of these steps is that Holdco and Investco each have a net value of $75,000; Holdco owns the shares of Opco (FMV $100,000) but owes Investco $25,000. Investco owns investments worth $50,000 and has a promissory note receivable from Holdco in the amount of $25,000.

3) During Parent's lifetime, it is advisable to effect an agreement between Holdco and Investco to deal with the terms of payment of principal and interest on the intercompany debt. Such an agreement will minimize friction between the siblings after Parent's death. Holdco and Opco can be combined so that the interest paid by Holdco on the intercompany debt is directly funded by Opco.

4) Finally, Parent bequeaths the shares of Holdco to child 1 and the shares of Investco to child 2.

This technique is equally effective if Holdco owns two business divisions of unequal value.

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CCRA Gains Further Access to Taxpayer Information

The *Van Egmond* case (2002 BCCA 226) appears to broaden the CCRA's investigative powers in respect of requirements to produce information regarding unnamed persons—potentially at the expense of the livelihood of those forced to provide such information.

Under subsection 231.2(1) of the Income Tax Act, a taxpayer may be "required" to provide certain information or documents in the course of an audit. Failure to comply with that requirement may constitute an offence under section 238. However, subsection 231.2(1) is subject to subsection 231.2(2), which states that no person is required to provide information or any document relating to one or more unnamed persons unless the CCRA is authorized by a judge to obtain such information. The judge must be satisfied that certain conditions (set out in subsection 231.2(3)) have been met—that the unnamed person or persons are ascertainable and that the requirement is made to verify the person's or persons' compliance with their duties or obligations under the Act.

Van Egmond was a GST tax consultant who had not filed his own personal income tax returns for seven years. When he filed all seven years at once, an income tax audit of the returns was commenced. In the course of the audit, the auditor requested Van Egmond's client list. Although Van Egmond was willing to disclose other records, he refused to disclose his clients' names and addresses. He advised the auditor that he was concerned that such information might be used to audit his clients' GST returns, which would hurt his reputation.

Van Egmond was convicted of an offence under subsection 238(1) of the Act for failing to provide the requested information. He appealed his conviction. The summary conviction appeal judge found that the information sought was for more than assessing Van Egmond's liability, and that the purposes extended to potential assessments of his clients. The judge felt that the CCRA was on a fishing expedition.

The British Columbia Court of Appeal disagreed, and

found that the documents were required for the audit to support Van Egmond's sales revenue figures. The *Richardson* case (84 DTC 6325 (SCC)) was distinguished on the basis that it stood only for the proposition that the CCRA cannot obtain certain taxpayer information unless someone's tax liability is the subject of investigation. Van Egmond clearly was under legitimate investigation. The *Canadian Forest Products* case (96 CTC 6506 (FCTD)) was also distinguished on the basis that the contested information bore on Van Egmond's own tax liability. Thus, notwithstanding that the requirement to produce such information could impair his source of revenue, the requirement to produce was justified. Finally, the Court of Appeal held that once it is determined that the CCRA can justifiably require information of the taxpayer, the auditor can share the information with other CCRA officials even if these officials use the information for the purpose of auditing the taxpayer's clients.

Several important issues are raised by *Van Egmond*. No application was made to a judge under subsection 231.2(2) or (3) for authority to require the production of documents relating to unnamed persons, notwithstanding that this procedure is mandated by subsection 231.2(2). The Court of Appeal did not consider the applicability of that subsection. Nor did the Court of Appeal consider the wording of subsection 231.2 and whether it required judicial authorization under subsection 231.2(2), even when the person on whom the demand is made is the taxpayer under investigation.

The Court of Appeal stated that whether the CCRA can legitimately require the client list from the investigated party depends on the purpose of the request. Had the proper procedure been followed, a judge of a superior court or the Federal Court would have reviewed this issue in the context of subsection 231.2(3). The British Columbia Supreme Court has accepted as fact that the minister's purpose was at least partly to increase the workload of CCRA auditors who would investigate Van Egmond's clients. But the Court of Appeal seemed to conclude that because the CCRA could pass the information between departments for the purpose of administering the Act once such information was received, then that purpose must be legitimate. This reasoning fails to properly address the original purpose of the requirement and whether that purpose was legitimate under section 231.2. The Court of Appeal failed to consider whether the requirement is unlawful if any purpose for making the request is unlawful. In this regard, the Court of Appeal could have looked to the *Richardson* and *Canadian Forest Products* decisions for guidance: in those cases, the courts stated that the information required could have been obtained through regulations passed under paragraph 221(1)(d). In *Van Egmond*, the CCRA could have done a net worth assessment on Van Egmond rather than making the demand under subsection 231.2(1). This would have put the onus on Van Egmond to satisfy the CCRA with respect to his revenue.

Finally, query whether Van Egmond could have avoided conviction by making an application for judicial review of the decision to make the requirement. Under subsection 231.2(5), when an authorization is granted under subsection (3), a third party on whom notice is served may apply within 15 days of service of the notice for a review of the authorization. Because the CCRA did not obtain an authorization, this procedure was not available to Van Egmond. However, it is possible that the general power of judicial review may be available in respect of the decision to issue a demand. In the *Canadian Forest Products* case, an application was made for judicial review notwithstanding that the CCRA had not followed the procedure in subsections 231.2(2) and (3).

None of this is any consolation to Van Egmond; in his case, the damage has already been done. Leave to appeal to the Supreme Court of Canada has not been requested.

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Income Splitting: The Spousal Loan

Because Canadian residents are taxed as individuals and not as a family unit, the ability to split income among family members has long been an attractive tax-planning strategy. Income splitting can be achieved in a variety of ways—by the payment of salaries to family members, by contributions to a spousal RRSP, or by corporate reorganizations that allow new shareholders to participate in the earnings and growth of the business. Income splitting also allows actual tax savings when one spouse lends money to the other spouse, who uses the loan to earn income that is then taxed at a lower tax rate than would have applied to such income in the hands of the lending spouse.

The spousal loan rules are simple. The higher-income spouse (the lender) may lend money to the lower-income spouse (the borrower), who then uses the funds for investment purposes. The tax liability on any investment income earned with these funds is in effect transferred to the borrower. However, there is one catch—the borrower must pay interest on the borrowed funds.

The CCRA issues quarterly "prescribed interest rates" that apply for various tax purposes. One of these purposes is to define the minimum interest rate that one spouse may charge on loans to the other spouse. The interest must be paid no later than January 30 of each

year following the loan. Otherwise, the CCRA will attribute the investment earnings back to the lender spouse. Importantly, taxpayers can use the prescribed rate in effect when the loan was made for the entire term of the loan, even though the prescribed rate may increase in future periods.

On June 4, 2002, the CCRA announced the prescribed interest rate for the third quarter of 2002 to be 3 percent. This is up slightly from the previous 2 percent rate, but is still one of the lowest prescribed rates in decades. It is applicable only until September 30, 2002; however, should the same or a similar rate continue through the fourth quarter, the spousal loan will still provide an excellent opportunity for income splitting.

Consider the following example: X and Y are married and reside in Alberta. X is in the highest income tax bracket and Y is in the lowest income tax bracket. X's investment of $500,000 earns 6 percent interest annually. Currently, X earns the following after-tax return on investment:

Interest income	$30,000
Tax	(11,700)
Net return after tax	$18,300

Now consider the effect of the spousal loan. X lends $500,000 to Y between July 1 and September 30, 2002 at the CCRA's prescribed rate of 3 percent. Y invests the $500,000 at 6 percent interest. Y will pay $15,000 interest to X on an annual basis.

	X	Y	Total
Interest income	$15,000	$30,000	
Less interest expense	—	(15,000)	
Net income	15,000	15,000	30,000
Tax	(5,850)	(3,900)	(9,750)
Net return after tax	$ 9,150	$11,100	$20,250
Net return after tax, without spousal loan			(18,300)
Annual tax savings			$ 1,950

By arranging a legitimate loan between spouses, this couple has successfully saved almost $2,000 in annual tax. And for those living outside Alberta, the annual tax saving increases with this strategy.

Although the current spread may seem minimal given today's markets, the 3 percent rate can be locked in permanently, which may provide considerable benefit in the future. And should the prescribed rate drop lower, the terms of the loan can easily be adjusted. Should the rate increase, however, there is no going back. Timing is everything.

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Stock Option Plans: Reporting Requirements of Foreign Corporations

Pursuant to subsection 7(1) of the Income Tax Act and sections 48 and 49 of the Quebec Taxation Act, a taxable benefit is conferred upon employees who exercise options under a stock option plan for an exercise price that is less than the fair market value (FMV) of the shares at the time of the acquisition. The benefit is equal to the FMV of the shares at the time of the exercise of the option minus the total of the exercise price of the option under the plan and the amount, if any, paid to acquire the options.

In certain circumstances, the inclusion of such a benefit may be deferred until the acquired shares are disposed of. And under paragraph 110(1)(d) of the Income Tax Act and section 725.2 of the Quebec Taxation Act, the employee may be allowed to deduct, in the calculation of his or her taxable income for the year, an amount equal to one-half of the value of the benefit if certain conditions are met.

For both federal and Quebec income tax purposes, the benefit will be treated as employment income to the employee. Therefore, the person who has granted the benefit will generally be required to report the benefit and to deduct and remit to the CCRA and Revenue Quebec the prescribed source deduction in respect of the benefit. In cross-border situations, employees of a Canadian subsidiary may be granted options to acquire shares of a parent corporation that is not a resident of Canada; in that case, if the Canadian subsidiary reimburses its foreign parent for the value of the benefit conferred on the Canadian subsidiary's employees under the stock option plan, the Canadian subsidiary (not the foreign parent) will be required to report the benefit, and to deduct at source and remit the prescribed amount. Conversely, if the Canadian subsidiary does not reimburse its foreign parent, the deduction and remittance obligations must be fulfilled by the foreign parent.

However, Revenue Quebec has recently issued a letter of interpretation (LI 01-010739, dated February 26, 2002), which departs from this interpretation for Quebec provincial income tax purposes. In Revenue Quebec's example, a US public corporation (Parentco) had a Canadian subsidiary (Canco). Parentco established a stock option plan

in which certain employees of Canco participated. Canco's employees were not employees of Parentco and were not required to report for work at a Parentco establishment in Quebec; they were only required to report for work at a Canco establishment in Quebec. Except for the benefits conferred under the plan, no remuneration was paid by Parentco to Canco's employees, and Canco did not reimburse Parentco for the benefit conferred upon Canco's employees under the plan.

Revenue Quebec stated that when an employee is not required to report for work at an establishment of the person who pays the remuneration (or confers the benefit), that person is not required to report the remuneration (or benefit) or to deduct at source and remit the prescribed amount to Revenue Quebec, if the remuneration (or benefit) is paid from (or conferred by) an establishment located outside Quebec. Canco is not required to report or deduct at source and remit to Revenue Quebec, because Canco is not a party to the plan and does not intervene in any manner in the granting of options, and no right or obligation is imposed on Canco under the plan. Revenue Quebec also stated that these comments apply equally to share purchase plans.

Finally, in Revenue Quebec's view, no contributions in respect of the Quebec Health Fund and the Quebec Pension Plan are required to be paid either by Parentco or by Canco for the benefit conferred under the plan.

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Reg 105: Who Is the Non-Resident Person?

Pursuant to regulation 105, a 15 percent withholding tax must be levied on any payment made by a Canadian payer to a non-resident person in respect of services rendered in Canada. However, the wording of the provision is quite broad and can have unexpected application to business transactions. If the correct amount of reg 105 tax is not withheld, then the payer may be subject to onerous penalties. The residency of a taxpayer is a question of fact, and practitioners are usually aware that the resolution of this issue is critical in assessing the application of reg 105. However, the determination of who is the non-resident person is often assumed and not queried. The meaning of "person" for tax purposes can sometimes be difficult to discern in light of the many business structures currently available.

The following examples illustrate the importance of identifying the non-resident person that renders the service in Canada.

Example 1: X Co, a resident of Canada, pays an installation fee in the amount of $1 million to Y Co, a non-resident, in respect of services rendered in Canada.

Example 2: Assume the facts in example 1, except that the $1 million payment is made to a joint venture in which a Canadian resident has a 49 percent interest and a non-resident has a 51 percent interest.

Example 3: Assume the facts in example 1, except that the $1 million payment is made to a partnership in which a Canadian resident has a 49 percent interest and a non-resident has a 51 percent interest.

Example 1 is straightforward: the non-resident person is Y Co and the amount of reg 105 withholding on account of part I tax is $150,000.

Example 2 is a little more complicated. The expression "joint venture" does not appear in the Act, but it refers to an arrangement between two or more parties that have combined their efforts and resources toward a specific task. It is accepted that a joint venture in this sense is not a separate person in its own right and is not a partnership. On this basis, the non-resident person in the second example is the non-resident who has a 51 percent interest in the joint venture; the amount of reg 105 withholding is $76,500 ($1 million × 51% × 15%).

The third example is less clear-cut. For the purpose of part XIII tax, where a Canadian resident pays or credits an amount to a partnership other than a Canadian partnership, the partnership is deemed in respect of that payment to be a non-resident (paragraph 212(13.1)(b)). A Canadian partnership is defined for the purposes of the Act to be a partnership in which all of the members are Canadian residents. The partnership described in the second example will be considered a non-resident, and will be subject to part XIII tax on certain payments from a Canadian resident.

However, numerous technical rulings and interpretations state that, for the purpose of part XIII tax, the non-resident partners can benefit from the treaty withholding rates on passive income paid to the partnership that are applicable to their respective countries (for example, TI 2001-0101813 and 2000-028475). The partners, not the partnership, are effectively the non-resident persons for the purpose of calculating the final liability for part XIII tax.

However, reg 105 applies for the purposes of the general income tax imposed under part I of the Act. The rules for part XIII, including paragraph 212(13.1)(b), do not apply for part I purposes. In part I, subsection 96(1) treats a partnership as a person for the purpose of computing the partnership's net income. This provision is nothing more than a statutory fiction: a partnership is not a person, but rather is a relationship between two or more persons carrying on business with a view to profit. When Parliament wants to treat a partnership as a person,

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it does so by statutory provisions such as paragraph 212(13.1)(b).

Reg 105 levies a 15 percent tax on any payment made by a Canadian person to a non-resident person. In the partnership case, in the absence of a rule such as paragraph 212(13.1)(b), it seems that the non-resident person is the partner who owns a 51 percent interest in the partnership. As a result, the amount of reg 105 withholding on the $1 million payment seems to be $76,500.

Legal counsel should make the ultimate determination whether an entity is a partnership or a joint venture. In practice, the resolution of this issue requires the application of basic principles of law to often complex facts. As many readers know all too well, drawing the line between a partnership and a joint venture can be extremely difficult.

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NON-TAXABLE SETTLEMENT PAYMENT

The TCC's recent decision in *Ipsco Inc.* (2002 DTC 1421) confirms that there is still some scope for receiving a non-taxable receipt in respect of certain lawsuit settlements or judgments. Ipsco made a claim against a supplier of a defective pipe treatment system. The TCC held that the settlement payment made by the supplier was a non-taxable receipt to Ipsco. The court rejected the minister's argument that Ipsco was obliged to reduce its undepreciated capital cost (UCC) of the relevant class, either by reducing the original capital cost or by deducting the receipt as proceeds of disposition. The court found that nothing in the Income Tax Act required such a reduction.

Ipsco had incurred additional capital outlays in excess of $6.1 million to improve the pipe treatment system to an acceptable working level. Ipsco added those additional capital costs to the UCC of its appropriate depreciable property classes. Later, Ipsco commenced a civil action, which ultimately was settled by a $4.8 million payment in respect of Ipsco's "claim for additional construction and installation costs" relating to the system. The system was not transferred back to the supplier under the terms of the settlement. For income tax purposes, Ipsco treated the settlement amount as a non-taxable receipt; for accounting and financial statement purposes, the historical cost of the system was reduced. The minister reassessed on the basis that the settlement reduced the UCC in respect of the system.

Rowe DJ observed that the Act provides an extremely precise and detailed method by which capital cost allowance is to be calculated, and those provisions override any general concept of calculating what the minister regarded as "true profit" for the year. Moreover, the CCRA's statement in IT-365R2 (at paragraph 9) that "[w]here the amount of compensation relates to a particular asset that was not disposed of, the amount will serve to reduce the cost of that asset to the taxpayer" was not supported by the relevant case law. The court's next conclusion was that no "disposition of property" within the meaning of subsection 13(21) occurred, because Ipsco did not transfer or dispose of in any manner the system or any portion thereof. The settlement payment represented compensation or reimbursement with respect to the additional capital costs incurred to make the system perform. The supplier received nothing in return except a discontinuance of the action. The exchange of releases by way of mutual discontinuances and minutes of settlement did not constitute "property" for the purposes of subsection 13(21). Rowe DJ commented that the use of an internal accounting procedure that reduced the historical cost of the system by the settlement amount did not mean that the same method had to be used when income was reported pursuant to the Act.

The court rejected the minister's position that the settlement amount constituted "proceeds of disposition" (subsection 13(21)) of property in the form of "compensation for property injuriously affected" or "compensation for property damaged." Rowe DJ also found that Ipsco's current deduction of legal costs in its tax returns did not transform the settlement amount into a receipt on income account.

Finally, the court distinguished *Mohawk Oil* (92 DTC 6135 (FCA)) on the basis that the capital asset in that case was taken back by the supplier, whereas Ipsco retained the pipe treatment system. The *Ipsco* decision was not appealed.

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