TAX FOR THE Owner-Manager

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Paragraph 251(5)(b): Good News and Bad News

Paragraph 251(5)(b) of the Income Tax Act can be important in determining relationship for income tax purposes and Canadian-controlled private corporation (CCPC) status. In broad terms, the paragraph provides that when a person has a right (even if that right is contingent) to acquire shares, that person is deemed to be in the same position vis-à-vis control of the corporation as if he owned the shares. (Some aspects of paragraph 251(5)(b), which are not pertinent for the purposes of this article, are not discussed here.)

Paragraph 251(5)(b) is an anti-avoidance provision. As a general rule, it is deemed not to apply if its application would produce a result beneficial to the taxpayer. There is, however, at least one circumstance in which paragraph 251(5)(b) can work to the taxpayer's benefit.

Paragraph 110.6(14)(b) provides that, for the purposes of determining qualified small business corporation (QSBC) share status and when considering whether a corporation is a small business corporation (SBC) or a CCPC, paragraph 251(5)(b) does not apply to a right under a purchase and sale agreement.

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Many conditions must be met for shares to qualify as QSBC shares. One of these conditions is that the corporation must be an SBC at the date of sale of the shares, which, in turn, requires that it must be a CCPC at that time. This can be a problem if a Canadian resident sells a controlling block of shares that would otherwise be QSBC shares to a non-resident. *The moment the purchase and sale agreement is signed*, the corporation will lose its CCPC status (and therefore its QSBC status) because of the operation of paragraph 251(5)(b). But for paragraph 110.6(14)(b) negating the impact of paragraph 251(5)(b), the gain on the closing of the sale would not be eligible for the capital gains exemption.

The following example, however, illustrates that paragraph 110.6(14)(b) can also produce a bad result. Assume that two unrelated Canadian-resident individuals, X and Y, each own 50 percent of the shares of Opco, all of the assets of which are used in an active business carried on in Canada. Assume further that X (20 percent) and Y (80 percent) form Realco to acquire the real estate on which Opco operates. To finance the acquisition, Realco borrows $400,000 from Opco and $600,000 from Y.

For the reasons discussed in an earlier article ("Associated but Not Related: An Important Distinction," *Tax for the Owner-Manager*, October 2002), Realco and Opco are not related. Therefore, the real estate that Realco leases to Opco is not used in the active business of a related corporation. As a consequence, Realco is not an SBC. As a further consequence, if Opco's $400,000 debt receivable from Realco exceeds 10 percent of Opco's assets, Opco too is not an SBC and its shares cannot qualify as QSBC shares.

Suppose that a Canadian resident contracts to acquire the shares of both Opco and Realco from X and Y. Paragraph 251(5)(b) deems the buyer to control both corporations, thus causing them to be related. Realco is now an SBC because its real estate is used in the active business carried on by Opco, now a related corporation. Opco's $400,000 receivable from Realco is now due from a "connected" SBC, which would normally make Opco an SBC. If that debt constitutes less than 50 percent of the assets of Opco, Opco's shares would normally qualify as QSBC shares as well, and (provided that all other conditions of the QSBC share definition are met) the sale of the Opco shares by X and Y would, but for the operation of paragraph 110.6(14)(b), be eligible for the capital gains exemption. Unfortunately, paragraph 110.6(14)(b) requires that paragraph 251(5)(b) must be ignored in these circumstances. Therefore, Opco's shares will not be QSBC shares.

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Section 84.1 and Succession Planning

(Editor's note: This article is the third in three years on section 84.1. (The first is in the January 2001 issue; the second is in the April 2002 issue.) The point is worth making again: the possible application of the section must be considered in any share reorganization that involves related parties.)

Most succession plans for small businesses contemplate the transfer of the business to one or more family members, key employees, or other shareholders, or to an interested third party. A key consideration for the vendor is whether the capital gains exemption will be available to reduce the tax payable as a result of the transfer. At the least, the vendor will want capital gain, not dividend, treatment on the proceeds of sale. The purchaser may be interested in financing some or all of the purchase price with funds to be drawn from the purchased corporation. (See "Related-Party Sale of Shares," below.) This usually dictates the interposition of a new corporation to act as the purchaser of the shares. The possible application of section 84.1 must always be considered at this stage of the planning.

Section 84.1 was enacted to stop related parties from extracting valuation-day values tax-free from their corporation. The provision was expanded in 1985, in conjunction with the introduction of the capital gains exemption, for a similar purpose.

The Key Components of Section 84.1

1) the vendor must be a taxpayer (individual) resident in Canada;

2) the shares disposed of must be capital property of the taxpayer;

3) the shares disposed of must be shares of a corporation resident in Canada;

4) the shares must be purchased by another corporation that is not at arm's length with the taxpayer; and

5) immediately following the transaction, the purchaser corporation and the subject corporation must be connected corporations.

The components of section 84.1 seem straightforward, but traps for the unwary lie in the "connected" and "non-arm's-length" provisions.

Subsections 186(4) and 186(2) must be analyzed to determine whether the subject corporation and the purchaser corporation are connected. Subsection 186(4) provides that a subject corporation is connected with the purchaser corporation if the purchaser corporation controls (other than by reason of paragraph 251(5)(b)) the subject corporation, or if the purchaser corporation owns, at the relevant time, more than 10 percent of the share capital on a votes-and-value basis.

In *Olsen* (FCA 2002), the expanded meaning of "control" in subsection 186(2) was held to be applicable to section 84.1. Under the expanded meaning, a subject corporation is considered to be controlled by a purchaser corporation if more than 50 percent of the issued share capital having full voting rights belongs to the purchaser corporation, persons not dealing at arm's length with the purchaser corporation, or the purchaser corporation and persons not dealing at arm's length with the purchaser corporation.

In *Olsen*, section 84.1 was applied to a taxpayer who sold shares of a company to corporations owned by his children. The purchaser corporations were found to be connected with the taxpayer's corporation.

The purchase of shares by a family member's corporation (a related party) often attracts section 84.1. The sale of shares to arm's-length employees or shareholders often (but not always) will not raise similar concerns.

Taxpayers and their advisers need to be aware that unrelated parties may act at non-arm's-length as a matter of fact. Numerous technical interpretations issued by the CCRA deal with sales to ostensibly arm's-length employees or shareholders. The TIs point out that even where the parties are not related they may be considered to be acting not at arm's length if it can be determined that there is an understanding between them to act in a predetermined manner—that is, that they are acting in concert.

Whether or not persons are acting in concert is a question of fact. The key criterion is whether the parties are asserting independent economic positions on the important aspects of the transaction: *Swiss Bank Corp.* (SCC 1972). If both parties receive independent accounting and tax advice with respect to the purchase, there is a strong presumption that they are acting at arm's length.

TI 2002-0159525 dealt with a situation in which a niece or nephew was to purchase shares from an uncle using a corporation. Under section 251, an uncle is not related to a niece or nephew—that is, they are at arm's length unless they are dealing at non-arm's-length as a matter of fact. Both parties were to consult with the same tax specialist. The CCRA confirmed that, at a particular time, it is a question of fact whether unrelated parties are dealing with each other at arm's length. The

CCRA noted that having only one tax specialist involved was not, in and by itself, conclusive as to the existence of non-arm's-length dealing. However, this element, in combination with others, may contribute to the finding that a non-arm's-length relationship does exist as a matter of fact.

Although section 84.1 may appear linear at first glance, it is complicated enough to warrant close scrutiny when an individual sells shares to a corporation. Situations involving buy-sell agreements and divorce settlements should also be carefully analyzed in this regard.

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Related-Party Sale of Shares

In most circumstances, the sale of shares to a non-arm's-length company for cash will result in a deemed dividend to the extent that the cash consideration exceeds the greater of the vendor's adjusted cost base (ACB) and the paid-up capital (PUC) of the shares being sold (section 84.1). In a recent advance income tax ruling (2002-0122743), the CCRA confirmed (1) that an individual (Sib 2) will recognize a capital gain on a share sale to his sibling (Sib 1) even though Sib 1 rolled the purchased shares to his holding corporation in related transactions following the purchase, and (2) that the GAAR will not be applied to the transactions.

As outlined in the ruling, Sib 1 and Sib 2 are each 50 percent shareholders of Opco. They have been involved in an ongoing dispute regarding the conduct of Opco's affairs. Sib 1 will acquire Sib 2's Opco shares for a cash payment equal to the fair market value (FMV) of the shares. This will allow Sib 2 to report a capital gain on the sale. The ACB of Sib 1's Opco shares will be increased by the amount paid to Sib 2. Sib 1 will then transfer his Opco shares to his newly incorporated company (Newco) under subsection 85(1) in exchange for a nominal amount of common shares and a Newco promissory note equal to the ACB of Sib 1's Opco shares. Because the agreed amount is equal to the ACB of the shares, no gain arises on the transfer. Newco and Opco will then amalgamate to form Amalco.

Because the amount of the promissory note that Sib 1 takes back from Newco is equal to the ACB of Sib 1's Opco shares, it will be at least equal to the purchase price paid by Sib 1 to Sib 2 for his shares. Sib 1 will receive payments on the note tax-free. This allows Sib 1 to fund the purchase from Sib 2 with Opco cash. (Caution: if Sib 2 owned the shares before 1972 or claimed the capital gains exemption in respect of the sale, this analysis may not apply.)

The ruling does not contain a discussion of section 84.1. That section applies when an individual resident in Canada disposes of shares of a Canadian-resident corporation ("the subject corporation") to a corporation with which the individual does not deal at arm's length ("the purchaser corporation") and, immediately after the disposition, the subject corporation is connected with the purchaser corporation. Where the section applies, there may be a reduction of the PUC of the purchaser corporation, and/or the purchaser corporation may be deemed to have paid a dividend to the individual transferor. The latter will generally be true if any non-share consideration received by the transferor exceeds his ACB of the subject shares.

In the situation described in the ruling, Sib 2 does not deal at arm's length with Newco because Newco is controlled by Sib 1, to whom Sib 2 is related. If Sib 2 had sold the shares directly to Newco, the subject corporation (Opco) would be connected with the purchaser corporation (Newco) immediately after the disposition because Newco would own all of the Opco shares. Thus, a direct sale of the Opco shares from Sib 2 to Newco for cash consideration would trigger section 84.1, thus converting Sib 2's capital gain into a deemed dividend. Dividends are currently taxed at a higher rate than capital gains. In Nova Scotia, for example, the top marginal tax rate on capital gains is 23.67 percent; the top marginal rate on dividends is 31.92 percent.

The benefits of the transaction described in the ruling are twofold. First, Sib 1 is able to fund the share purchase with pre-tax payments from Newco in satisfaction of the promissory note. Second, Sib 2 is taxed on the sale at a capital gain rate rather than at a dividend rate.

This strategy should be considered in any share sale that involves related parties. In estate situations, for example, it may be useful to convert ACB resulting from gains taxed on death into shareholder loans to the beneficiaries. Again, in any such planning it is important to carefully consider section 84.1 to ensure that its provisions do not come into play.

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Meaning of "Control of a Corporation"

The issue in *Silicon Graphics* (FCA 2002) was whether or not a corporation—Alias, a widely held corporation more than 50 percent of whose shareholders resided in the United States—was a Canadian-controlled private corporation (CCPC) in its 1992 and 1993 taxation years under subsection 125(7) of the Income Tax Act as it read at that time. The specific question was whether or not Alias was controlled, either de jure or de facto, by one or more non-resident persons. In the relevant years, the definition of a CCPC did not include paragraph (b) of the present definition, which states that, for the purpose of determining whether a corporation is a CCPC, all of the shares held by non-residents will be considered to be owned by a single person.

The Tax Court had held that Alias was not a CCPC during the relevant years on the basis that once the number of non-resident shareholders reaches 50 percent plus one, de jure control rests with the non-residents. The Federal Court of Appeal disagreed and held that a mathematical majority is not enough. There must also be some common connection between the non-resident shareholders before they can be said to be in control.

On the issue of de jure control, the court found the *Buckerfield's* (Ex. Ct. 1964) line of cases of little help because none of them involved a widely held corporation. When the issue is whether several shareholders who between them own more than 50 percent of the shares have control, it is necessary to ask whether or not they are connected in some way. The court found that the place of residence of the shareholders alone (that is, in the United States) is not sufficient. In *Income Tax Technical News* no. 25, released October 30, 2002 (ITTN 25), the CCRA stated that it accepts the finding on this issue and has not sought leave to appeal *Silicon Graphics* to the SCC.

The FCA's finding is important for three reasons. First, the court expressly separates the concept of control from that of ownership for the purposes of the Act: Parliament, it said, could have used the word "owned" in the CCPC definition if it had intended that simple ownership alone was the test.

Second, the decision narrows the gap between the concepts of de jure and de facto control by implying that considerations that normally come into play only in the question of de facto control must be considered in determining whether there is a sufficient connection between several shareholders to support an allegation of control. For example, the court suggests that a common connection will be found if there is something to indicate that shareholders will vote as a bloc in the election of directors or are in agreement on the major issues relating to the control of the corporation—such as a voting agreement, an agreement to act in concert, or other business or family relationships.

Third, the court states that the phrase "one or more persons" should be interpreted in the same way as the phrase "group of persons" when the issue is control. This will affect the interpretation of other provisions in the Act in which the phrase is used. In ITTN 25, the CCRA states that it accepts the reasoning in *Silicon Graphics* on this point.

Having concluded that the non-resident shareholders did not have de jure control of Alias, the court went on to consider whether or not they exercised de facto control and found that they did not. The court set a high threshold: it stated that to support a finding of de facto control, "a person or group of persons must have a *clear right and ability* to effect a *significant change* in the board of directors or the powers of the board of directors or to influence *in a very direct way* the shareholders who would otherwise have the ability to elect the board of directors" (emphasis added). In ITTN 25, the CCRA recognizes that these circumstances are narrower in scope than those set out in *Interpretation Bulletin* IT-64R4, "Corporations: Association and Control." However, the CCRA also states that it is not considering any change to the bulletin at this time, implying that it hopes that the upcoming FCA decisions in *Mimetix* and *Poirier* will provide it with a standard more in line with its own stated position.

Although the decision in *Silicon Graphics* concerns a now outdated definition of a CCPC in subsection 125(7), it is clear that the case has broad implications. It limits the applicability of the de jure control test set out in *Buckerfield's*, narrows the distinction between the concepts of de jure and de facto control, suggests a high threshold for a finding of de facto control, and sets out an interpretive guide to the meaning of "one or more persons" where the phrase is used in the Act in the context of control.

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Compound Interest Deductibility: The Meaning of "Paid"

There is currently much discussion concerning the CCRA's draft administrative positions on the deductibility of simple interest. (See, for example, "Interest Deductibility Update," *Canadian Tax Highlights*, October 2002.) A related but often overlooked issue is the deductibility of compound interest. Simple interest is generally defined as the cost of borrowing calculated as a proportion of the principal amount of the debt. Compound interest is calculated on the amount of any accrued but unpaid interest. Simple interest is deductible, subject to the conditions in paragraph 20(1)(c) of the Income Tax Act, if it is paid in the year or is payable in respect of the year. However, compound interest is deductible *only* when it is *paid* in the year, and if it meets the conditions in paragraph 20(1)(d). The difference in the meanings of "paid" and "payable" seems innocuous at first glance.

As the following examples show, however, the distinction may be significant.

Example 1. X Co owes $1 million to Y Co, at a 10 percent interest rate. X Co incurred $100,000 of interest expense in respect of its 2001 fiscal year. X Co has cash flow problems at the end of 2001, and Y Co allows the $100,000 of interest to remain unpaid. At the end of 2001, therefore, X Co owes Y Co $1.1 million. X Co's cash flow problems persist in 2002, and Y Co permits a similar deferral for 2002. The amount of X Co's indebtedness at the end of 2002 is $1.21 million.

In fiscal 2001, the $100,000 of simple interest in respect of the $1 million due to X Co is deductible under paragraph 20(1)(c). In fiscal 2002, X Co's $110,000 interest obligation consists of $100,000 of simple interest in respect of the original principal and $10,000 of compound interest in respect of the unpaid interest from 2001. The $100,000 of simple interest is deductible pursuant to paragraph 20(1)(c). The contentious issue is the timing of the deduction of the $10,000 of compound interest. When is the compound interest "paid"?

X Co is not considered to have paid the compound interest by simply accruing the amount owing to Y Co. At common law, a payment occurs only when the debtor parts with money, or some other valuable consideration, in satisfaction of its obligation to the creditor. This common law concept is espoused by the CCRA in doc. no. 9203707. X Co has not "paid" interest to Y Co because it has not parted with anything of value. X Co will be able to deduct the $10,000 compound interest when it pays $10,000 in cash or equivalent value to Y Co to settle its compound interest obligation.

Example 2. Assume the same facts as in example 1, except for the following:

1) In fiscal 2001, X Co pays Y Co $100,000 by cheque to settle its interest obligation.

2) Y Co immediately lends $100,000 to X Co by way of a new loan. At the end of fiscal 2001, the aggregate principal amount of both debts is $1.1 million.

3) X Co enters into the same series of transactions in 2002 with respect to its interest obligation of $110,000 for that year.

As in example 1, the $100,000 of simple interest is deductible pursuant to paragraph 20(1)(c) in fiscal 2001 and 2002. Because a new debt with a principal amount of $100,000 was created in 2001, the $10,000 of interest thereon is simple, not compound, interest and is deductible under paragraph 20(1)(c) (and not under paragraph 20(1)(d)), since it is payable in respect of the year. *Hill* (TCC 2002) supports the argument that X Co should not be denied the deduction only on the basis of the circular flow of funds. Absent any evidence of sham or window dressing, *Hill* supports the finding in *Singleton* (SCC 2001) that the crossing of cheques defines the legal relationship between the parties. There is a bona fide relationship of debtor and creditor between X Co and Y Co in respect of the new loan of $100,000 created in 2001. As a result, the interest thereon is simple and deductible.

These examples illustrate the difference in the deductibility of simple interest and compound interest. The difference applies both to corporate and to personal debt. Existing debt that attracts compound interest may have to be restructured to meet the "paid" criterion in paragraph 20(1)(d). Tax advisers should be wary of the fine line between simple and compound interest and, where appropriate, recommend suitable action to avoid the non-deductibility of accruing compound interest.

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Deductibility of Interest and Repayment of Principal

Under subparagraph 20(1)(c)(i) of the Income Tax Act, a taxpayer may deduct, in computing income from a business or property, an amount paid pursuant to a legal obligation to pay interest on borrowed money used for the purpose of earning income from business or property. At common law, money is "borrowed money" if the borrower is bound to repay the principal amount at a certain time.

However, contracts and financial instruments do not always provide for the mandatory repayment of principal. Indeed, some contracts may provide that the principal is to be repaid in accordance with a formula, and the formula amount may be less than the full principal amount. For example, the amount to be repaid may be determined according to an index, or the lender's right to recourse against the borrower may be limited to property that fluctuates in value. Is interest payable on money borrowed on such terms deductible under subparagraph 20(1)(c)(i)?

Alberta and Southern Gas (FCTD 1976) appears to indicate that in order for a "loan" to exist, the principal amount must be repayable in its entirety. Therefore, if it is clear from the beginning that the principal of a debt may not be repaid in full, interest on it is not likely to be deductible. (See also *Ticketnet Corp.* (FCTD 1999).) On the other hand, some commentators have argued that although repayment of the loan in full is an important indicator of "borrowed money," it is not necessarily the determinative element. The better view seems to be that where, in view of all the circumstances, it appears that the parties intended to create a debt obligation, the fact that something less than the full principal amount may be repaid will not of itself undermine that intention. Some authority for this view is found in the non-tax decision in *Canada Deposit Insurance Corp. v. Canadian Commercial Bank* (SCC 1992).

For administrative purposes, the CCRA has stated that interest is deductible on the full amount of a limited-recourse loan, provided that it is not certain from the outset that the value of the security on maturity will be less than the principal amount borrowed (doc. no. January 1991-292). This position, though relatively old, has been confirmed on several occasions and is noted favourably in the literature. (See, for example, Siobhan Monaghan and Robert Raizenne, "Recent Cases of Interest to Corporate Financing Transactions," in *Report of Proceedings of the Fiftieth Tax Conference*, 1998 Conference Report (Toronto: Canadian Tax Foundation, 1999), and C. Anne Sanderson, "Interest Relating to Limited Recourse Financing," in *Current Issues in Resource Taxation* (Toronto: Canadian Tax Foundation, 1997).) It is also supported by recent jurisprudence: see *Redclay Holdings* (TCC 1996) and *Barbican Properties* (FCA 1997). This flexibility on the part of the CCRA and the courts is welcome and to be encouraged. However, taxpayers and advisers should pay careful attention to the structuring of any arrangement in which the borrower may not be obligated to repay the full principal amount so as to ensure that interest will be deductible.

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Alberta Warning: File Notice of Assessment Actions

Ordinarily, the Alberta taxation authority can reassess a corporation only within the normal reassessment period (three years from the issuance of an original assessment for a CCPC, four years otherwise), except in limited circumstances. These provisions generally parallel the federal Income Tax Act.

However, there is one important exception: when a federal or other provincial taxation authority takes an "assessment action" in respect of a corporate taxpayer, the Alberta Corporate Tax Act (ACTA) may authorize the provincial treasurer to reassess that corporate taxpayer outside the normal reassessment period.

Assessment Action

Generally, an "assessment action" is defined in ACTA section 43(1.1) to include assessments, reassessments, or confirmations of tax, interest, or penalties issued by federal or other provincial taxation authorities. It also includes loss determinations and notices of no tax payable.

Former ACTA section 43(1.2) allowed the provincial treasurer to issue a reassessment outside the normal reassessment period if the reassessment was issued no later than 12 months after the *issuance* of an assessment action affecting the particular taxation year ("the 12-month period"). Effective December 9, 1998, however, ACTA section 36.2(1) requires a corporate taxpayer to file with the provincial treasurer a copy of any assessment action within 90 days from the later of the date of the assessment action and the corporate taxpayer's Alberta tax return due date for the relevant taxation year.

Section 43(1.2) was amended so that the 12-month period commences when the corporation files the assessment action information with the provincial treasurer, not when the assessment action is issued. *Thus, the timing for an assessment or reassessment to be issued under ACTA can be extended indefinitely if a corporate taxpayer does not file the required information with the provincial treasurer.*

Penalty

A corporation that fails to comply with the filing requirements of section 36.2(1) within the 90-day deadline is liable to a penalty equal to the aggregate of

1) 5 percent of the aggregate of any increase in income tax and reduction in refundable credits for that taxation year that was unpaid at the end of the 90-day filing deadline, and

2) 1 percent of the aggregate of any increase in tax and reduction in refundable credits for that taxation year that was unpaid at the end of the 90-day filing deadline for each complete month, not exceeding 12, that the assessment action was not filed after the 90-day filing deadline.

Recommendation

Whether or not they are taxable in a particular year, corporations with an Alberta permanent establishment should file as soon as possible with the provincial treasurer a copy of any assessment action issued by a federal or other provincial taxation authority for any current or prior taxation year. By doing so, corporations can limit or avoid liability for penalties; the 12-month period will commence, and the indefinite assessment period will be avoided.

Since the penalty for failing to comply with ACTA section 36.2(1) is calculated by reference to the increase in tax of the *taxation year*, a corporation may be able to limit or avoid the imposition of a penalty by reducing its taxable income for Alberta purposes when it has additional discretionary claims. This presumes that there was no decrease in refundable credits.

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Separate Existence of Corporation Upheld

As is well known, a corporation is a separate legal person distinct from its shareholders. The shareholders' liability for the obligations of the corporation (with certain exceptions) is limited to the amount of their capital investment. These principles were established in the 1897 decision of the House of Lords in *Salomon* and have since been enshrined in modern corporate statutes in Canada. In the absence of express statutory authority, courts will pierce the corporate veil only in cases of fraud, sham, or improper conduct, or if the corporation is acting as the agent of its shareholders.

These principles were applied recently in *Meredith* (FCA 2002). Meredith was an engineer with an established reputation in his field. He incorporated Stem Applications Inc. ("Stem") in 1993 and was its sole director and employee. In 1997, Stem entered into contracts to perform services for two arm's-length US companies. Meredith provided the services called for under the contracts in the United States, where he lived for more than six months in 1997. Stem invoiced the American companies and received the fees for the services rendered by Meredith. Stem paid Meredith a salary in 1997.

Meredith claimed an overseas employment tax credit for the 1997 taxation year (under section 122.3 of the Income Tax Act) in respect of the tax otherwise payable by him on the salary received from Stem. One of the conditions in section 122.3 is that the individual must have provided services in a foreign country *as an employee*.

The Tax Court held that Meredith was an independent contractor, not an employee of Stem. The court applied the tests in *Wiebe Door* (FCA 1987) and ignored the separate existence of Stem, and the contractual relationships between Meredith and Stem and between Stem and the customers.

The Federal Court of Appeal has now allowed an appeal from that decision. In reaching its decision, the court relied on two important legal principles recently re-established by the Supreme Court of Canada. First, the separate legal relationships created by taxpayers must be respected in the absence of an allegation of sham or improper conduct, or where there is statutory authorization to do so. Second, a court is not permitted to recharacterize the bona fide relationships between parties on the basis of what the court deems to be the economic realities underlying those relationships: see *Continental Bank Leasing Corp.* (SCC 1998), *Shell Canada* (SCC 1999), and *Ludco Enterprises* (SCC 2001).

This decision of the Federal Court of Appeal illustrates the stricter approach to statutory interpretation enunciated by the Supreme Court of Canada. This approach, including the restrictions on the court's ability to recharacterize legal relationships, should make it more difficult for the courts to pierce the corporate veil in the absence of statutory authority. However, it is still vitally important for taxpayers and their advisers to ensure that the legal formalities of relationships and transactions are satisfied and respected, and that they reflect the actual intentions of the parties; otherwise, a court may find a way to disregard or recharacterize them.

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The GST and Partnerships: A Developing Landscape

The provisions of the Excise Tax Act (ETA) that determine the manner in which partners and partnerships are taxed for GST purposes are not the most straightforward in that statute. For some time, the CCRA has been struggling to develop detailed policies for administering the partnership provisions in ETA section 272.1. In the meantime, a number of difficult issues have arisen, and some of them are being settled by the courts.

In *Janelle* (TCC 2002), two partners were assessed for their partnership's GST liability, although the partnership had not yet been assessed. The two partners applied to the court for an order quashing the assessment, likely relying on a previous case (*Decaire* (TCC 1999)) in which the Tax Court concluded (before the enactment of the new partnership provisions in ETA section 272.1) that such assessments were invalid because the partnership was required to be assessed first.

The court in *Janelle* distinguished *Decaire*, noting that new ETA subsection 272.1(5) appears to provide that all the partners are liable for the GST liabilities of the partnership. Given other provisions of the ETA, such as paragraph 296(1)(e), which allows the CCRA to assess amounts that partners are liable to pay under the partnership rules in ETA section 272.1, the court concluded that the law is now such that partners can be assessed without any previous assessment of the partnership. Some other recent Tax Court cases have come to the same conclusion.

Business owners should understand the ramifications of this new liability and plan accordingly for it.

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Allocation of Partnership Income: Section 103 Issues

Subsection 96(1) of the Income Tax Act provides that the income of a partnership is to be computed as if the partnership were a separate person. Beyond this, it is silent on how that income is to be allocated among the partners. Generally, this is determined by the partners themselves, and allocation is usually set out in the partnership agreement. If the principal reason for the partners to share income in a certain way is the postponement of tax, subsection 103(1) provides for a reallocation to amounts that are reasonable having regard for all the circumstances. Cases and CCRA technical interpretations dealing with the meaning of "the principal reason" and "one of the main reasons" in other sections of the Act may be useful when considering the scope of section 103.

Where the partners do not deal with each other at arm's length, subsection 103(1.1) uses a "reasonableness" test rather than a purpose test, which is a more subjective test than the subsection 103(1) test. The amount of capital contributed and the effort expended on behalf of the partnership are specific criteria to be considered.

Interpretation Bulletin IT-231R2 sets out the CCRA's view on subsection 103(1.1). Both the time expended and the expertise provided will be considered in determining the "reasonableness" of any income allocation. If a partner brings little expertise to the affairs of the partnership, he will be expected to contribute more time or capital than a partner who provides specialized skills.

Some partnership agreements provide for the payment of a salary to one partner before the partnership income is distributed. The CCRA has said many times that a partner is not entitled as a matter of general partnership law to be paid a salary by the partnership. Accordingly, an amount distributed as "salary" will be treated as a distribution of income and therefore will be subject to reallocation under section 103 (doc. no. 2002-0132797). Where the distribution to a partner exceeds his share of income, the excess may be considered a withdrawal of partnership capital or a distribution of income to which section 103 applies.

A partnership can be used to effect an estate freeze. In this type of freeze, a parent transfers his business assets to a partnership formed with his child. Usually, the child's capital contribution is limited to a nominal amount. Problems may arise if a majority of partnership income is allocated to the child in the future, unless the income is commensurate with the child's work on behalf of the partnership. It is the CCRA's opinion that subsection 103(1.1) may be applicable on the basis of the child's nominal capital contribution. Compare this with the case in which the freeze vehicle is a corporation. In that situation, the CCRA is prepared to accept a nominal capital investment in equity shares by the child even when discretionary dividend shares are used to pay to the child dividends in excess of those paid to the father (see *Neuman* (SCC 1998)). If the parent rolls farmland and depreciable property to the partnership, one can argue that subsection 103(1.1) should not be applied to an income allocation because the parent could have rolled those assets directly to the child without income attribution (on the assumption that the farming activity is a business).

Subsection 103(1.1) was applied in *Zalesky* (TCC 2000). The taxpayer and his wife operated a distributorship of personal and household products in partnership. The husband had a full-time job and helped out in the business when time permitted. The wife worked full-time in the business and had no other source of income. All of the partnership losses were allocated to the husband. The CCRA applied subsection 103(1.1) and allocated the losses 50-50.

The court ruled that a 100 percent allocation of the loss to Mr. Zalesky was unreasonable and ordered a 75-25 split in his favour. Mr. Zalesky's capital contributions (he had funded all of the operating losses) justified this approach. The court also suggested that the 75-25 split should continue when the business became profitable in the future.

Clearly, taxpayers in partnership with related persons must ensure that their annual allocation of income is reasonable, taking into consideration the contributions of time, expertise, and capital by each partner. It may be prudent to document the reason for the income allocation chosen, although this is seldom done in practice. Once an allocation of income has been established, it should be changed only if there is a change in the respective contributions of the partners.

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TAX FOR THE *Owner-Manager*

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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Update on Section 84.1

The CCRA recently issued a technical interpretation (doc. no. 2002-0128955) dealing with section 84.1 deemed dividends and the subsection 83(2) capital dividend election. The TI represents a shift in administrative policy and overrides a 1998 TI (doc. no. 9729855). In the recent TI, the CCRA was asked to comment, on the basis of a given fact situation involving related parties where subsection 84.1 applied, as to whether the purchaser corporation could make a subsection 83(2) election in respect of the dividend deemed paid by it to the transferor pursuant to paragraph 84.1(1)(b). The taxpayer referred to a 1998 TI in which the CCRA said that a deemed dividend under paragraph 84.1(1)(b) was to be considered a "taxable dividend paid by the corporation on shares of its capital stock in the year" for the purposes of subparagraph 129(1)(a)(i).

The CCRA took the position that a deemed dividend under section 84.1 does not meet the requirement in subsection 83(2) that the dividend becomes payable to shareholders of any class of shares of a corporation's capital stock and that there is no deeming provision in the Act to that effect, in contrast to the original version of subparagraph 84.1(1)(c)(iii). The CCRA is of the opinion that the presumption in subsection 84(7) does not allow the application of subsection 83(2), since it does not deem the recipient of the dividend to be a shareholder of the payer corporation. However, given the fact that both subsection 84(7) and the technical notes to that subsection clearly refer to section 84.1, which could be evidence that the tax policy is to permit such an election in the case of section 84.1 deemed dividends, the CCRA mentioned in the TI that it has informed Finance accordingly. As to the 1998 TI, the CCRA simply said that it no longer represents its position.

From informal discussions with the CCRA, we understand that this new administrative position on section 84.1 is not intended to be retroactive and will be applied prospectively. With respect to the specific issue dealt with in the TI, the CCRA confirmed that its main concern in that case was that the recipient of the section 84.1 deemed dividend for which the payer corporation filed a subsection 83(2) election was not a shareholder of that corporation. We have also been informed that the CCRA's new policy will allow a subsection 83(2) election to be made in respect of a section 84.1 deemed dividend where the recipient of the deemed dividend is otherwise a shareholder of the payer corporation. The CCRA also said that it will not allow a dividend refund under subsection 129(1) even if the dividend recipient is effectively a shareholder of the payer corporation immediately after the disposition. It appears that the CCRA is in the process of preparing a note to Finance pointing out the technical glitch in allowing dividend refunds under section 129 in situations involving section 84.1 deemed dividends. The ball is now in Finance's court.

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Editor's Note

"Canadian Parents Financing US Subs: Alert" (*Tax for the Owner-Manager*, October 2002) dealt with pending US legislation of interest to Canadian taxpayers with operations in the United States. In the numbered list that appeared on page 30 of the print version, point number (4) should read as follows:

> (4) the carryforward of excess limitation is eliminated.

The electronic version of the October issue has been corrected and is available at http://www.ctf.ca.

The author notes the following clarifications that should be considered when reviewing the proposed legislation:

> Based on the actual wording, the proposed amendments would be applicable to taxable years beginning after December 31, 2003. However, there is a specific exception to this general rule for recent debt providing that the proposed amendments would also be applicable to taxable years ending after July 10, 2002, and beginning before the first taxable year to which such amendments would generally apply. In such a case, the increase in the amount disallowed under paragraph 163(j) by reason of such amendment shall not exceed the amount of disqualified interest for such year on indebtedness incurred after July 10, 2002.

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