TAX FOR THE Owner-Manager

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Accountant-Client Privilege and Section 231.2 Requirements

In *Kitsch* (FCA 2003, on appeal from FCTD 2002), the issues were (1) whether the documents and information in the possession of the applicants' accountants were subject to a privilege protecting them from disclosure, and (2) whether certain "requirements to provide information" were within the scope of subsection 231.2(1) of the Income Tax Act.

In response to issue 1, the lower court held that accountants and their clients do not have a class privilege similar to solicitor-client privilege (see *Baron,* FCA 1991). Furthermore, the court held that the relationship between a client and his or her accountant does not meet the requirements of "case-by-case privilege" set out by Lamer CJ in *R v. Gruenke* (SCC 1991, decided under the Criminal Code). The FCA agreed with the FCTD and held that communications between accountants and their clients are not privileged unless a lawyer directs the communication.

With respect to issue 2, the applicants and their accountants objected to the requirements on the basis that the accountants were requested to create and produce documents and information that did not exist. Specifically, the requirements asked the accountants to prepare new documents setting out their subjective understanding of their clients' intention. The lower court ruled that subsection 231.2(1) required the production of documents and information in existence but did not authorize the minister to conduct a written examination for discovery, and it set aside those parts of the requirements that would have had that effect.

The FCA disagreed and allowed the Crown's appeal on this point. The court said that paragraphs 231.2(1)(a) and (b) have different meanings in that paragraph (a) requires the production of "any information," while paragraph (b) requires the production of "any document." Although "document" is defined in the Act (section 231), "information" is not. The court adopted the *Oxford English Dictionary* definition of "information" as "facts or knowledge provided or learned," and held that paragraph 231.2(1)(a) allows the minister to ask questions to elicit "information," meaning knowledge or facts.

The decision on these two issues has significant implications. With respect to the second issue, the FCA held that tax-planning information can shed light on intention and that the taxpayer's subjective intention may be relevant to determine the applicability of the general anti-avoidance rule (GAAR). With that said, if unwritten communications are not confidential, then tax planning has become considerably more challenging. On the basis of *Kitsch*, both the taxpayer and his or her accountant may be required to disclose unwritten communications relating to the purpose of specified transactions. The accountant may be required to state his or her understanding of the taxpayer's purpose in entering into the transactions. This will provide the CCRA with a significant advantage in cases involving GAAR-based assessments.

With respect to the first issue, should an accountant-client privilege exist? It has been well established that the solicitor-client privilege is necessary for the proper administration of justice. Is there a need for a similar relationship with one's accountant? Recent events, such as the Enron and WorldCom scandals, have fuelled the public's distrust of the accounting profession in general and undoubtedly support the court's decision to disallow such a privilege in this case. Some people may object to the fact that advice from a tax accountant and advice from a tax lawyer are not awarded the same confidentiality entitlements. However, the courts have refused to extend the privilege to the accountant-taxpayer relationship, and prudent taxpayers and advisers should govern themselves accordingly.

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In This Issue

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Tax Shelters: No Block Discount for Art Donations

In *Malette* (TCC 2003), the Tax Court held that the simultaneous donation of 981 works of art to the same institution in a "tax shelter market" context did not affect the value of the art. Rather, each piece of art was to be valued individually.

The facts are straightforward. On or around January 31, 1997, Mr. Malette and two other individuals collectively purchased 981 works of art by Harold Feist, each of which satisfied the criteria set out in sections 29(3)(b) and (c) of the Cultural Property Export and Import Act (CPEIA). Initially, the purchase price was set at $250,000, but ultimately it was agreed that payment would be based on 25 percent of the amount certified by the Review Board under the CPEIA.

On July 22, 1998, the art was donated to the Art Gallery of Algoma. The appellant submitted that the value of the art on that date was $879,714; however, the Review Board determined that the fair market value of the art was $293,246. Unhappy with the board's determination, the appellant appealed to the Tax Court of Canada pursuant to section 33.1 of the CPEIA.

The sole issue before the Tax Court was whether the 981 works of art should be valued individually or as a group subject to a "block discount." The parties agreed before trial that the fair market value of the art without a block discount was $828,000. The appellant also conceded that if the Tax Court found that a block discount was appropriate with respect to cultural property donations, the 90 percent discount levied by the minister's appraiser would be applicable and the fair market value of the art for the purposes of the gift rules would be $141,402.

Mr. Justice Beaubier first noted that both the CPEIA and the Income Tax Act referred in their donation of cultural property provisions to the singular ("object") rather than the plural ("objects"). For example, subsection 118.1(1) of the Act refers to "the total of all amounts *each* of which is the fair market value of *a* gift of *an* object" (emphasis added) and defines "total cultural gifts" in a similar manner. He held that because the Act treats donations of cultural property as individual objects, the simultaneous donation of other objects is an irrelevant consideration in determining the value of such objects.

Second, Mr. Justice Beaubier observed that it is "the disposition that creates the question of value, not the transaction between the Appellant and [the artist]." Thus, he dismissed the relevance of the purchase price of the art, stating that it is only the disposition transaction that counts in determining value.

Finally, he noted that the appellant had purchased the art for 8 to 15 percent of its fair market value and that the donations had occurred in the "tax shelter market" context. The minister's appraiser had taken the tax-driven aspect of the donations into consideration in applying the 90 percent block discount. However, Mr. Justice Beaubier noted that in *Pustina, Whent and Zelinski* (TCC 1996) a similar argument was rejected at trial, and that this decision was upheld on appeal (FCA 1999). It is somewhat surprising, then, that the minister pursued the *Malette* case to trial.

While one might perhaps have preferred a more detailed analysis of the issue in *Malette*, the judgment affirms the principle that a block discount is not appropriate in a case involving art donations in the tax-shelter context. It concludes with policy reasons for rejecting such a discount—namely, the intent of Parliament to encourage large donations of art to public galleries.

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Accounting Profit Versus Tax Profit

The recent case of *Glueckler Metal* (TCC 2003) highlights once again that "profit" for tax purposes is not necessarily determined by accounting concepts. In *Glueckler Metal*, a majority of the shares of the taxpayer were held by Parentco. In 1994 the taxpayer made and claimed a deduction for a voluntary payment of $500,000 to Parentco on account of administration services ($200,000) and interest on loans ($300,000), both relating to years prior to 1994. The payment was made following a review of the intercompany accounts by the company's accountants at the insistence of the company's bankers. The review determined that Parentco had been inadequately compensated for those items in prior years. The CCRA disallowed the deductions, arguing that the deduction of the full amount in 1994 did not reflect an accurate picture of the taxpayer's income for that year.

The TCC allowed the deduction, relying on the 1998 SCC decision in *Canderel*. It said that taking the full deduction in 1994 provided the most accurate picture of the company's economic situation in 1994. According to *Canderel*, a taxpayer is free to adopt any method of computing profit as long as it is not inconsistent with the provisions of the Act, with the case law, and with well-accepted business principles. The matching principle as applied in accounting is not a principle of tax law. Well-accepted business principles are not necessarily determined by GAAP, are not rules of law, and are to be determined on a case-by-case basis. Once a taxpayer shows that its chosen method of computing profit is in accordance with these tests and provides an accurate picture of income for a particular year, the onus shifts to the minister to demonstrate that the taxpayer's position does not represent an accurate picture of its income.

There is little guidance in the case law as to what constitutes "well-accepted business principles," but establishing them in a particular case is the starting point in determining whether a particular method of computing profit is acceptable. Practically speaking, such principles will often be identical to GAAP. However, this will not always be the case. The court in *Glueckler Metal* said that "the competing concepts of running expenses and matching . . . fall into the category of well-accepted business principles." The court made two other important points in *Glueckler Metal*:

- A voluntary payment can be deductible.
- The obligation arose only in 1994 and should not have been deducted in the years to which it related.

A surprising aspect of the decision is the court's failure to analyze the interest component of the payment separately from the management services aspect. Interest is deductible under paragraph 20(1)(c) if it is "paid in the year or payable in respect of the year (depending upon the method regularly followed by the taxpayer in computing the taxpayer's income)."

Mid-West Abrasive (FCTD 1973) involved a payment of interest that was made to a parent company in 1967 but that related to borrowings made in 1960 and 1961. The loan document provided that interest was payable "if requested." The parent did not demand the interest for all years until 1966. The taxpayer paid it in 1967. The interest had not been accrued as an expense in earlier fiscal years even though profits were computed under the accrual method.

The court held that the year referred to in paragraph 20(1)(c) is the year in which the borrowed money is used. It also held that the "method" regularly followed is not confined to either the paid or the accrual basis. However, it said that if the accrual basis is used in computing income, then generally interest is deductible only under that method and not on the paid basis, *except in unusual circumstances.*

Significantly, in *Mid-West Abrasive* the court held that the liability for interest was created when the note was signed, not when the parent requested it. This differs from *Glueckler Metal*, where the interest liability was created in a year after the funds were borrowed. Perhaps this is one of the "unusual circumstances" in which interest can be deducted on the paid basis even though the company otherwise follows the accrual method generally. However, the court's failure to address this point in *Gleuckler Metal* leaves open the question whether the same decision would have been reached if the *Mid-West Abrasive* argument had been cited to the court. It is not apparent from the reasons for judgment that it was.

The Department of Finance is expected to release draft legislation in connection with interest deductibility before the end of the year to implement a measure referred to in the 2003 federal budget. It will be interesting to see whether the legislation addresses that point.

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Cascading Section 160 Assessments

Under section 160 of the Income Tax Act, the CCRA may assess a taxpayer for amounts owing under the Act by another taxpayer. Subsection 160(1) applies where a person liable for tax makes a direct or indirect transfer of property to his or her spouse or common law partner, a person who has since become the transferor's spouse or common law partner, a minor under age 18, or any person who does not deal with the transferor at arm's length. The transferee becomes jointly and severally liable for the transferor's liability under the Act in or in respect of the taxation year in which the property was transferred and in any preceding taxation year. The transferee's liability is limited to the excess of the fair market value of the transferred property at the time of the transfer over the fair market value of any consideration given for the property.

In the recent decision in *Jurak* (FCA 2003, affirming TCC 2001, leave to appeal to SCC dismissed 2003), a wholly owned subsidiary corporation had paid a dividend to its parent corporation in 1988. The voting shares of the parent corporation were held by Mr. Jurak's common law spouse. The subsidiary, the parent corporation, and Mr. Jurak did not deal with each other at arm's length. The subsidiary was liable for amounts under the Act in or in respect of the taxation year in which the dividend was paid or a preceding taxation year. The CCRA raised a section 160 assessment against the parent corporation in 1993 for all or a portion of the subsidiary's tax liability. This assessment was not challenged.

Mr. Jurak was assessed under section 160 for the parent corporation's liability under its section 160 assessment. Mr. Jurak's assessment was in respect of a transfer of a residence from the parent corporation to him in 1991 and a discharge of a debt by the parent in 1992. The Crown contended that the fair market value of the residence and of the discharged debt was less than the fair market value of the consideration received from Mr. Jurak.

The appellant, relying on the decision in *Nanini* (TCC 1994), argued that a recipient of property cannot become liable under subsection 160(1) for the transferor's own liability under subsection 160(1). The Tax Court of Canada and the Federal Court of Appeal refused to adopt the reasoning in *Nanini* and held that the transferee of property may also become a transferor subject to subsection 160(1) if, at the time of the second transfer, the transferee is a tax debtor liable either on his own account or jointly and severally with the first transferor. Earlier decisions supporting the validity of cascading section 160 assessments (*Zobay*, TCC 1996, and *White*, TCC 1994, unreported) were approved.

It was also argued that the parent corporation was not a tax debtor at the time of the transfer of the residence and the discharge of the debt because it had not yet been assessed under section 160. The Tax Court rejected this argument and confirmed that it was section 160, not the assessment, that created the tax liability.

The December 20, 2002 draft legislation proposes to amend section 160, inter alia, to clarify that a transferee is liable for the transferor's subsection 160(1) liability regardless of whether the transferor has been assessed by the CCRA, and to subject the liability under subsection 160(1) to interest. Under the prior wording of the section, courts have held that interest was not applicable to an assessment under section 160 because an assessment did not create a new tax debt and incorporated interest owing by the transferor. The amendments will be applicable to assessments made after December 20, 2002.

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Employee-Independent Contractor Tests Expanded

The recent cases of *Poulin* (FCA 2003) and *Sanclemente* (TCC 2003) show that the court is no longer confined to the tests in *Wiebe Door Services Ltd.* (FCA 1986) in determining whether there is an employer-employee relationship. In these two cases, the intention of the parties and the wording of the actual contracts played more important roles than the *Wiebe Door* tests.

In *Poulin*, the Federal Court of Appeal had to decide whether the Tax Court of Canada was right in concluding that three attendants hired by the taxpayer were his employees. During the taxation year in question, the taxpayer retained the services of three individuals: a personal care attendant, a personal care attendant and nursing assistant, and a visiting homemaker. The taxpayer required their services because he had been rendered quadriplegic by a car accident.

The Tax Court judge relied mainly upon the control test. In overruling the lower court, Létourneau JA of the FCA first considered three of the traditional tests in analyzing the relationship: (1) the existence of control and a relationship of subordination, (2) the ownership of the tools needed for the performance of the work, and (3) the chances of profit and risks of loss. Létourneau JA said that on the facts of the case, the notion of control as a test was at best neutral and at worst misleading, that little weight ought to be placed on the ownership-of-tools test, and that the chance-of-profit test was of no use at all.

Létourneau JA then went on to examine the intention of the parties and in the end relied upon it as the key in making the determination. Although there were no written agreements in this case, Létourneau JA inferred from the facts and statements by the three attendants that insurable employments were not intended. He also observed that in view of the taxpayer's physical condition and the consequences that would result from employer status, it was unreasonable to infer that the taxpayer intended to enter into a contract of employment with the three attendants.

This focus on the intention of the parties as the determining factor, while welcome on the facts of this case, may not be as significant in other situations. Certainly, the court should not be taken as holding that parties are free to characterize their relationship by labelling it a contract for services, regardless of the true nature of the relationship. With respect, in many cases taxpayers do not welcome the consequences that result from employer-employee status, but this desire cannot of itself change the true legal nature of the contract.

It should be noted that one objective fact in *Poulin* indicated an employment relationship: the taxpayer had paid vacation pay to two of the attendants. Létourneau JA brushed this aside, saying that the employer's doing so was understandable in the circumstances. One might speculate whether another court faced with less sympathetic facts will take the same view.

The importance of a written contract setting out the parties' intended relationship was underscored in *Sanclemente*. In that case, the taxpayer worked as a supervisor with a construction company. Contracts between the taxpayer and the company clearly contemplated a contract for services, and this was noted by the Tax Court as an important factor in its finding that the taxpayer was an independent contractor. O'Connor J stated that although a written contract was not always determinative, when one did exist it should be ignored only if its terms were inconsistent with the evidence and the entirety of the relationship.

These two decisions indicate an evolution in the factors that constitute an employer-employee relationship. In *Poulin*, Létourneau JA suggested that the *Wiebe Door* tests might have to be overhauled to reflect the new reality of an increase in short-term, part-time jobs, several of which might be performed by the same individual. Although he stopped short of stating how they should be overhauled, he placed a greater emphasis on intention than perhaps has been done in the past. (See *671122 Ontario Ltd. v. Sagaz Industries Canada Inc.*, SCC 2001.) *Sanclemente* might also reflect this new reality. O'Connor J said that he was influenced in his decision by the taxpayer's testimony that in years other than those in dispute, he had contracts with parties other than the construction company. This can be seen as a course of conduct supporting an intention on the part of the taxpayer to be an independent contractor rather than an employee.

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The GST and Motor Vehicle Allowances

Section 174 of the Excise Tax Act (ETA) allows an employer to claim input tax credits (ITCs) for certain allowances paid to employees, including "mileage allowances" for motor vehicles, and broadly parallels the income tax rules providing for "employer deductibility" for similar allowances in paragraph 6(1)(b) of the Income Tax Act (ITA). Where section 174 applies, it deems the employer to have incurred the employee's expenses and to have paid the GST, which in effect allows the employer to recover the GST paid by the employee.

A recent GST case, *Melville Motors* (TCC 2003), clarifies the treatment of a mileage allowance based on kilometres travelled subject to a fixed ceiling. Previously, this issue had been somewhat uncertain: the CCRA had viewed these types of situations as involving allowances based on something other than kilometres and therefore as non-recoverable for GST purposes and non-deductible for income tax purposes.

This article summarizes the requirements that an employee must meet in order to obtain section 174 ITCs; it outlines the relevant parts of the *Melville Motors* case and provides commentary on the case's implications for owner-managers.

Section 174 ITCs: The Legislative Backdrop

In order to qualify for section 174 ITCs, an employer must ensure that the following requirements are met: (1) the automobile expenses must be incurred in Canada and GST must have been paid on the expenses; (2) the amount paid as the allowance must be deductible by the employer for income tax purposes; (3) the amount of the allowance must be "reasonable" (at the time it was paid); and (4) the employee must not receive a reimbursement from the employer in respect of the same vehicle.

With respect to requirement 2, paragraph 18(1)(r) of the ITA currently limits the deduction an employer may make for income tax purposes to a maximum of 36 cents per kilometre. If an employer chooses to reimburse in excess of this amount, the GST applicable to the excess amount is not recoverable. With respect to requirement 3, the word "reasonable" is subject to interpretation. Although the CCRA generally considers an allowance to be "reasonable" if it is based on the maximum deductible allowances set out above, other allowances may be reasonable, depending on the circumstances. Significantly, however, subparagraph 6(1)(b)(x) of the ITA provides that motor vehicle allowances are *not* reasonable if the allowance is "not based solely on the number of kilometres for which the vehicle is used in connection with or in the course of the office or employment."

The Melville Motors Case

In *Melville Motors*, the Tax Court was asked to determine whether motor vehicle allowances based on kilometres travelled, up to a fixed ceiling, could be considered to be "based solely on the number of kilometres" and thus reasonable under the rules described above.

The appellant operated an automobile dealership in Melville, Saskatchewan, and paid several employees an allowance for their motor vehicle expenses. The employees leased the vehicles from the appellant and used them in the course of their employment. Each employee submitted invoices setting out the overall kilometres travelled in the vehicles. Because the appellant's employees travelled extensively, there was a fixed ceiling on the number of kilometres for which the allowance would be paid. According to the appellant, without these fixed ceilings the mileage allowances claimed would have been greater than the amount the employees were paying the appellant to lease their automobiles. (It appears that the fixed ceilings were equal to the lease payments paid by the employees and that the allowances actually paid always reached the ceiling—that is, the allowances were always equal to the employee's lease payments.)

The CCRA seemed troubled by this arrangement, perhaps because the overall economic effect of the relationship was to allow the employees free use of the vehicles, except for the cost of the gas. The CCRA reassessed to disallow the ITCs on the allowances. It took the position that, as a matter of fact, the allowances were based on the lease payments and not solely on the number of kilometres travelled.

The Tax Court held—properly, in our view—that the allowances were in fact based on mileage and that the stipulation of a fixed ceiling did not change that. It held that the allowances (and the ceilings) were reasonable. It observed that the method of computing the allowances was a sensible one for the appellant to use, and that the appellant was entitled to exercise control over its employees and conduct its business in the manner it chose.

Commentary

Melville Motors is a helpful addition to the case law on the scope of section 174 and subparagraph 6(1)(b)(x). The Tax Court's willingness to recognize a ceiling arrangement is particularly welcome, given the practical difficulty that most employers face in policing the mileage travelled by their employees. In many, if not most, of the cases on allowances for business use of an automobile, an element of personal use is involved. Accordingly, it is not unreasonable for an employer to impose a limit on the amount of an allowance, provided that the limit is related to the expected business use of the automobile.

Melville consolidates and confirms previous jurisprudence. *Tri-Bec* (TCC 2002) also dealt with ceilings on motor vehicle allowances, but in less certain terms. In *Tri-Bec*, allowances of between $50 and $75 a week were paid to several employees; the Tax Court allowed ITCs to be claimed only on the allowance paid at a flat rate of $75 per week. With regard to the other allowances, the court found that the "details were too vague" to believe that they were based on actual kilometres travelled, and it denied the employer a deduction of them for income tax purposes.

Finally, the importance of tying allowances to kilometres travelled (even if at a capped amount) cannot be overstated. In *Melville* the court was satisfied, first and foremost, that the allowances were in fact based on actual kilometres travelled. Accordingly, owner-managers who rely on section 174 (and its income tax counterpart) should maintain sufficient documentary evidence to establish the business kilometres travelled by their employees. This process will usually start with an express requirement for the keeping of travel logs.

To the extent that a motor vehicle allowance meets the prescribed conditions, it can confer tax benefits on both the employer and the employee, because the allowance is not taxable in the hands of the employee and, unlike salaries paid to employees, entitles the employer to a full ITC.

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Partnerships: Compliance Issues

Editor's note: This is the second in a planned series of articles on selected tax consequences of carrying on business in a partnership (see "Partnerships Versus Joint Ventures: The Separate Person Concept," Tax for the Owner-Manager*, April 2003.) This article considers two compliance issues, one involving section 116 certificates, the other the decision to file (or not file) form T5013.*

The Section 116 Requirements of a Non-Resident Partner

When a non-resident person disposes of taxable Canadian property (TCP), the purchaser is obligated to withhold and remit to the CCRA 25 percent of the gross selling price unless the non-resident vendor has obtained the requisite tax clearance certificate in accordance with the provisions of section 116 of the Income Tax Act.

Assume that a non-resident partner is a member of a partnership that carries on business in Canada. The partnership, not the non-resident partner, disposes of TCP that is not excluded property under subsection 116(6) of the Act. Does the non-resident partner have to obtain a section 116 clearance certificate? The answer turns on the theoretical question of who is disposing of the TCP: the non-resident partner or the partnership.

The CCRA's administrative position is that each non-resident partner must submit a separate form T2062 requesting a section 116 clearance certificate (question 87 of the 1987 Revenue Canada Round Table). If the CCRA is satisfied that the requirements of section 116 are met, the appropriate clearance certificate will be issued to each non-resident partner. Each non-resident partner is liable for Canadian tax on its share of the gain and is required to file a Canadian tax return (see paragraph 2(3)(c) and subsection 150(1) of the Act).

If the disposing partnership has numerous non-resident partners, it may not be practical for all of them to apply for a section 116 certificate. To reduce the compliance burden in such a case, the CCRA will accept one form T2062 on behalf of all the non-resident partners, provided that the names and addresses of all of them are attached and the percentage interest of each partner is specified. Each non-resident person is still required to file a Canadian tax return.

The CCRA's administrative position is theoretically sound. The non-resident partner is considered to be carrying on the business of the partnership, notwithstanding that the partnership is regarded as a separate person for the purposes of the income calculation. Section 253.1 deems a partner not to be carrying on the business of the partnership in the limited circumstances in which the partner is truly a passive investor. In most other cases, as a matter of the general law of partnership the partner is carrying on the business of the partnership. Therefore, the non-resident partner, not the partnership, is considered to be the person disposing of the TCP in this example and must comply with the legislative and administrative requirements of section 116.

Filing the Form T5013 Partnership Information Return

Regulation 229(5) provides that a T5013 partnership return must be filed within certain time limits, depending on whether the members of the partnership are corporations, individuals, or a combination thereof. Subsection 220(2.1) authorizes the minister to exempt members of any partnership from the filing requirement if there are five or fewer members and none of them is another partnership (see paragraph 11 of *Information Circular* 89-5R, June 21, 1991). Many small professional partnerships rely on this administrative concession and do not file form T5013. However, there is a potential negative consequence to not filing.

Subsection 152(1.4) of the Act provides that the minister may, within three years after the day that is the later of the day on or before which a member of a partnership is required to file an information return for a fiscal period of the partnership and the day the return is filed, determine any income or loss of the partnership for the fiscal period and any deduction or other amount in respect of the partnership for the fiscal period that is relevant in determining the taxable income of any member of the partnership for any taxation year. Therefore, if a T5013 return is not filed, subsection 152(1.4) gives the minister an indefinite period in which to reassess the members of the partnership (see TI-9726115, October 29, 1998, and TI-2000-0010935, July 17, 2000). Further, paragraph 152(1.7)(a) provides that a determination or redetermination made by the minister pursuant to subsection 152(1.4) is binding on the partnership and its members for the purpose of calculating the income or taxable income of the members for any taxation year. Consequently, it may be prudent for a partnership to file the T5013 even if it is not administratively required to do so.

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Subsection 55(2): Phantom Income Is Safe

In *Kruco* (FCA 2003), the court ruled that safe income must be computed in accordance with the provisions of the Income Tax Act rather than rules devised by the CCRA. One might have thought this proposition to be unworthy of judicial reinforcement, but complex areas of income tax law have long been governed by administrative rules and policies. Safe income is one such example.

In 1981, John R. Robertson made the CCRA's first public presentation on the subject of capital gains strips under section 55. During that presentation, Robertson enunciated 22 propositions concerning the calculation of safe income. These propositions are known in the tax community as "the Robertson rules." In *Kruco*, when the CCRA recalculated the respondent's safe income in accordance with the Robertson rules, the respondent objected on the grounds that the Act, not the Robertson rules, governed the calculation of safe income. Happily, both the Tax Court of Canada and the Federal Court of Appeal have agreed with the respondent.

The facts in *Kruco* are easily summarized. A dispute between the respondent—a minority shareholder of Kruger Inc. ("Kruger")—and Kruger's majority shareholder led to an agreement whereby Kruger repurchased 3,627,100 common shares from Kruco for $99,000,000. Kruger guaranteed that at least $70,000,000 of safe income would be attributable to the repurchased common shares. In its tax return for the relevant year, the respondent reported a $73,000,000 dividend paid out of safe income and a $17,027,105 capital gain.

The CCRA's adjustments to the respondent's safe income calculation reflected its view that safe income—that is, "income earned or realized" in accordance with subsection 55(2)—does not include "phantom income." The Robertson rules define phantom income as "income recognized in the computation of income under

Division B of Part I of the Act although it is not supported by a corresponding cash inflow." According to the CCRA, if safe income is not "on hand" or "disposable," adjustments in accordance with the Robertson rules are necessary. Therefore, the CCRA subtracted from the respondent's safe income the investment tax credits (ITCs) that reduced the capital cost and undepreciated capital cost of the respondent's eligible property, and the ITCs that were added to the respondent's income, because there was no cash inflow corresponding to these increases in income.

The Tax Court judge acknowledged that adjustments to safe income beyond those mandated by paragraph 55(5)(c) for private corporations were permissible. However, he distinguished adjustments for taxes paid, dividends distributed, non-deductible expenses, and losses of foreign affiliates, which affected a corporation's cash position, from the minister's adjustments, which affected the respondent's calculation of income. In his view, Parliament had deliberately based the safe income calculation on income for tax purposes rather than on income in the economic or accounting sense. He dismissed the minister's "economic reality" argument, relying upon both the "letter" and the "spirit" of the deeming rule in paragraph 55(5)(c) to determine the respondent's safe income. He also noted that the minister's adjustments would have resulted in double taxation.

The Federal Court of Appeal dismissed the minister's appeal, essentially for the reasons given by the Tax Court judge. Noël JA emphasized Parliament's intention to allow the tax-free distribution of intercorporate dividends from income already subjected to tax and its efforts to quantify such income. He noted the mandatory language in paragraph 55(5)(c) for calculating the safe income of private corporations, and the fact that the two exceptions in that paragraph were not associated with cash outflows. According to Noël JA, paragraph 55(5)(c) did not conflict with post-safe income adjustments, because such adjustments pertained to the quantification of the capital gain reasonably attributable to anything other than safe income. Thus, safe income includes "phantom income"; however, it must be "disposable" or "on hand" to fund the dividend if subsection 55(2) is to apply.

Kruco is of interest for two reasons. First, it clarifies the scope of the phrase "income earned or realized" in subsection 55(2) and thus refines the mechanics of the safe income calculation. Second, it reinforces the notion that although administrative policies such as the Robertson rules may be helpful in a general sense, they cannot supplant the Act when it comes to determining a taxpayer's income tax liability. Once again the court has affirmed that such liability is appropriately based on legal rules rather than administrative policies and accounting principles.

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Transfer-Pricing Rules Revisited

From time to time the Department of Finance issues private comfort letters indicating support for proposed amendments to the Income Tax Act. Although proposed amendments do not have the force of law, taxpayers usually proceed on the basis that the amendments will be enacted in due course. The comfort letters are addressed to individual taxpayers, but are made public under the Access to Information Act. A recent letter (dated March 11, 2003 and issued over the signature of the director general of the Tax Policy Branch) deals with a proposed amendment to the transfer-pricing rules. It is of interest to Canadian companies that finance offshore business operations by means of a guarantee.

The proposed amendment will add a new subsection 247(7.1), which will exempt from the rules in section 247 certain guarantees by Canadian-resident corporations of loans to their controlled foreign affiliates (CFAs). At present, interest on loans to CFAs is not subject to the transfer-pricing rules. Because section 247 is silent on the treatment of a guarantee, however, taxpayers have been uncertain whether a fee must be charged in respect of it. As a policy matter, it would be inconsistent to exempt interest on a loan but require the payment of a guarantee fee, and the comfort letter indicates that an amendment will be recommended to deal with this anomaly.

The amendment will make it easier for resident corporations to finance the business operations of their CFAs. According to the comfort letter, proposed subsection 247(7.1) will ensure that subsection 247(2) does not apply to adjust the amount of consideration paid, payable, or accruing to a Canadian parent corporation in a particular taxation year for the provision of a guarantee of the repayment, in whole or in part, of an amount owing by a CFA to a lender (including a person or partnership related to the lender).

Proposed subsection 247(7.1) will apply if

1) the guarantee is pursuant to an agreement in writing entered into with the lender or with a person or partnership related to the lender;
2) the non-resident person is a CFA of the Canadian parent corporation for the purposes of section 17

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throughout the period in the particular year during which the amount owing is owing; and

3) it is established that the guarantee amount owing would, if it were an amount owing to the parent, be an amount described in paragraph 17(8)(a) or (b).

Because of the third condition, the guarantee, in order to be exempt from section 247, must be in respect of a loan or advance to the affiliate and must be used for the purpose of earning income from an active business (per subsection 95(1)), or income that is included in computing the income from an active business of the affiliate (per subsection 95(2)). The loan or advance may also be for the purpose of making a loan or advance to a second CFA where, if interest became payable on the second loan or advance at any time and the first affiliate was required to include that interest in computing its income for a taxation year, the interest would not be foreign accrual property income of the affiliate. Alternatively, the amount owing must have arisen in the course of an active business carried on by the affiliate throughout the period during which the amount owing remains outstanding.

Although the proposed amendment is laudable, the strict conditions under which subsection 17(8) now applies may limit the availability of relief under proposed subsection 247(7.1). In particular, it will be necessary to trace the use of the funds supported by the guarantee to determine whether such funds have been put to an eligible use *throughout the applicable period.* It can be argued that the proposed rule ought not to incorporate the anomalies and technical traps now existing in section 17.

For example, consider the situation in which a CFA borrows funds from an arm's-length financial institution to acquire shares of a target company. Any guarantee given in that context would not benefit from the application of new subsection 247(7.1) given the limited scope of subsection 17(8). One can ask whether this result is necessary or desirable in policy terms. Other anomalies in section 17 are also of concern, and taxpayers who plan to rely on the new subsection will need careful advice if they are to avoid unintended consequences.

Finance has indicated that the proposed amendment will have prospective application from the announced effective date; however, taxpayers will be able to elect to have it apply to taxation years commencing after 1997. To exercise this option, a taxpayer will need to file an election with the minister on or before the filing due date for its taxation year that includes the day on which the amendment is assented to.

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