TAX FOR THE Owner-Manager

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Contingent Liabilities

General Motors (TCC 2003) highlights the fact that although the accrual of an expense might present the "most accurate picture of profit" for the purposes of section 9 of the Act (see "Accounting Profit Versus Tax Profit," *Tax for the Owner-Manager*, October 2003), paragraph 18(1)(e) will deny the deduction if the accrual represents a contingent liability.

Pursuant to a formula set out in an agreement with a union, GM was required to accrue an amount to a particular fund but was not required to segregate and pay the amount accrued to a trustee, custodian, etc. Rather, the accrued amounts were to be paid, at undetermined future times, to support certain programs. The December 31, 1995 accrual was fully paid out by January 1999.

The TCC disallowed the accrual on the basis that no creditor with a legally enforceable claim could be identified in 1995. The documentation indicated that payments would be made by GM "only if needed"; in the court's view, this supported the conclusion that the liability was contingent.

The facts set out in the judgment do not expressly describe what was to happen to the accruals if the amounts were never "needed." It is arguable that if GM could not reverse any part of the accrual and the union was entitled to the accrued amount in any event (say, by way of a claim in a bankruptcy), the fact that amounts would be paid "only if needed" appears to make the timing of the payment contingent, but not the liability itself. The court did not investigate whether any part of the accrual could have been reversed. The only evidence in this regard was a memorandum of understanding appended to the agreement, which provided that the future use of amounts accrued to the fund was open to negotiation when collective bargaining took place.

A contingent liability is generally regarded to be one that depends upon an event that may or may not happen. Absent a specific rule in the Income Tax Act to the contrary, the fact that a liability existing today may be paid at some undetermined time in the future does not make it contingent. The *Canadian Pacific* case (Ont. CA 1998) makes this point. In some cases, the Act specifically recognizes this as well. For example, subsection 78(4) provides that various forms of remuneration that are unpaid 180 days after the end of a taxation year are deemed to have been incurred as an expense not in the year accrued but only in the year paid. In other words, a specific provision is necessary to place a time limit on a legitimate accrual.

In some cases, the issue will be whether an expense has been incurred in the period, not whether it is contingent. In *Burnco* (FCA 1984), a corporation was required to backfill a gravel pit after it had been mined. The cost of backfilling was estimated and accrued in a year before any expenses had been incurred to effect the backfilling. The lower courts allowed the deduction on the basis of the matching principle. The FCA denied the deduction on the basis that an obligation to do something in the future that may entail the payment of money is not an expense until that thing occurs. This principle is often unwittingly ignored.

Consider, for example, the accrual of accounting fees. It is normal practice to accrue estimated accounting fees in the preparation of annual financial statements and tax returns. The accountant will generally not have performed the bulk of the work until after the year-end. In light of *Burnco*, the accrual should not be recognized for income tax purposes, because no expense is incurred until the work is performed.

In some instances, the Act specifically permits the deduction of a reserve in respect of work to be done after the end of the year, provided that the taxpayer has received an amount in the year in respect of that work. Consider, for example, the situation of a house builder. The sale of a house is often closed before the builder has performed all of its obligations—for example,

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the laying of sod and final grading. Good accounting practice requires the builder to estimate and accrue the cost of work that will be completed after the year-end. On the basis of *Burnco*, such accruals will not be deductible. However, assuming that the full purchase price is paid on closing, the builder should be entitled to a paragraph 20(1)(m) reserve on account of "services that it is reasonably anticipated will have to be rendered after the end of the year."

General Motors turned on the finding that there was no obligation enforceable against the company in 1995. On that basis, the accrued amount was a contingent liability and was not deductible. Had the judge been persuaded that the legal effect of the agreement was the creation of an obligation to the union in 1995, subject only to an uncertainty as to the time of payment, the accrued amount should have been deductible.

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No Reserve for Indemnities in Maintenance Plans

Suppliers of computer software and hardware frequently offer after-sale maintenance services. The tax treatment of an amount prepaid for those services can be tricky. The key is the nature of the services provided. A recent technical interpretation (TI) (2003-0037947) clarifies the CCRA's views on this issue.

A company sold a prepaid maintenance plan for the accounting software it distributed. Paragraph 12(1)(a) of the Income Tax Act allows the deduction of a reserve under paragraph 20(1)(m) in respect of the prepaid amount, so it was important to determine whether the amount received was to be included in the company's income under that paragraph or under subsection 9(1). Paragraph 12(1)(a) generally applies to amounts received by a taxpayer in respect of services not rendered or goods not delivered before the end of the year or amounts that, for any reason, may be regarded as not having been earned in the year or a previous year.

With respect to the application of subsection 9(1), the TI reiterates what the CCRA said at the Canadian Tax Foundation's 2003 annual conference: a prepaid amount should be included under subsection 9(1), and not under paragraph 12(1)(a), if the inclusion under subsection 9(1) provides a more accurate picture of income—for example, if there has been a substantial performance of services at the time of the payment or if the taxpayer can retain the payment even if future services are not provided.

On the facts outlined in the TI, the CCRA concluded that paragraph 12(1)(a) should apply to the maintenance plan being examined. However, the taxpayer was not allowed to claim a reserve in respect of part of the prepayment because of the prohibition in paragraph 20(7)(a) against the deduction as a reserve in respect of guarantees, indemnification, or warranties. The CCRA expressed the same view at the 2001 conference of the Tax Executives Institute; it based its position on the decision in *Sears* (FCA 1989), in which the court held that an undertaking to service and maintain appliances as required by customers was an indemnity.

In the TI, the CCRA stated that software and hardware maintenance agreements are generally considered to be a form of indemnity provided to purchasers to protect them against certain repair costs or the costs of acquiring updates. The CCRA noted that the software upgrades provided under the maintenance plan protected customers from having to purchase new versions of the accounting software, and cited this as an indication of the indemnity nature of the maintenance plan.

The TI is important in two respects. First, if the terms of the agreement are such that the taxpayer cannot lawfully retain the fee without performance of its obligations, the fact that the fee paid for a maintenance plan is non-transferable and non-refundable does not make subsection 9(1) applicable to the payment. Second, if a maintenance plan contains both indemnification and non-indemnification elements, the fee can be prorated among those elements to identify the deductible portion.

Generally, it will be advantageous to have paragraph 12(1)(a) rather than subsection 9(1) apply in order to preserve the right to claim a reserve under paragraph 20(1)(m). Where possible, the taxpayer should avoid providing an indemnity to customers as part of its maintenance services. As an example of an acceptable non-indemnification element, the TI cited a telephone technical support service that the taxpayer is bound to provide to customers should they choose to avail themselves of it.

If a supplier does want to provide an indemnity to its customers as part of its maintenance plan, the agreement should expressly allocate a portion of the fee to the indemnity elements so that the remainder remains eligible for the claim for a reserve. In this way, the supplier should be able to defend its claim for a partial reserve, and it will not be seen to be taking an overly aggressive position when only part of a prepaid amount qualifies for the reserve.

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Loss Limitation Proposals: Finance Responds to the Supreme Court

On October 31, 2003, the Department of Finance issued draft legislation regarding the deductibility of interest and other expenses. These proposals, which are more appropriately described as loss limitation proposals, were released simultaneously with *Interpretation Bulletin* IT-533, "Interest Deductibility and Related Issues." The draft legislation is a response to certain aspects of the decision in *Ludco* (SCC 2001) and the decisions in *Stewart* (SCC 2002) and *Walls* (SCC 2002).

In *Ludco*, the SCC held, among other things, that to support a deduction of interest under subparagraph 20(1)(c)(i) of the Income Tax Act, a taxpayer must establish only a reasonable expectation of gross income, where "income" means an amount that would come into income for taxation purposes, not just net income. The SCC also stated that absent sham, window dressing, or other vitiating circumstances, courts should not be concerned about the sufficiency of income.

In *Stewart* and *Walls*, the SCC rejected the "reasonable expectation of profit" (REOP) test for the purpose of determining whether a taxpayer had a source of income from business or property. The SCC replaced the REOP test with a two-stage test in which REOP is relevant only when the activity involves a personal element. The SCC also suggested in *Stewart* that an anticipated capital gain might be relevant in assessing whether a taxpayer had a REOP.

Under the draft legislation, a taxpayer will be allowed to claim a loss for a taxation year from a business or property income source only if, in the year, a cumulative profit test is satisfied. With respect to a business, it must be reasonable to expect that the taxpayer will realize a cumulative profit for the period in which the taxpayer has carried on, and can reasonably be expected to carry on, the business. With respect to a property, the test is applied for the period in which the taxpayer has held, and can reasonably be expected to hold, the property. The draft legislation specifically provides that the cumulative profit test is to be applied without reference to capital gains or losses. According to the technical notes, the test is supposed to be objective rather than subjective, and "profit" is to be determined in accordance with generally accepted commercial principles. The draft legislation is to apply for taxation years commencing after 2004.

The draft legislation is unsatisfactory. The cumulative profit test does not differentiate between wholly commercial activities and those with a personal element. The test is to be performed on a yearly basis. This could result in the acceptance of losses for some years and the denial of losses for other years. Any income earned will be taxable, but future or prior-year losses may be denied. It is unfair for the government to collect taxes on profits and deny losses on legitimate business ventures or investments. Furthermore, the test introduces great uncertainty about the circumstances in which losses will be allowed. For example, for how many years will losses from a startup business be deductible? How will the test apply to risky business ventures or investments? The cumulative profit test is likely to result in a return to the CCRA's denial of losses if a taxpayer reports two or three consecutive years of losses, and to its practice of challenging taxpayers' business and investment decisions.

In its present form, the draft legislation is a disincentive to the undertaking of risky ventures. The Department of Finance invited the submission of comments on the draft legislation by December 31, 2003. However, it is understood that Finance does not regard December 31 to be a final cutoff date, since the Joint Committee on Taxation and other interested parties have yet to finalize their responses to the proposals.

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Offshore Tax Planning: Unintended Consequences

In their zeal to avoid the Canadian tax net, taxpayers sometimes take steps that defy belief. *Chambers v. HSBC Securities (Canada) Inc.* (Ont. SCJ 2003) illustrates a point that sometimes is forgotten in the attempt to avoid tax—namely, arrangements constructed to legally divest the taxpayer of any interest in assets with a view to creating a filing position with the CCRA may be enforceable against the taxpayer by third parties.

The plaintiffs in the action, Chambers and a numbered Ontario company, sought advice from HSBC Securities (Canada) Inc. regarding the setting up of an offshore investment account in such a way that neither the income from the account nor persons resident in Canada would be subject to tax. The contract that governed the operation of the account stated that it was opened, owned, and operated exclusively by another HSBC client, Sussex Asset Management Ltd., now known as Trinity Capital Limited. The contract also stated that no other person or persons had a financial interest in the account.

Trinity Capital was incorporated in the Turks and Caicos Islands (TCI). The funds invested in the offshore account were placed with Trinity Capital by another TCI tax-exempt corporation, RASA Ltd., which in turn was owned by an irrevocable discretionary trust resident in the TCI (the RASA trust). The declaration of trust establishing the RASA trust specifically excluded any person resident in Canada from benefiting or having any interest whatsoever in the RASA trust or its property. The plaintiffs were resident in Canada. The beneficiaries of the RASA trust were two individuals (who shared the plaintiff's surname), one of whom resided in the United States and the other in Scotland.

The plaintiffs were not officers, directors, or shareholders of Trinity Capital or RASA Ltd. or trustees of the RASA trust. Trinity Capital, RASA Ltd., and the RASA trust were not included in the litigation. Funds in the account were managed by an employee of HSBC. Substantial investment losses were sustained; the plaintiffs attributed these losses to the negligence of the employee responsible for the account.

Chambers alleged that he was the beneficial owner of the account, that the losses sustained in that account were consequently his, and that he was entitled to recover those losses from HSBC. The defendants brought a motion to dismiss the claim on the basis that there was no evidence to support the plaintiffs' allegations as to ownership of the account. The Ontario SCJ agreed.

According to the reasons for judgment, the plaintiffs did not deny that if one looked only to the documentation surrounding the account, they had no ownership interest, beneficial or otherwise, in it and no legal connection with it. Neither plaintiff had an interest in any of the entities that had any interest in the account. Nonetheless, Chambers attempted to persuade the court that regardless of the legalities, he had always understood that the money in the account belonged to him and that the formal legal structure was put in place only for tax reasons.

The court held that neither plaintiff could maintain a cause of action for damages against the defendants, since any losses suffered by the account were not suffered by either of them: "[F]or a Court to award the plaintiffs damages based on those allegations, would be to sanction a situation where Mr. Chambers was entitled to create one legal reality for the tax department and then to ignore that reality when it no longer suited his purposes."

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Poor Books and Records Mean Big GST Assessments

Most readers know that when they are engaged in commercial activities they are eligible for input tax credits (ITCs) for any GST paid on business inputs. However, many may not fully appreciate the stringent requirements set out in the GST legislation for the maintenance of books, records, and receipts necessary to support ITC claims. GST auditors are well aware of the requirements, however, and they seem to take great pleasure in identifying situations in which GST registrants have not kept sufficient documentation.

The Basic Documentation Requirements

Subsection 169(4) of the Excise Tax Act (ETA) provides as follows:

> A registrant may not claim an input tax credit for a reporting period unless, before filing the return in which the credit is claimed,
>
> (a) the registrant has obtained sufficient evidence in such form containing such information as will enable the amount of the input tax credit to be determined, including any such information as may be prescribed; and
>
> (b) where the credit is in respect of property or a service supplied to the registrant in circumstances in which the registrant is required to report the tax payable in respect of the supply in a return filed with the Minister under this Part, the registrant has so reported the tax in a return filed under this Part.

Almost by design, it seems, the more specific documentation requirements are buried in something called the Input Tax Credit Information (GST/HST) Regulations (SOR/91-45, as amended). These regulations set out three classes of documentation, depending on the value of the input on which the ITC claim is being made (that is, the value of the property or service that was acquired and on which the GST was paid).

For supplies valued at less than $30, the registrant must document

1) the name or business name of the supplier;
2) the date of the invoice, if an invoice is issued;
3) the date on which the GST was paid or payable, if no invoice was issued; and
4) the total amount paid or payable for all of the supplies.

For supplies valued between $30 and $150, all of the information above is required, plus the following information:

5) the supplier's GST registration number;
6) the amount of the GST paid or payable in respect of each supply, and/or other specific information;
7) where the amount paid or payable for the supply or the supplies includes the amount of tax paid or payable in respect thereof, a statement to the effect that tax is included in the amount paid or payable for each taxable supply, and other specific information;
8) where the status of two or more supplies is different, an indication of the status of each taxable supply that is not a zero-rated supply.

For supplies valued in excess of $150, all of the information above is required, plus the following:

9) the recipient's name or the business's name,
10) the terms of payment, and
11) a description of each supply sufficient to identify it.

In addition, subsection 286(1) of the ETA requires every GST registrant to keep books and records sufficient to enable the minister to determine the registrant's GST liabilities and obligations (that is, the GST ultimately remittable by the registrant).

To the extent that these obligations are not met, the CCRA is able to (1) deny ITCs (in the case of ITC documentation requirements) or (2) decline to accept filed GST returns and issue its own estimated assessments (in the case of missing or insufficient books and records).

As the following cases illustrate, if a corporation fails to keep proper records, the Tax Court is generally inclined to uphold the assessments, regardless of how unfair that may seem or how imprecise or questionable the CCRA's estimated assessments may be.

Denied ITCs

In *1116186 Ontario Inc.* (TCC 2003), the Tax Court considered a GST registrant whose business involved the purchase and resale of tickets to entertainment and sporting events. The appellant did not have receipts indicating that GST had been paid on most of the tickets (probably because tickets were purchased for cash from ticket outlets by casual labour hired by the appellant).

The appellant was carrying on business under the name of "National Tickets" or "National Promotions"; it purchased tickets at face value or at a deep discount and then resold them to the general public for a profit. The issue in the case involved the purchase and sale of tickets for Canadian-held sporting events and concerts; the appellant was required to pay GST when it acquired the tickets and to charge GST when it sold them. Depending on the popularity of the event, the appellant arranged to have as many as 60 people attending in line at ticket outlets such as Ticketmaster, Copps Coliseum, and Maple Leaf Gardens to purchase tickets; the appellant gave cash to each person to make the purchases, and it then resold these tickets to individuals or groups.

The appellant claimed back, by way of ITCs, the GST it paid on the ticket acquisitions. Because its business was generally transacted on a cash basis, it did not obtain the proper documentation to substantiate the ITC claims—or, for that matter, keep the books and records that would be expected in most business environments. (The appellant said that it purchased tickets for the most part with cash, paid the GST, received no receipts other than the tickets, and then resold the tickets for cash, again without receipts.) Accordingly, the CCRA, while allowing some ITCs, disallowed a substantial portion of the claims made by the appellant.

The Tax Court agreed with the CCRA's position, finding that "without question, the Appellant did not satisfy the requirements" outlined above with respect to ITC documentation. The court recognized that the ETA requirements were "rigid," but indicated that it had no choice except to require the documentation set out in the statute: "I am asked to accept in blind faith that the entire cheque proceeds less a small amount went to buy tickets and that GST was paid on those tickets in all instances. Subsection 169(4) and Regulation 3 do not give me that latitude." In the result, the appellant was denied the ITCs claimed.

Cases like these should serve as a useful warning to all owner-managed businesses of the importance of observing the ITC documentation requirements set out in the ETA.

Estimated Assessments

Some recent cases have also dealt with estimated assessments made by the CCRA where books and records were insufficient. In *Khullar Au Gourmet International Ltd*. (TCC 2003), two companies that ran convenience stores were assessed for failing to report and remit GST. The companies did not provide proper records (such as cash register receipts), and the GST auditor decided to estimate the GST owing on the basis of the corporate bank deposits. While the Tax Court recognized that an assessment of GST liability based on bank deposits was "imprecise" and possibly "questionable," it agreed with the CCRA's approach, noting that since the companies had failed to keep proper records, the CCRA's "approach was acceptable and necessary." The Tax Court also found that the CCRA could, in this case, assess beyond the normal four-year limitation period, since the companies had made misrepresentations on their returns that were attributable to carelessness, neglect, or wilful default.

In a similar case, *2868-2656 Québec Inc.* (TCC 2003), the court upheld another GST assessment based on deposits made to the corporation's sole shareholder's bank account. The corporation, which operated a restaurant, failed to maintain proper records of its sales and was unable to provide adequate evidence to counter the assessment. Accordingly, the Tax Court accepted the CCRA auditor's methodology.

In a slightly different case, *Gestion VCCCC Inc.* (TCC 2003), the court found that an assessment of another convenience store could be based on the CCRA's auditor's analysis of a three-month period of information, which was then extrapolated over the entire assessment period, resulting in a significant GST assessment. The court again looked to the corporation's records and, finding them "questionable," upheld the CCRA's approach.

Conclusion

The bottom line for owner-managers is that if ITCs are claimed or GST remittances are questioned on audit, the best (and perhaps the only) line of defence is proper documentation.

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Automobile Standby Charges: Updates

An employee whose employer supplies him or her with an automobile must include in income a standby charge, along with the value of any benefit relating to payment of the vehicle's operating costs. The standby charge or income inclusion is 2 percent of the original cost of the vehicle to the employer (or two-thirds of the leasing cost if it is leased) multiplied by the number of 30-day periods during the year that the automobile was available to the employee.

However, amendments applicable to the 2003 and subsequent taxation years provide that the standby charge may be reduced if personal use of the vehicle is less than 1,667 kilometres per month (approximately 20,000 kilometres per year) and the automobile is used *primarily* in connection with or in the course of the office or employment. (See Notice of Ways and Means Motion, March 19, 2003, clause 69.) For taxation years from 1998 through 2002, the standby charge is computed under the old rules and may be reduced only to the extent that the employee drives fewer than 12,000 personal-use kilometres per year and *all or substantially all* of the employee driving is for business purposes.

The CCRA's administrative position, set out in IT-63R5, is that "all or substantially all" means 90 percent. By contrast, according to the budget supplementary information on the legislation introducing the recent amendments, "primarily" means more than 50 percent. This somewhat more taxpayer-friendly provision is intended to relieve against the excessive taxable benefits that sometimes arose under the old rules. To the extent that taxation years prior to 2003 are still open, however, the more restrictive provisions must be contended with.

The meaning of the phrase "all or substantially all" was at issue in *Keefe* (TCC 2003). The taxpayer was the sole shareholder and employee of a company. Throughout the relevant taxation years, a company-owned automobile was available to the taxpayer. Because of the nature of the company's business (the supply and installation of commercial floor covering), much of the taxpayer's work was conducted at clients' offices or at project sites rather than at the company's office. The taxpayer occasionally took the automobile home—for example, if he was going home directly from a job site or if he had to go directly to a client's location the following morning. The taxpayer had some access to two other vehicles for non-employment purposes; one was a vehicle monopolized by his son, and the other belonged to his wife.

From the taxpayer's information regarding his personal use of the vehicle, the minister calculated the business-use portion at 81 percent. In accordance with the CCRA's administrative policy, this figure formed the basis for the minister's assertion that the kilometres driven were not "all or substantially all" for business use.

Sheridan J held that the position espoused by the CCRA in IT-63R5 was not conclusive, since the 90 percent figure was not legislated and the case law has established that what constitutes "all or substantially all" is a question of fact in each case. The nature of the taxpayer's single owner-operator business obliged him to be onsite as required, and the success of the enterprise depended on his ability to travel to clients' premises. Accordingly, Sheridan J was satisfied that "all or substantially all" of the kilometres travelled in the vehicle were for the purpose of earning income.

At least in the context of taxation years prior to 2003, *Keefe* confirms that a taxpayer whose business use of an employer-owned vehicle is less than 90 percent will not necessarily be denied a reduction in the standby charge. *Keefe* also serves as a reminder that administrative guidelines are just that—guidelines without force of law, despite their sometimes rigid application by the CCRA and the seeming ease with which they can become absorbed into the popular understanding of provisions of the Income Tax Act.

Keefe brings to light a few other points worth bearing in mind. One point specific to the automobile context is that although the taxpayer in *Keefe* did not maintain a log book—a factor that has proved persuasive against taxpayers in other decisions—he was still successful. (There is no doubt, though, that having a log is a practical advantage when dealing with the CCRA on matters of this kind, and clients should be encouraged to maintain one.) Further, Sheridan J noted at the outset of his judgment that the taxpayer was a credible witness whose "answers were direct and clear and were consistent with what would normally be expected from a sensible small business operator." A second and related point is that in such fact-based cases, the subjective element of a likeable witness who can show that the conduct of his or her business is honest and reasonable can play a crucial role. A third point is that the taxpayer bears the onus (which was discharged in *Keefe*) of presenting evidence that, on a balance of probabilities, the use of the vehicle was *all or substantially all* for the purpose of earning income. From 2003 on, the burden will be on the taxpayer to show that his or her use of the vehicle was *primarily* for this purpose.

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Foreign Personal Holding Company Rules: Service Providers Beware

Among the myriad of anti-deferral rules with which US citizens and green-card holders living in Canada must contend are the foreign personal holding company (FPHC) rules. These rules, which are similar to the Canadian foreign accrual property rules, generally tax the shareholder on a share of accruing FPHC income each year, rather than in the year the income is actually received. In general, the FPHC rules are designed to prevent the deferral of tax on passive income; however, certain types of income from services may also be caught by the FPHC net.

A corporation is an FPHC if at least 60 percent (50 percent if, in any previous year, the corporation was an FPHC) of the corporation's gross income for the taxation year is FPHC income and if certain ownership requirements (see below) are met. The main types of FPHC income are dividends, interest, rents (with an exception as set out below), royalties, annuities, and amounts from personal service contracts. Some slightly different rules pertain to the interest and dividends received from related parties. Generally, these rules state that income received from a related party will be FPHC income only to the extent that it would have been FPHC income to the entity that pays such amounts.

The ownership requirements will be met if, at any time during the taxation year, more than 50 percent of either (1) the total combined voting power of all classes of voting stock or (2) the total value of the stock of the corporation is owned, directly or indirectly, by or for not more than five individuals who are US citizens or residents. The "directly or indirectly" rules operate to attribute stock owned by related parties (specifically, brothers, sisters, spouse, ancestors, and lineal descendants) to the particular shareholders, whether or not they are US residents or citizens. Other rules (not discussed here) attribute stock ownership to family members when a trust, second corporation, or partnership actually owns the stock.

The main exception to income otherwise classified as FPHC income under these rules is for certain rents received. Specifically, if rents constitute 50 percent or more of the gross income of the corporation, they are not included in FPHC income. For this purpose, "rents" is defined to mean compensation, however designated, for the use of or the right to use property.

One of the biggest traps in the FPHC inclusion rules is personal service contract income. Such income includes amounts received pursuant to a contract under which the corporation is to furnish personal services if either (1) some person other than the corporation has the right to designate (by name or description) the individual who is to perform the services, or (2) the individual who is to perform the services is designated (by name or description) in the contract. In addition to these two requirements, personal services income will include amounts received for services only if at some time during the taxation year 25 percent or more in value of the outstanding stock of the corporation is owned, directly or indirectly (again, the attribution rules apply; see above), by or for the individual who has performed (or is designated by name or description to perform) such services.

It should be noted that the person who has the right to designate who is to perform the services need not be a party to the contract. Thus, for example, if a professional provides services through a professional corporation and the professional's governing body requires that the services be performed by a qualified individual (as opposed to simply the corporation), that particular individual would meet the criteria outlined in point 1 above, thus triggering the application of the FPHC rules.

The FPHC income inclusion operates only to the extent of the shareholder's pro rata share of the undistributed FPHC income. Undistributed FPHC income is essentially the taxable income of the corporation for the year less specific adjustments (such as income taxes paid) and reduced by certain dividends paid during the year (see below). The pro rata share is based upon the dividends a shareholder would otherwise have received had all applicable amounts been paid out at the end of the taxation year. To the extent that these amounts are subsequently paid out to the shareholder and have previously been included in income under these rules, they are received tax-free for US purposes. If the individual is a Canadian resident, he or she is taxable in Canada with no foreign tax credit relief.

This leaves open the question of what amount should be considered the pro rata share of dividends when a discretionary dividend clause exists. The IRS may argue that the total amount is receivable and thus all undistributed FPHC income is taxable to the shareholder, while the shareholder may take the opposite approach. It is unclear which position is correct in these circumstances. Dividend history has been used (although, since the dividends are discretionary, this approach has its flaws), as has the argument that all dividends are paid pro rata on shareholdings (effectively removing the discretionary nature of the dividend).

Dividends are deductible from undistributed FPHC income, provided that they are not "preferential" dividends. A preferential dividend is a dividend that either (1) treats shareholders of the same class of stock differently (for example, by the payment of different dividend amounts per share on the same class of shares), or (2) treats a class of stock otherwise than in accordance with its dividend rights as a class.

A discretionary dividend clause in the company's articles of incorporation should not create preferential dividends, since the amounts paid are in accordance with the articles and are specifically permitted. However, one must be wary of the IRS treating various classes of stock as one class of stock. The IRS will attempt to group different classes of stock onto one class if there are not enough distinguishable characteristics among the classes of stock. Classification as one group may be avoided if the shares have different liquidation rights, dividends rights, voting rights, etc.; but this issue should be approached with caution. Unfortunately, many of the rulings and other guidance given in this area concern regulated investment companies only, not regular corporations.

One other important point should be noted: dividends received (or, in the case of undistributed FPHC income, deemed to be received) as income are not subject to the reduced rate of tax on dividends (15 percent) implemented under the recent US federal budget.

The FPHC rules can be punitive, and imputed dividends are not afforded any relief under the Canada-US income tax convention. US citizens living in Canada and Canadian residents with green-card status in the United States should be especially cautious when family estate freezes are contemplated. If a Freezeco is formed in Canada, it is easy to lose sight of the possible application of the FPHC rules.

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Director's Liability for Source Deductions

Section 227.1 of the Income Tax Act makes the directors of a corporation jointly and severally liable along with the corporation if source deductions are not withheld and remitted as required by the Act. Subsection 227.1(3) provides a defence for a director who exercises the degree of care, diligence, and skill necessary to prevent the failure to remit that a reasonably prudent person would have exercised in comparable circumstances. *McKinnon* (TCC 2003) is the latest in an emerging line of cases in which the courts have imposed a less rigid standard of care than the early decisions on the subsection. *McKinnon* is of particular interest for the arguments advanced by the Crown in support of the assessment, and for what the court had to say about them.

The taxpayer was the sole shareholder and director of a private company in the door and window business. The business was successful at first, and the required payroll deductions were remitted as required. However, the company experienced cash flow problems in 1997 when it lost one important customer and a second customer defaulted on its obligations to make payments due under a contract. As a consequence, the company did not remit two amounts due on account of source deductions in 1997, totalling about $11,700. The minister assessed the taxpayer for that amount under section 227.1. By the time the case reached the court, the liability had escalated to $25,465.02 after the addition of penalties and interest. The taxpayer raised the subsection 227.1(3) defence and argued that

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he had done everything reasonably possible to see that the company met its obligations under the Act.

Judge Bowman decided the case. He said that the substance of the subsection 227.1(3) defence was reflected in the question: What could McKinnon reasonably have done to prevent the failure to remit? On the evidence, he said, the cash flow problems were attributable to decisions by customers of the business and were therefore beyond McKinnon's control. This was an important finding, for it meant that the taxpayer had not personally received and misused the funds that otherwise would have been used to make the remittances. Further, the taxpayer gave evidence of the considerable efforts he had made to save his business, and he was an honest and credible witness at trial.

Two arguments were advanced by the Crown. The first was that the business was undercapitalized from the outset and should have been wound up sooner, or allowed to go down the drain before the cash flow problems arose. Judge Bowman rejected this argument out of hand, saying that it was "neither commercially realistic nor morally defensible." The second argument was that the taxpayer's conduct amounted to stealing money that was supposed to be held in trust for the Crown. His Honour said that this was "an inaccurate and unfair characterization." In cases like this one, no money is ever set aside in an account earmarked for the Crown and later raided to run the business. The reality is that the net amount paid to the employees is all there is to go around. The employees and creditors are paid as much as the business can manage because "if they are not the business will be closed down."

The case illustrates two important points. First, the taxpayer was a credible witness on his own behalf. The court was satisfied that he had acted throughout with the intention of saving the business and not with a view to his own advantage. Second, the court recognized that the taxpayer had decided to pay trade accounts rather than source deductions in the hope that he could catch up on the source deductions when circumstances improved. The court was not prepared to deny him the benefit of the subsection 227.1(3) defence because of this, at least in the circumstances of this case. The court seems to be saying that the failure to remit to Her Majesty when others are being paid will not of itself be grounds for denying a director the benefit of the defence.

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