TAX FOR THE Owner-Manager

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Still Coming to GRIPs with the New Dividend Tax Credit Rules

In "The New Dividend Tax Credit Rules: Coming to GRIPs" (*Tax for the Owner-Manager*, October 2006), I discussed a technical inconsistency in the one-time GRIP (general-rate income pool) adjustment. If an opco paid a dividend to a holdco from its GRIP in the 2000-2005 period, the holdco would not have a corresponding increase in its GRIP. This was so because the one-time GRIP adjustment formula did not include a dividend received from the opco. Finance tried to rectify this issue in the October 16, 2006 proposed legislation. (See *Explanatory Notes Relating to Remaining Budget 2006 Income Tax Measures, Dividend Taxation and Canadian Vintners and Brewers*.) Although the proposed amendments to subsection 89(7) partly address this anomaly, some unresolved technical issues still need to be addressed.

Connected Corporations

The proposed amendments permit taxable dividends received from connected corporations that are subject to the subsection 112(1) deduction to be included in the recipient's opening GRIP if the dividend may reasonably be considered to be attributable to income that is subject to tax at the general corporate rate. Corporations are connected for this purpose if one corporation controls the other (see the extended definition of "control" in subsection 186(2)) or if one corporation owns shares representing 10 percent of the votes and value of all issued shares of the other corporation. The proposed amendment eliminates the technical inconsistency noted in the earlier article for connected corporations only. Non-connected corporations still suffer the same fate that existed for all corporations before the October 16, 2006 proposed amendments.

Two types of corporations will be caught by the current form of the legislation: (1) a holdco that is not connected with an opco that received GRIP dividends in the period 2000-2005, and (2) an investment holdco that owns portfolio stock of public companies that received GRIP dividends in the period 2000-2005. In the second case, however, if the opening GRIP included such dividends, the investment holdco would not be concerned that any low-rate income pool (LRIP) dividends received from the public companies for 2000-2005 would reduce its opening GRIP calculation. This is because the LRIP calculation begins for non-CCPCs only for 2006 and subsequent years. Finance's response in informal discussions (implicitly confirmed in the technical notes to proposed subsection 89(7)) is that it intends to restrict the beneficial impact of the opening GRIP calculation to limited situations. The policy reasons for such a restriction are unclear: the regular GRIP formula (proposed subsection 89(1)) does not impose a similar restriction for 2006 and subsequent years. Is the restriction intended to control the government's tax expenditures that would otherwise arise because of the one-time GRIP adjustment?

The Impact of Specified Future Income Tax Consequences on Opening GRIP

The proposed amendments inadvertently create another technical anomaly by excluding from the calculation of the opening GRIP specified future income tax consequences (that is, loss carrybacks and loss carryforwards). There is no impact if the loss carryback was from a taxation year that commenced in 2006, because the regular GRIP formula would reduce the pool balance from 2006 onward. However, the following example illustrates that the opening GRIP pool, on the basis of current legislation, would be overinflated if the loss arose in 2000-2005.

Assume that in calendar years 2000-2004, Opco had a GRIP of $200,000 in each year, for a total of $800,000. In 2005, Opco suffered a $600,000 loss, which it carried

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back to its preceding years to recover the income taxes paid on $600,000 of prior years' GRIP. Logically, the opening GRIP balance for Opco as of January 1, 2006 should be $200,000. However, the proposed legislation ignores the impact of the loss carryback of $600,000 and calculates the opening GRIP for Opco at $800,000. The $600,000 loss would not be deducted under the regular GRIP formula, since that formula is in effect only for taxation years commencing in 2006. Finance is aware of this technical glitch and is preparing amending legislation to rectify the error.

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Eligible Dividends: Issues for CCPCs

Under the June 29, 2006 proposed legislation (Draft Changes To Eliminate the Double Taxation of Large Corporation Dividends), an eligible dividend received by a Canadian-resident individual will be subject to an enhanced gross-up of 45 percent and an enhanced tax credit of $^{11}/_{18}$ of the gross-up. The effect of the enhanced gross-up and credit is to significantly reduce the tax payable on eligible dividends; the precise impact will vary depending on the taxpayer's province of residence. All provinces have now announced changes to respond to the proposed legislation. However, the changes that will be implemented by Nova Scotia and Newfoundland will only maintain the effective tax rate on eligible dividends, as opposed to actually reducing the tax payable on the dividends.

An eligible dividend is a dividend that is received by a person resident in Canada and is paid after 2005 by a corporation resident in Canada and designated in writing by that corporation to be an eligible dividend. New part III.1 of the Act will impose a penalty (generally at a 20 percent rate) on CCPCs paying excess eligible dividends. A CCPC will have paid an excess eligible dividend in a year if it has paid eligible dividends in a taxation year that exceed its general-rate income pool (GRIP) at the end of the year. The calculation of GRIP is relatively complex; however, the intent of the calculation is to determine the net after-tax income that has been subject to tax at the general corporate tax rate or that has been repatriated from a foreign affiliate. The intended effect of the proposals is to lessen the disintegration that results when active business income is taxed in a corporation at the general corporate rate and then paid to shareholders as taxable dividends. (See "Distribution of Corporate Earnings to the Owner-Manager," *Tax for the Owner-Manager*, January 2006.)

For dividends to qualify as eligible dividends under the proposed legislation, written notice must be provided to shareholders at the time the dividend is paid. The legislation does not provide for the required notice to be made at a later date. However, for dividends paid in 2006 and before the legislation receives royal assent, the required notice can be made up to 90 days after royal assent. Royal assent is expected to be received in December 2006; thus, advisers should consider whether notice should be given in respect of any dividends paid by the client in 2006 and before the date on which royal assent is received. In addition, after royal assent is received the required notice will have to be given at the time the dividend is paid if the dividend is intended to be an eligible dividend.

Bonusing Down

Table 1 highlights the potential deferral that is currently available in respect of active business income in excess of the federal small business deduction limit of $300,000. The deferral is subject to a cost if it is necessary to draw the funds out of the CCPC. If the dividend is not paid until a subsequent year, however, the tax payable on the dividend may be less than that shown in the table. In Ontario and Alberta, the rate of tax on eligible dividends will decrease over the next several years. In addition, planned reductions to the corporate tax rates will have the effect of further reducing or eliminating the disintegration. For comparative purposes, table 2 illustrates the projected deferral rates for 2010.

Table 1 Tax Deferral on ABI Subject to Tax at the Federal General Corporate Rate, 2006

	Ontario (ABI $300,000-$400,000)	Ontario (SBD clawback)	Ontario	Alberta	British Columbia
			percent		
General corporate tax rate	27.6	40.8	36.1	32.1	34.1
Tax rate on eligible dividend	25.1	25.1	25.1	18.2	18.5
Effective tax rate after eligible dividend	45.8	55.6	52.1	44.4	46.3
Personal tax rate	46.4	46.4	46.4	39.0	43.7
Potential deferral	18.8	5.4	10.3	6.9	9.6
Savings (cost)	0.6	(9.2)	(5.7)	(5.4)	(2.6)

Table 2 Tax Deferral on ABI Subject to Tax at the Federal General Corporate Rate, 2010

	Ontario (SBD clawback)	Ontario	Alberta	British Columbia
		percent		
General corporate tax rate	35.7	31.0	29.0	31.0
Tax rate on eligible dividend	22.4	22.4	14.6	18.5
Effective tax rate after eligible dividend	50.1	46.4	39.3	43.7
Personal tax rate	46.4	46.4	39.0	43.7
Potential deferral	10.7	16.4	10.0	9.6
Savings (cost)	(3.7)	0.0	(0.3)	0.0

RDTOH Recovery

If a CCPC has a positive GRIP balance and a positive RDTOH, there will be an increased incentive to pay a dividend to recover the existing RDTOH. If the CCPC does not have a GRIP balance, the current rate of tax on a dividend paid to an Ontario-resident individual subject to tax at the highest marginal rate is 31.3 percent. Thus, there is a 2 percent tax recovery when RDTOH is refunded equal to 33 percent of the amount of the dividend. Given that the recovery is only 2 percent, it is generally not significant unless the RDTOH balance is quite large. However, if the dividend generating the RDTOH refund can be designated as an eligible dividend, the tax recovery rate will increase significantly as a result of the lower tax rate on such dividends. Advisers will want to ensure that dividends are paid annually to the extent of GRIP if such dividends will result in a recovery of RDTOH. In addition, if a client holds an interest in a corporation that generates active business income and aggregate investment income, consider structuring the corporation so that GRIP and RDTOH can, in one way or another, be combined in the same corporate entity.

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Application of Subsection 75(2) to Loans

In *Howson v. The Queen* (2006 TCC 644), the Tax Court held that the attribution rule in subparagraph 75(2)(a)(i) does not apply to a loan made by a capital beneficiary to a trust. Subparagraph 75(2)(a)(i) applies where a trust has received property from a taxpayer and the trust holds the property on condition that it may revert to that person. There are few reported cases interpreting this subparagraph and the scope of the terms “held on condition” and “revert.” The uncertainty surrounding the interpretation of the provision has, in some circumstances, acted as a deterrent to taxpayers wishing to utilize loans to fund a trust.

Ms. Howson immigrated to Canada from South Africa in 1994. She was a discretionary capital and income beneficiary of the non-resident Howson trust, which was settled prior to Ms. Howson’s arrival in Canada with the intention of qualifying for the 60-month immigrant trust tax exemption. The Howson trust was partly funded by a loan advanced by Ms. Howson. The deed governing the Howson trust specifically authorized the arm’s-length South African trustees to receive funds on deposit from the beneficiaries and to pay interest on the deposit. The loan was not documented, bore no interest, and was unsecured. However, the annual financial statements of the trust showed a loan outstanding to Ms. Howson, and a loan agreement was eventually signed three years after the loan was advanced. Ms. Howson was reassessed pursuant to subparagraph 75(2)(a)(i) to attribute to her the income earned by the trust on the funds borrowed from her.

The CRA’s administrative position with respect to the application of subparagraph 75(2)(a)(i) to loans, as most recently restated at the 2006 STEP Canada National Conference Practitioner–CRA Round Table (June 13, 2006), is that the CRA will not seek to apply that subparagraph to a genuine loan, provided that the loan is made outside and independent of the terms of the trust. Some of the factors the CRA will consider in determining whether a loan is genuine include whether it was evidenced in writing, whether interest has been paid, and whether the borrower has given security for the loan. The CRA also adopted the position that a loan to a trust of an income-producing property, other than cash, would be caught by subsection 75(2). The CRA’s rationale is that in these circumstances the property is held on condition and in full expectation of its return to the transferor.

In *Howson*, the Crown argued that the advance of funds by Ms. Howson was not a genuine loan; alternatively, if the court found that the advance was a genuine loan, then subparagraph 75(2)(a)(i) had no application. In its decision, the court rejected the CRA’s criteria for the existence of a genuine loan and concluded that the existence of a loan does not require a contemporaneous written agreement, interest payments, or security given by the borrower. The court held that the evidence—particularly Ms. Howson’s testimony, the trust’s financial statements showing indebtedness to Ms. Howson, and the written agreement (although made three years after the fact)—overwhelmingly established the existence of a loan. The court further noted that subparagraph 75(2)(a)(i) does not apply to a loan because "a *bona fide* loan is, on its face, not subject to reversion by the terms of the Trust. It returns to the lender by operation of the loan itself and the law of creditor rights."

The *Howson* decision is the first judicial confirmation that subparagraph 75(2)(a)(i) does not apply to a loan; the case also rejects the CRA's restrictive views on the necessary preconditions for a genuine loan. In addition, *Howson* suggests in principle that the CRA's stated position on loans of non-cash property is not sustainable. Provided that the loan of property is made, and the property returns to the lender, pursuant to an agreement that is outside of and independent of the terms of the trust, *Howson* suggests that subparagraph 75(2)(a)(i) has no application. There is no apparent reason to distinguish between cash and non-cash properties in this regard.

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Supreme Court Rules on Paragraph 20(1)(f)

In *Imperial Oil Limited* (2004 TCC 207; 2004 FCA 361; 2006 SCC 46) and *Inco Limited* (2004 TCC 468; 2005 FCA 38; 2006 SCC 46), the courts revisited the conversion of amounts denominated in a foreign currency into Canadian dollars for the purposes of the Income Tax Act. The leading case had been *Gaynor* (91 DTC 5288 (FCA)), which held that Canadian currency was the only monetary standard of value known to Canadian law. To determine the taxpayer's capital gain that arose on the sale of US-dollar-denominated securities, the court in *Gaynor* held that the cost and the sale proceeds must be converted into Canadian dollars at the exchange rate in effect at the time of purchase and the time of sale, respectively.

In a 4-to-3 decision, the Supreme Court of Canada allowed the Crown's appeals and confirmed the minister's assessment, as varied by the Tax Court in *Imperial Oil*. Both the majority and the minority agreed that the specific issue in the case was whether the deduction in paragraph 20(1)(f) was limited to original-issue discounts or whether it encompassed a broader range of financing costs (including foreign exchange gains and losses). Under paragraph 20(1)(f), a taxpayer that has issued debt at a discount from its principal amount may be entitled to a deduction for all or part of the excess of the original-issue proceeds over the lesser of the principal amount and the amount paid in satisfaction thereof.

In both cases, the taxpayers had issued US-dollar-denominated debentures at a discount. Several years later, some of the discounted debentures were redeemed. Over the years, the Canadian dollar had depreciated in value. Accordingly, the face amount of the debt in Canadian dollars calculated at the exchange rate in effect at the time of redemption was significantly higher than the face amount calculated at the exchange rate in effect at issue.

Miller J, in *Imperial Oil* (TCC), held that the principle in *Gaynor* was limited to computing capital gains. The case was distinguished on the basis that a capital gain required the acquisition and disposition of an asset, whereas an expense on income account required a snapshot at the time of payment. Miller J held that each amount in paragraph 20(1)(f) did not have to be converted into Canadian dollars; only the result—that is, the deductible amount—had to be converted at the exchange rate in effect at the time of redemption. Alternatively, Miller J would have converted each US-dollar-denominated amount in the formula into Canadian dollars at the exchange rate in effect at the time of redemption. Miller J found that Parliament's intent was that foreign exchange losses were deductible not under paragraph 20(1)(f) but under subsection 39(2). As a result, the taxpayer was entitled to a small deduction under paragraph 20(1)(f) and to a large capital loss under subsection 39(2).

In *Inco* (TCC), Bonner J agreed with Miller J that paragraph 20(1)(f) did not permit the deduction of foreign exchange losses. In Bonner J's view, the face amount of an obligation is fixed at issue, and the conversion to Canadian dollars is to be made at the exchange rate in effect when the obligation is issued. Because the taxpayer repaid exactly what it borrowed, no gain or loss arose. The object of paragraph 20(1)(f) is to allow a deduction, within limits, only of discounts that are closely related to interest but do not fall within paragraph 20(1)(c). Consequently, no deduction was allowed.

The Federal Court of Appeal in *Imperial Oil* overturned the Tax Court's decision and held that the principle in *Gaynor* was not limited to the computation of capital gains and losses, but was applicable to paragraph 20(1)(f). Sharlow J stated that *Gaynor* stood for the proposition that if a foreign-currency transaction is an element of any computation required by a statutory formula, the amount of the foreign currency must be converted to Canadian dollars at the conversion rate prevailing at the time of the transaction—for example, at the time of redemption and at the time of issue. As a result, the taxpayer was entitled to a deduction of three-quarters of its loss on redemption under subparagraph 20(1)(f)(ii). However, the taxpayer was denied a capital loss under subsection 39(2) for the balance of the loss on the basis that subsection 248(28) prohibited the double counting of the transaction in subsection 39(2). The FCA had also allowed Inco's appeal on the basis of the FCA decision in *Imperial Oil*. Although the minority in the SCC agreed with Sharlow J's analysis in *Imperial Oil*, the majority did not, and the Crown's appeal was allowed.

Lebel J, speaking for the majority in the SCC, concluded that the borrowing was on capital account and that any foreign exchange loss on the debentures would be a payment on account of capital and would be deductible only if expressly permitted under the Act. As part of his analysis, Lebel J reviewed, among other things, the ratio decidendi in *Gaynor* as well as cases involving foreign-currency transactions. He concluded that the latter cases stood for the proposition that foreign exchange gains and losses incurred in relation to foreign trade cannot be separated from the underlying transaction.

On the basis of his review of *Gaynor* and the related British tax cases, Lebel J rejected the proposition (for which the *Gaynor* case has been cited) that all amounts referred to in the Act must be converted into Canadian dollars. Lebel J seemed to conclude that the *Gaynor* principle applies when a disposition involves the sale of capital assets or inventory, but does not apply in a borrower-lender relationship involving only the payment of principal by a debtor to a creditor.

Lebel J found that paragraph 20(1)(f) was never intended to apply to foreign exchange losses. While the SCC has resolved the interpretation of paragraph 20(1)(f), it may have created uncertainty about which foreign-denominated amounts must be converted into Canadian dollars under the Act, and when.

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Assessments Sent to Wrong Address Were Not Issued at All

Under the Income Tax Act (ITA) and the Excise Tax Act (ETA), the date on which the CRA assesses a taxpayer is critical. In both statutes, there are time limitations on when the minister may make an assessment and when the taxpayer may make an objection to it. Special rules provide that the date on which an assessment is made is not necessarily the date on which the CRA decides to assess the taxpayer, or even the date on which the taxpayer receives the notice of assessment. Rather, the date on which an assessment is made is deemed to be the date on which the notice was "mailed" to the taxpayer: ITA subsection 244(15).

In *236130 British Columbia Ltd.* (2006 FCA 352), the Federal Court of Appeal held that if an assessment is sent to an incorrect address it is not an assessment; it has no effect because it is not "made" until it is mailed; and it will not be regarded as "mailed" if it was sent to an incorrect address. (But see the discussion below: the taxpayer must have provided the minister with a correct address in order to bring this principle into play.)

The taxpayer had waived the normal limitation period for the CRA to reassess income tax for the years at issue, pursuant to ITA subparagraph 152(4)(a)(ii). However, the taxpayer later revoked that waiver, which gave the CRA six months in which to make an assessment starting from the first day after the revocation was filed: ITA subsection 152(4.1). (ETA subsection 298(9) is the comparable provision for GST purposes.)

The CRA mailed notices of reassessment within the applicable limitation period but to an incorrect address. When the notices were ultimately returned to the CRA, it mailed them again (also within the applicable limitation period), but this time to the taxpayer's "books and records" address—for which the taxpayer had entered an incorrect postal code, causing further delay. The taxpayer eventually received the notices after the six-month limitation period for issuing the reassessments had expired.

The Tax Court found that the CRA had not validly reassessed the taxpayer. The court based its decision on case law specifying what the CRA has to do in order to take advantage of the special rules regarding the mailing of notices, and on the deeming rule specifying that the date on which assessments are made is the date on which they are mailed: ITA subsections 244(14) and (15). (The comparable provisions of the ETA are subsections 335(10) and (11).) The court acknowledged that the CRA may take advantage of the deeming rule by showing that the notices would have been mailed on time under its normal mailing procedures: *Schafer* ([1998] GSTC 60 (TCC)) and *Kovacevic* ([2003] GSTC 112 (FCA)). However, in this case, the CRA was on notice that the address it had for the taxpayer was incorrect because the original mailing was returned: the CRA was not entitled to rely on the provisions of ITA subsection 244(14) to the effect that a notice is mailed on the date shown on the notice when in fact it knew that it had mailed the notice to an incorrect address.

The Crown appealed the Tax Court's decision to the Court of Appeal. That court found for the taxpayer, but for reasons different from those of the Tax Court.

The FCA confirmed that the rules in ITA subsections 244(14) and (15) deem an assessment to be made on the date that the notice of assessment is mailed to the taxpayer, which can be presumed to be the date printed on the notice itself. However, unlike the Tax Court—which concluded that the CRA had not met its onus of showing that the notices of reassessment were mailed on time—the FCA said that the fact that the notices were sent to the wrong address meant that the reassessments were not issued at all.

The FCA relied on *L.B. Scott* (60 DTC 1273 (Ex. Ct.)), in which the Exchequer Court held that Parliament did not intend that a notice of assessment be deemed made on the date of mailing if the notice was sent to an incorrect address. In that case, the court said that nothing in the legislation suggested that a taxpayer should be bound by an assessment mailed elsewhere than to the taxpayer's actual address or to an address that the taxpayer had authorized or adopted for that purpose.

The FCA also noted that the taxpayer must file its income tax returns on a prescribed form, which specifically requires the taxpayer to provide an address for mailing purposes. This address is the only one authorized or adopted for mailing purposes, and it was the address to which the notices should have been sent. Finally, the FCA noted that if the notices had been sent to the taxpayer's mailing address rather than to its "books and records" address, the reassessments would have been made on time. In the result, the FCA dismissed the Crown's appeal. In our view, the court reached the right conclusion, and for the correct reason. The reassessments were, at law, nullities, and the only thing the Crown could have done to revive them was mail them to the correct address before the limitation period expired.

The case illustrates the significance of the statutory rules governing assessments. The ETA deeming provisions parallel the ITA provisions, so the rules should be the same for GST purposes. In the case of provincial retail sales tax, the statutory provisions and administrative practices may be different, and the decision may not be applicable in the RST context, depending on the circumstances and the province.

Finally, although the taxpayer escaped reassessment because of a series of clerical errors on the part of the CRA, the case affirms the general rule that the minister is entitled to rely on a mailing address provided by the taxpayer. It follows from this that if the taxpayer provides an incorrect address, the minister may rely on it when mailing a notice of assessment, and the taxpayer will find itself out of luck if subsequent assessments are not received because they were sent to that address.

It should be noted that the CRA will not be bound by limitation periods if the taxpayer has made misrepresentations or has committed any fraud in filing the return; in that case, penalties and other sanctions may be assessed in addition to tax and interest.

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Form, Substance, and "Legal Substance"

The Supreme Court of Canada's 1999 decision in *Shell* ([1999] 3 SCR 622) and the CRA's response to it appeared to have put to bed a good deal of controversy regarding the question whether the supposed economic substance of an arrangement overrides its legal form for income tax purposes. *Shell* stands for the proposition that, in the absence of a sham or a specific provision to the contrary in the Income Tax Act, economic realities cannot be used to recharacterize a taxpayer's bona fide legal relationships for income tax purposes.

One example of the positive fallout from *Shell* was the issuance of *Income Tax Technical News* no. 21 (June 14, 2001) to publicize the fact that whether a contract is considered to be a sale or a lease for income tax purposes depends on the legal relationships created by the contract. *Interpretation Bulletin* IT-233R, which discussed when such contracts might be recharacterized, was withdrawn.

The recent TCC decision in *CCLI* (2006 TCC 240) has added an additional dimension to the form-versus-substance argument. The transactions reviewed by the court were as follows.

CCLI, which was in the moneylending business, borrowed funds in US dollars to acquire major assets from customers. It immediately leased those assets back to those same customers. The lease agreements contained an option to purchase; the exercise of the options was not automatic.

CCLI characterized the leasebacks as financing leases (that is, as secured interest-bearing loans) for accounting purposes in accordance with section 3065.09 of the *CICA Handbook*. However, the leasebacks were treated as operating leases for income tax purposes, and capital cost allowance was claimed in connection with the leased assets.

Because of exchange rate fluctuations, CCLI incurred losses when it repaid the US-dollar loans. Such losses, along with unrealized foreign exchange losses, were deducted in full on the basis that the borrowed funds constituted inventory of CCLI's moneylending business. The TCC held that in legal substance as well as legal form, the leasebacks were leases, notwithstanding that in economic substance they were akin to loans. As a consequence, the court treated the losses as capital losses. As such, they could be offset only against capital gains and would be recognized only when they were realized, not when they were accrued.

In *Shell*, the Supreme Court did not refer expressly to the concept of "legal substance." In *CCLI*, the court not only identified it as a concept, but went on to make it clear that legal substance is critical when it differs from legal form. The court stated that a contract sometimes mischaracterizes the legal substance of an arrangement. It cited the specific example of a contract between an employer and an employee which stipulates that the contract is one of client and independent contractor.

The *CCLI* decision makes sense. If the legal substance of a transaction differs from its legal form, the legal substance (not the legal form) overrides economic reality in income tax matters. It is therefore necessary to do more than merely read legal documents to ascertain the tax effect of various arrangements. The principle enunciated in *CCLI* will be important in assessing, for example, whether or not an unincorporated joint venture is really a partnership, notwithstanding a statement to the contrary that is commonly found in joint venture agreements. *CCLI* also serves as a vivid reminder that ordinary commercial principles rather than GAAP govern in computing income for income tax purposes.

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The CRA's SR & ED Claim-Processing Procedures

(Editor's note: This is the first of two articles on the CRA's SR & ED claim-processing and review procedures. In this article, the authors provide an overview of the requirements of an SR & ED claim. In the forthcoming article, they will discuss procedures for disputing the CRA's assessment of the eligibility of the work or costs claimed.)

The importance of filing a complete SR & ED claim cannot be overemphasized. A complete claim is one that contains all of the information prescribed on form T661 ("Claim for Scientific Research and Experimental Development (SR & ED) Carried Out in Canada") and schedule 31 ("Investment Tax Credit—Corporations"). The taxpayer must submit its claim on the most current version of form T661. Failure to file a complete claim can have significant negative consequences for a claimant, including the outright rejection of the entire claim for a fiscal year, with no possibility of refiling. The SR & ED claim must be filed within 12 months of the normal due date of the tax return for the particular year in which the SR & ED was performed. For a corporation, this means that the SR & ED claim must be filed within 18 months after the fiscal year-end. The CRA no longer has any discretion to extend this deadline.

In processing SR & ED claims, the CRA strives to meet several service standard objectives. Certain CCPCs may be entitled to a refund of all or part of the investment tax credits (ITCs) that exceed their income tax liability. For refundable claims, the CRA generally does not assess the associated tax return until the review of the SR & ED has been completed. The CRA strives to complete the process within 120 days of receipt of a complete claim (for non-refundable claims, within one year from receipt of a complete claim). However, for non-refundable claims filed with the initial tax return for the year, the SR & ED tax credits are processed as filed with the assessment of the tax return. Any adjustments resulting from a review of the SR & ED claim will result in a reassessment of the tax return. The CRA also attempts to process all refundable and non-refundable taxpayer-requested adjustments (amended claims) within 240 days and one year, respectively.

To help the CRA expedite the processing of a claim, the T661 and related schedules should be attached to the top of the tax return when it is submitted to the Taxation Centre (SR & ED claims cannot yet be filed electronically). It is important to note that local Tax Services Offices are no longer accepting claims. If the claim is submitted close to the 18-month deadline, it is advisable to send the claim via registered mail in order to have proof of timely delivery.

Once the SR & ED claim arrives at the Taxation Centre, the CRA will endeavour to identify the claim as quickly as possible and forward it to the appropriate Coordinating Tax Services Office (CTSO). When the file arrives at the CTSO, it is checked for completeness. If the claim is not complete, the claimant is informed of the deficiencies, usually via a letter requesting that additional information be submitted within 30 days. However, the CRA will neither request nor accept additional information after the 18-month deadline. An incomplete claim is then generally denied, and there is no recourse to file an amended claim.

When a claim is determined to be complete, it proceeds to risk assessment. The risk assessment of an SR & ED claim can take up to three stages.

Stage 1 involves a desk review by both technical staff and financial staff. At this stage, the CRA may conclude that there is minimal risk of material error and process the claim as filed. It is very important to note that when an SR & ED claim is processed as filed (that is, without audit), it does not mean that the work has been deemed eligible—only that the CRA has chosen to allow the claim as filed and not to conduct an audit of the claim. If the CRA determines, on the basis of the available information, that the claim cannot be processed as filed, the claim will move to the second stage of risk assessment.

At stage 2, the CRA contacts the company by letter, phone, or a site visit to gain additional information that may allow the claim to be processed as filed. If the CRA is unable to obtain sufficient comfort to assess as filed, the claim will undergo a stage 3 risk assessment.

Stage 3 consists of a detailed financial and/or scientific and technical review (that is, an audit). A detailed review does not mean that all projects and all costs will be scrutinized. The depth of the review is at the discretion of the CRA, and the level of detail may change as the CRA gathers more information. If only one section (financial or scientific and technical) decides to conduct a detailed review, the other section always reserves the right to do a detailed review based on the new information from the first section. If only a scientific and technical review was performed and the CRA has concerns about the work claimed, a financial reviewer will determine the dollar amount of any adjustments.

Once a stage 3 technical review has been completed, the CRA issues a research and technology review report if it proposes to deny some or all of the work claimed. It is our understanding that a report is not required if the claim is to be processed as filed; however, a research and technology review report seems to be the norm even in such circumstances.

If the claim is subject to a stage 3 review and the CRA intends to adjust the claim, a draft of the research and technology review report should be provided to the claimant as soon as it is available, outlining the reasons for the proposed changes. The financial reviewer will issue a 30-day proposal letter reflecting the financial results of the scientific and technical review, along with any other adjustments resulting from the financial review. The purpose of the letter is twofold: (1) it enables the CRA to set out in writing the reasons for its concerns and the impact of those concerns on the qualified expenditures and resulting ITCs; and (2) it provides the claimant with a reasonable amount of time (usually 30 days) in which to submit additional information, clarification, or other support for its position. The proposal letter should hold no surprises: the CRA should be communicating any concerns to the claimant as they arise. If this communication does not occur regularly during the review process, the claimant should ask the CRA to initiate it.

Once a proposal letter is received, the claimant can either concur with or dispute the CRA's proposal. If the claimant concurs with the CRA's proposal, it can expedite the processing of the claim by so advising the CRA as soon as possible; otherwise, the CRA will wait until the 30-day response time has expired before processing the claim. If the claimant disputes the proposal, it must provide its rebuttal in writing. From this point on, the claimant and the CRA should work together to finalize the claim.

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Directors' Liability Update

Although it is initially up to the shareholders to elect a director of a corporation, the decision to act as a director is ultimately the particular individual's. In the context of a closely held family corporation, it is common for both spouses to act as directors of an operating corporation even when only one of them is actively involved in the business—often as a means of income splitting or to allow the inactive spouse to feel that he or she is participating in the business, even if it is in name only.

However, consenting to act as a director is not a decision that should be taken lightly. In addition to their stringent obligations under corporate statutes and at common law, directors can be personally liable on a joint and several basis with a corporation under section 227.1 of the Income Tax Act. Specifically, a director may be personally liable for a corporation's failure to deduct, withhold, or remit certain amounts under the Act during the time he or she was a director of a corporation where

1) the CRA has unsuccessfully attempted to recover the amounts from the corporation directly;
2) the CRA assesses the director for the amounts either during the time the director held office or no later than two years from the date of the director's resignation; and
3) the director did not exercise the degree of care, diligence, and skill necessary to prevent the failure that a reasonably prudent person would

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have exercised in comparable circumstances (the so-called due diligence defence).

The large number of reported cases (21 as of December 15, 2006) dealing with section 227.1 assessments indicates that the CRA is willing to pursue both de jure and de facto directors for the failure of a corporation to deduct, withhold, or remit amounts under the Act.

Liability under section 227.1 may also attach to individuals who ostensibly act as directors despite not being formally appointed as such (that is, de facto directors). De facto directors cannot insulate themselves from a section 227.1 assessment merely by appointing an inactive "puppet" director.

The Act makes no distinction between active, inside directors and passive, outside directors. However, the courts have imposed different due diligence standards on inside and outside directors, which take into account directors' specific backgrounds and skill sets. Specifically, the Federal Court of Appeal stated in *Soper* (97 DTC 5407, at 5416) that

> [t]he standard of care laid down in subsection 227.1(3) of the Act is inherently flexible. Rather than treating directors as a homogeneous group of professionals whose conduct is governed by a single, unchanging standard, that provision embraces a subjective element which takes into account the personal knowledge and background of the director, as well as his or her corporate circumstances in the form of, *inter alia*, the company's organization, resources, customs and conduct.

This statement led to a lower due diligence standard being applied to passive, outside directors. Nonetheless, an outside director still has a positive duty to act when he or she obtains information or becomes aware of facts that might lead one to conclude that there is or could reasonably be a potential problem with remittances. In other words, it is incumbent upon an outside director to take positive steps if he or she knew, or ought to have known, that the corporation could be experiencing a remittance problem. Further, there is recent judicial authority for the proposition that a sole director of a corporation is implicitly an inside director; he or she cannot rely on any other person to bear the responsibilities of a director. On this basis, it will be very difficult for a sole de jure director to successfully challenge an assessment under section 227.1 on the basis that he or she was an outside director of a corporation that was actually controlled by a de facto director.

The decision to act as a director should be made very carefully in all circumstances, particularly if an individual is to be the sole director of a corporation or a director in name only and not actively involved in the corporation's affairs. Because an individual is liable for a corporation's failure to deduct, withhold, or remit only during the time he or she is a director (and in order to start the two-year limitation period as soon as possible), a director who is purporting to resign from office should

1) resign in writing;
2) deliver appropriate notice of his or her resignation to the corporation;
3) notify the appropriate corporate registry of his or her resignation; and
4) stop performing the functions of a director.

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