TAX FOR THE Owner-Manager

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GRIP Tips: Subsection 55(2) and Safe Income

The general rate income pool (GRIP) was created as part of the October 2006 amendments to the dividend taxation regime to reduce personal income taxes on dividends—a measure intended to equalize the treatment of corporations and income trusts by eliminating the double taxation of income earned by corporations. A CCPC can, to the extent of its GRIP balance, pay "eligible dividends" that qualify for the enhanced gross-up and credit. GRIP is a cumulative calculation made at the end of a CCPC's taxation year; it generally consists of the CCPC's full-rate active business income (net of notional income tax), plus eligible dividends received from other corporations, less eligible dividends paid. (For a complete discussion of GRIP and the new dividend taxation regime, see Heather Evans and Pearl E. Schusheim, "Dividend Taxation: The New Regime," in *Report of Proceedings of the Fifty-Eighth Tax Conference*, 2006 Conference Report (Toronto: Canadian Tax Foundation, 2007), 1:1-28.)

Some new concepts do not mesh seamlessly with the existing provisions of the Income Tax Act, and GRIP is no exception. This article highlights two inconsistencies that can arise in the context of subsection 55(2).

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Permanent Depletion of GRIP When Subsection 55(2) Applies to an Intercorporate Dividend

At the 2007 STEP Conference Round Table, the CRA expressed the view that there will be a permanent depletion of GRIP when subsection 55(2) applies to an intercorporate dividend that exceeds safe income on hand. To pay a GRIP dividend (whether to a corporate or an individual shareholder), the dividend payer must make a designation pursuant to subsection 89(14) notifying the dividend recipient that the dividend is an eligible dividend (CRA document no. 2007-0233771C6, June 8, 2007). Partial designations are not possible: the subsection 89(14) designation must cover the entire dividend (Evans and Schusheim, supra, at 1:7).

If subsection 55(2) is applicable to an intercorporate dividend, the dividend is deemed to be a gain of the dividend recipient (or proceeds of disposition, in the case of a deemed dividend resulting from a share redemption), not a dividend received by the corporation. Predictably, a dividend to which subsection 55(2) applies will not be added to the GRIP of the dividend recipient. Item G of the GRIP definition in subsection 89(1) provides a GRIP inclusion only for eligible dividends received by a corporation; the fact that a payment was made and designated by the payer as a GRIP dividend is not material.

Subsection 55(2) applies only to the dividend recipient. According to the CRA, a disconnect results from the lack of an adjustment to the payer's GRIP as a consequence of the deemed capital gain treatment of the payment in the hands of the dividend recipient. Item I of the GRIP definition stipulates that the amount of any eligible dividend paid by a corporation in its preceding taxation year must be deducted in the computation of its GRIP. In the CRA's view, the tax treatment of the dividend to the recipient CCPC has no bearing on the computation of the GRIP of the payer CCPC. As a result, where subsection 55(2) applies to a dividend designated by the payer as a GRIP dividend, there will be a permanent depletion of GRIP in the corporate group.

The CRA has stated that it will generally accept that the recipient CCPC adds to its GRIP the part of the dividend that is covered by safe income, provided that the CCPC recipient made or makes a designation under paragraph 55(5)(f) so that the "safe income" portion of the dividend will be considered a separate taxable dividend.

The CRA's interpretation of item I of the GRIP definition appears to be incorrect. Item I reduces the dividend payer's GRIP by the amount of eligible dividends paid by the corporation in its preceding taxation year. However, paragraph (a) of the "eligible dividend" definition in subsection 89(1) requires that the dividend be received by a person resident in Canada. It does not appear that this requirement will be met if subsection 55(2) applies to deem the payment not to be a dividend received by the payee corporation.

Contrary to the CRA's comments at the STEP Round Table, it appears (on the basis of the "eligible dividend" definition in subsection 89(1)) that the portion of a dividend subject to deemed capital gain treatment under subsection 55(2) may not reduce the GRIP of the dividend payer. GRIP should move from the dividend payer to the dividend recipient to the extent of any designation made by the recipient under paragraph 55(2)(f) for the purpose of receiving a separate dividend to the extent of the safe income on hand attributable to its shares of the dividend payer.

Safe Income Is Consolidated, GRIP Is Not

Subsection 55(2) contemplates that tax-free intercorporate dividends can be paid to the extent of the payer's safe income on hand attributable to the shares on which the dividends are paid. The CRA accepts that the language of subsection 55(2) permits the consolidation of safe income within a corporate group, and the top corporation in a multi-tiered corporate structure can pay a safe dividend without the need for its subsidiaries to first pay safe dividends up the corporate chain.

A CCPC's GRIP, on the other hand, is not calculated on a consolidated basis. The benefit of GRIP is that it can be used to reduce income taxes payable by individual shareholders of a CCPC on eligible dividends. If the GRIP is in a CCPC at the bottom of a multi-tiered corporate structure, eligible dividends must be paid up the chain to the top-level holding corporation in order for the GRIP to be available to fund dividends to the individual shareholders.

Practitioners working with subsection 55(2) and safe income should always consider the GRIP balances of all corporations in the group. Movement of the GRIP balances is a separate issue, and the safe income attributable to the shares may or may not correlate with the desired GRIP allocation. Consider, for example, the case in which shares of a CCPC with GRIP have been purchased in an arm's-length transaction.

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The Income Tax Treatment of the Cost of a Supply Contract

The recent *Basell* case (2007 TCC 685) addressed the proper treatment, for income tax purposes, of the cost of a contract for the supply of raw materials. Basell acquired the assets of a business. As part of the acquisition, Basell paid a significant amount for the assignment to it of a supply contract originally entered into by the vendor of the assets. The contract entitled Basell to acquire raw materials for use in its production process, at a price that was, at the time of the assignment, lower than the market price. When negotiated by the vendor, the contract had a 10-year term. At the date of assignment, the contract had a remaining term of approximately six years.

For both income tax and accounting purposes, Basell initially amortized the cost of the contract over its remaining term. However, when the market cost of the raw materials declined below their cost under the contract, Basell wrote off the unamortized cost for both tax and accounting purposes. The Crown's position was that the amount paid for the contract was on account of capital and was an eligible capital expenditure.

The Crown cited jurisprudence that, in its opinion, characterized an expenditure made for the purchase of a business as a going concern (that is, a profit-making structure and an enduring asset) as a capital outlay on the basis that it is made to obtain a source of income rather than in the course of earning income. This was especially true, said the Crown, because the purchase of the structure was intended to add to an existing structure. Even though part of the purchase price was specifically allocated to the contract, the Crown felt that the purchase of the business could not be said to be the acquisition of severable disparate parts. Furthermore, the cost of the contract could not be said to be either a prepaid expense for its future raw material needs or, alternatively, simply the cost of inventory because the payment was not made to the supplier and did not represent the cost of raw material actually purchased.

The court held that the tax treatment adopted by Basell was appropriate in accordance with subsection 9(1) and paragraph 18(1)(a) of the Income Tax Act. In coming to this conclusion, the court quoted with approval other jurisprudence to the effect that the cost of the contract was no more than the payment for the supply, and that the cost of obtaining the stock in trade of a business on the taking over of another business can be offset against sales proceeds. Intuitively, this is a reasonable result the principles of which appear

to apply to the cost of acquisition of such a contract, whether in a standalone transaction or, subject to the comments below, in the course of the acquisition of a business. Why, then, was the court's analysis so lengthy?

In the court's view, it was significant that the sale agreement specifically allocated a portion of the purchase price to the contract. (In this regard, the taxpayer's circumstances differed from those in the jurisprudence cited by the Crown in support of its position.) In fact, Basell could apparently have purchased the business without acquiring the contract; the acquisition of the contract stood on its own and was treated separately from the cost allocation in the documentation of the asset purchase. The court felt that these facts supported the proposition that the contract was not purchased as part of the profit-making structure. The obvious implication is that if there had not been a separate allocation, the court might have ruled in the Crown's favour. The court also held that the acquisition of the contract did not ensure an enduring benefit: the market cost of the raw material could drop below the contract price in the future. (In fact, such a drop did occur.)

The court left one question unanswered: could Basell have written off the entire cost of the contract immediately in accordance with the Supreme Court of Canada's decision in *Toronto College Park* (98 DTC 6088), and similar cases?

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New Information Circular on Voluntary Disclosures Program

The CRA has released a new information circular on the voluntary disclosures program (VDP) (IC 00-1R2, dated October 22, 2007). The new circular, which replaces IC 00-1R, dated September 30, 2002, is dramatically expanded to 65 paragraphs and provides much more information on the VDP. The new circular deals with a variety of issues, including the taxes to which the program applies, the penalty and interest relief that can be provided under the program, the circumstances in which relief may or may not be granted, the disclosure methods, the conditions of a valid disclosure, the information and documentation required to make a disclosure, and the rights of redress available to the taxpayer if a disclosure is denied.

The 10-year limitation period on the CRA's discretion to grant relief is explained in paragraphs 13 to 17. (See "Limitation on the Waiver of Penalty and Interest," *Tax for the Owner-Manager*, April 2007.) For a disclosure to be valid, it must be complete. No information is provided on how to address the situation in which a taxpayer's failure to disclose includes a period for which the CRA has no discretion to provide relief. Paragraph 35 deals with the requirement that the disclosure must be complete.

Paragraphs 26 to 30 of the new circular deal with the "no-name" disclosure method and state that on the basis of the preliminary information required to be provided for such a disclosure, a VDP officer may confirm that nothing in such information would disqualify the taxpayer from further consideration under the program. The CRA may also advise on the possible tax implications of a disclosure. The new circular clearly states that discussions that occur prior to disclosure of the taxpayer's name are non-binding and informal and that the CRA will provide a final and determinative decision on a no-name disclosure only after the identity of the taxpayer is known and all the facts of the disclosure with respect to the validity conditions have been verified.

The four conditions necessary for a valid disclosure remain essentially the same:

1) the disclosure must be voluntary;
2) the disclosure must be complete;
3) the disclosure must involve the application or potential application of a penalty; and
4) the disclosure must include information that is
   a) at least one year past due, or
   b) less than one year past due where the disclosure is to correct a previously filed return or where the disclosure contains information that also meets the condition in point (a) above.

However, much greater detail on the "voluntary" condition is provided in the new circular.

Under paragraph 32, a disclosure will not be considered voluntary in two situations: (1) the taxpayer was aware of, or had knowledge of, an audit, investigation, or other enforcement action set to be conducted by the CRA or any other authority or administration with respect to the information being disclosed to the CRA; or (2) enforcement action relating to the disclosure was initiated by the CRA or any other authority or administration against the taxpayer or against a person associated with or related to the taxpayer (including, but not limited to, corporations, shareholders, spouses, and partners), or against a third party where

the purpose and impact of the enforcement action against the third party is sufficiently related to the particular disclosure. In addition, the disclosure will not be considered voluntary if the enforcement action is likely to have uncovered the information that is being disclosed.

Paragraph 33 provides four examples of what the CRA considers to be an enforcement action. For example, enforcement action includes requests, demands, or requirements issued by the CRA relating to unfiled returns, unremitted taxes or instalments, and deductions required at source. An enforcement action that relates to one specific year or reporting period is to be considered an enforcement action for the purposes of the VDP for all taxation years or reporting periods. An enforcement action includes an audit, investigation, or other enforcement action by another authority or administration, such as a police force, securities commission, or provincial authority.

Paragraph 34 provides a couple of examples of CRA-initiated enforcement action that may not cause a disclosure to be denied. For example, a CRA payroll audit will not necessarily invalidate a voluntary disclosure for unremitted GST/HST. Paragraph 34 suggests that if there is no correlation between the two issues, then a particular enforcement action on one issue will not invalidate the disclosure on another issue.

The fourth condition for a voluntary disclosure is slightly different in the new circular. Paragraph 39 of the new circular requires that a disclosure include information that is either (1) at least one year past due or (2) less than one year past due where the disclosure is to correct a previously filed return or where the disclosure contains information that also meets the condition of the first requirement. (The old circular provided that if the disclosure related to information that was less than one year past due, it could not be initiated simply to avoid late-filing or instalment penalties.)

The new circular is must reading for tax professionals who advise on, or assist taxpayers in the making of, voluntary disclosures.

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The CRA's Right to Illegally Seized Funds

In general, where property is illegally seized by the police, the courts have held that the owner of the property is entitled to have it returned to him or her as a remedy pursuant to section 24 of the Charter of Rights and Freedoms. What happens when the CRA seeks an equitable charging order with respect to the illegally seized property because outstanding taxes are owed by the owner? Does the CRA have a right to the property? Or does the owner have a right to the property above that of the CRA?

This issue was at the heart of the recent decision of the British Columbia Court of Appeal in *Canada (Deputy Minister of National Revenue, Customs, Excise and Taxation—MNR) v. Millar* (2007 BCCA 401), in which the court held that the CRA was entitled to funds illegally seized by the Vancouver police, based on prior claims it had made in respect of the appellant's assets. The *Millar* decision has implications for situations involving contraband cigarettes and other property involved in tax evasion schemes.

In *Millar*, the CRA filed certificates in the Federal Court in 1995 and 1997, certifying that the taxpayer owed more than $600,000 to the CRA. Under that process, the $600,000 was thus deemed to be a debt due to the CRA. In mid-1996, the RCMP seized more than $200,000 in cash from a vehicle driven by the taxpayer. The taxpayer was charged with, among other things, distribution of illegal television converters. At his trial, however, the seizure was ruled to be illegal and in contravention of his rights under section 8 of the Charter. Accordingly, the seized funds were paid into court.

In an attempt to gain access to those funds, the CRA initially filed a petition in the British Columbia Supreme Court seeking an equitable charging order over the seized funds. The taxpayer resisted the CRA's position, arguing that the CRA was not entitled to equitable relief because its claim to the seized funds was tainted by the unconstitutional conduct of the police; therefore, the CRA did not come to court with clean hands.

Observing that the CRA and the police were not "one indivisible entity" of government, the court concluded that the CRA did not have "unclean hands based on the actions" of the police, and granted the order. The seized funds were paid to the CRA.

The taxpayer appealed to the British Columbia Court of Appeal and raised three arguments: (1) that the CRA was not entitled to an equitable charging order over the seized funds because it could not legally claim them from the police; (2) that pursuant to the common law, illegally seized funds must be returned to their rightful owner; and (3) that the charging order violated the taxpayer's constitutional rights, and that he was entitled to the return of the seized funds as a remedy under section 24 of the Charter.

The Crown's position was (1) that the CRA was entitled to take execution proceedings against the seized funds under British Columbia's Court Order Enforcement Act; (2) that the court's jurisdiction to return illegally seized funds to their rightful owner was always subject to other proper claims (which the CRA asserted it had); and (3) that there was no breach of the taxpayer's Charter rights by the CRA.

The Court of Appeal agreed with the CRA, finding that it was irrelevant that the seized funds had been in the possession of the police before being paid into court and that it was open to creditors to assert a claim to the funds. The Court of Appeal also rejected the taxpayer's common-law and Charter arguments, finding that there was no authority for the proposition that the seized funds had to be returned to the taxpayer under the common law (to the contrary, the law indicated that judgment creditors were entitled to a charging order against the funds), and that the CRA's claim to the seized funds was not tainted by the police's Charter breach.

The *Millar* decision is interesting reading and could be an unfortunate result for taxpayers involved in seizures of contraband goods, as the taxpayer in *Millar* was. The CRA—and presumably provincial tax authorities—appear able to utilize their collection remedies to attach the contraband goods and/or money to satisfy any tax debts owing at the time of the seizure.

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RRSPs: Limiting the Risk of Exposure to the CRA and Other Creditors

Some types of assets are obviously available for execution; others, such as insurance policies with named beneficiaries, are not (by virtue of section 173(2) of the Insurance Act (Ontario) and similar provisions in most insurance statutes across Canada). RRSPs present unique challenges and opportunities because of their statutory "trustlike" nature. RRSPs often contain significant personal assets that are intended to support the annuitant and his or her family in the future, and advisers are frequently asked whether and when those assets can be seized by the CRA and other creditors.

The CRA's involvement as a judgment creditor begins when it obtains and registers a certificate under subsections 223(2) and (3) of the Income Tax Act, at which point it becomes a judgment creditor with the same rights as any other judgment creditor. This was confirmed in *Piccott* ([2004] GSTC 121 (FCA)).

While it is not clear that an RRSP is a trust by virtue of the operative language contained in section 146 of the Act (specifically, subsection 146(4)), a number of cases have nonetheless concluded that RRSPs are trusts. (For example, see *Watt v. Trail* ([2000] NBJ no. 298 (CA)); *National Trust Co. v. Canada* ([1998] FCJ no. 968 (CA)); *DeConinck v. Royal Trust Corp. of Canada* ([1988] NBJ no. 1012 (CA)); and *Guttman v. TD Bank* ((1984), 3 DLR (4th) 723.) It is possible that the analysis turns on the nature of the underlying agreement and the instruments establishing the trust, as opposed to the statutory language itself.

Amherst Crane Rentals Ltd. v. Perring ([2004] 5 CTC 5 (Ont. CA); leave to appeal to the SCC refused by [2004] SCCA no. 430) highlights the unique nature of an RRSP as well as the importance of naming a beneficiary. In *Amherst*, the court was asked to consider the proper treatment of RRSP proceeds following the death of the individual annuitant. The appellant, Amherst Crane Rentals Ltd. (A Ltd.), was a creditor of the deceased as a result of a successful claim against the deceased as a director of a corporation. The respondent was the widow of the deceased, the executrix of her late husband's estate, the sole beneficiary of the estate, and the designated beneficiary of two RRSP funds established by her late husband. She received the proceeds of the two funds from the plan administrators following the death of her husband. The estate of the deceased was unable to pay all of its debts, and it declared bankruptcy. A Ltd. filed a proof of claim in the bankruptcy but remained unpaid. Unable to recover from the estate, A Ltd. obtained an assignment of the claim from the trustee and sought to obtain payment of the estate's outstanding debt from the proceeds of the RRSPs. The wife refused to pay, claiming that A Ltd. had no right to any such payment.

The Court of Appeal considered two questions: first, whether the proceeds of an RRSP devolve directly to a designated beneficiary or whether they form part of the estate of the deceased owner; and, second, if the proceeds do not form part of the estate, whether creditors have a claim against the proceeds in the hands of a designated beneficiary when creditors of the estate remain unpaid.

The court considered *Canadian Imperial Bank of Commerce v. Besharah* ((1989), 68 OR (2d) 443 (HCJ)) and *Pozniak Estate v. Pozniak* ((1993), 88 Man. R (2d) 36 (CA)), which held that RRSPs devolved to a deceased's estate and could be paid out as a specific bequest only after all creditors of the estate were satisfied. Feldman JA, writing for the court, did not

agree with *Besharah*; he stated that the decision of the Supreme Court of Canada in *Kerslake v. Gray* ([1957] SCR 516) compelled the opposite conclusion; he noted that the more recent decisions in *Fekete Estate v. Simon* ((2000), 32 ETR (2d) 202 (Ont. Sup. Ct.)) and *Banting v. Saunders Estate* ((2000), 34 ETR (2d) 163 (Ont. Sup. Ct.)) also reached the opposite conclusion.

The court found that RRSP proceeds do not form part of a deceased's estate but devolve directly upon the designated beneficiary. This interpretation is required by the statutory language of section 53 of the Succession Law Reform Act (SLRA), which excludes the personal representative of the deceased owner of the RRSPs from any right to enforce payment, and is in accord with the Supreme Court's decision in *Kerslake*. In that case, the Supreme Court considered language in an older version of the Ontario Insurance Act that was "virtually the same" as section 53 of the SLRA. With respect to the argument that there was a claim against the proceeds that devolve directly upon a designated beneficiary, the court concluded that there was neither a legal principle nor statutory authority for such a claim. The court noted that although the RRSPs belonged to the deceased owner before death and were liable during the life of the owner for the claims of the owner's creditors, this did not mean that they also remained liable for the creditors' claims after the owner's death.

Amherst demonstrates that, where practical, an annuitant should designate a beneficiary of the RRSP. This will ensure that proceeds held in an RRSP at the death of the annuitant will be available to the beneficiary, which in many circumstances will be the husband or wife of the annuitant. In the absence of a beneficiary designation, the money is left to be disposed of by the estate, with potentially negative effects that may prejudice the family savings. On facts like those in *Amherst*, very little would have been left for the wife if it were not for the beneficiary designation.

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Restrictive Covenant Trap

The taxation of amounts received as consideration for restrictive covenants was significantly altered in 2003 by the addition of proposed section 56.4 and corresponding amendments to section 68. The proposed subsection was amended in 2005 and is now making its way through the legislative process as Bill C-10. The changes generally will be effective for payments received (or receivable) after October 7, 2003.

In very general terms, subsection 56.4 requires the recipient of a payment for a restrictive covenant to include the amount in income unless the recipient and payer can elect to have the payment treated as part of the consideration for the disposition of an "eligible interest" in a corporation or partnership. The actual scope of the new section is both broader and more complex than this very brief summary might indicate, and the details of the section should be carefully considered when a transaction involves a restrictive covenant.

If subsection 56.4(5) applies, section 68 is deemed not to apply to deem consideration otherwise received as being in respect of a restrictive covenant. The amount received for the restrictive covenant is then subject to taxation under the default charging provision in subsection 56.4(2). Very generally, that subsection brings the full amount of the payment into income. However, if the exception in subsection 56.4(5) applies, then the tax consequences may be significantly different. The exception in subsection 56.4(5) is triggered if one of subsections 56.4(6) to (8) inclusive applies.

Let us examine a scenario in which it seems at first glance that the combination of subsections 56.4(5) and (7) will be applicable. Assume that Mr. X and Mrs. X each own 50 percent of the common shares of X Co. X Co sells a customer list for $1 million, and Mr. X and Mrs. X each grant a restrictive covenant to the purchaser for a nominal consideration.

Subsection 56.4(7) is applicable if X Co is an "eligible corporation" to each of Mr. X and Mrs. X. Subsection 56.4(1) defines an eligible corporation as a taxable Canadian corporation of which the taxpayer holds, directly or indirectly, shares of the capital stock, and individuals with whom the taxpayer does not deal at arm's length hold less than 10 percent of the fair market value of all of the issued and outstanding shares of that corporation.

In the example, X Co is not an eligible corporation of either Mr. X or Mrs. X because each spouse owns 50 percent of the fair market value of the corporation. It follows that section 68 may apply to allocate a portion of the proceeds received by X Co for its customer list to the restrictive covenant granted by Mr. X and Mrs. X. In that event, the amount so allocated is included in income by Mr. X and Mrs. X, notwithstanding that each of them received only a nominal amount for granting the restrictive covenants.

The only way section 68 will not apply at all in this case is if both Mr. X and Mrs. X own less than 10 percent of the fair market value of X Co. The preceding statement implies that the majority of the shares of X Co have to be held by a person who is at arm's length with both Mr. X and Mrs. X.

Despite this provision's obvious disregard for the considerable jurisprudence on legal substance, it makes no sense for the tax rules to be biased against non-arm's-length persons selling their business interests to third parties given the preponderance of family businesses in Canada. It is hoped that Finance will make a legislative change to address this issue.

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Borrowing To Return Paid-Up Capital

Under paragraph 20(1)(c), interest paid on money borrowed to earn income is deductible. Generally, the CRA accepts that money borrowed to acquire common shares meets the "for the purpose of earning income" test, as long as there is a reasonable prospect that dividends will be paid on the shares. Although the addition of section 3.1 proposed in the October 31, 2003 draft legislation on "reasonable expectation of profit" raised some questions about whether the administrative practice would change, as yet the proposed addition has not been implemented. In the meantime, most advisers are proceeding on the assumption that interest paid on money borrowed to acquire common shares is deductible.

In this context, a technical interpretation issued earlier this year is of interest. TI 2005-0156891E5, "Déductibilité des intérêts—retour de capital," May 11, 2007 (available only in French), responds to a question regarding the deductibility of interest paid on money borrowed to invest in common shares of a controlled corporation in the following circumstances.

Mr. X acquires 100 common shares of Opco on incorporation; the shares have an ACB and a PUC of $100. Two years later, Mr. X borrows $100,000 and subscribes for an additional 50 common shares. He now holds 150 common shares having an ACB and PUC equal to $100,100. In year 5, at a time when the shares have an FMV of $500,000, Opco reduces the PUC of the outstanding shares by $100,000. Following the reduction, the common shares have an FMV of $400,000. Mr. X uses the proceeds of the reduction for personal purposes and does not repay the borrowing made to acquire the additional 50 shares.

The CRA was asked to comment on the continued deductibility of the interest paid on the loan. In its view, the interest was no longer deductible. In a very short comment, the CRA noted that deductibility under paragraph 20(1)(c) depends on the existence of a direct link between the borrowed funds and an income-earning purpose. There can be no quarrel with this statement of the law. However, the CRA then said that in the case of a reduction of capital such as that described in the example, it was a condition of deductibility that the funds received on the reduction of capital be linked to an income-producing use. Because the funds were used for personal reasons, the interest would no longer be deductible.

This conclusion is directly contrary to the one given in an earlier TI, 9817625 ("Déductibilité des intérêts"). In a note in the October 1, 2007 issue of *Tax Notes International*, Yi-Wen Hsu comments that the CRA has confirmed orally that the latest TI represents a reversal of its earlier position on this matter. As yet, it has not given a rationale for the change.

It seems to me that the CRA's latest position misapplies the purpose test in paragraph 20(1)(c). GAAR aside, the paragraph is clear in requiring a link between the use of the borrowed money and the income-earning activity. As long as the common shares remain outstanding following the reduction of PUC, the necessary link is maintained. Note in the example that the shares are assumed to have an FMV of $400,000 following the reduction of PUC. This is well in excess of the principal amount of the loan—$100,000—and supports an inference that Opco is doing well financially and may be expected to pay dividends. The fact that Mr. X chooses to use the reduction proceeds for personal reasons should be irrelevant.

This being said, there may be variations on the example that would support a GAAR attack on the attempt to deduct interest following the reduction. One might speculate on the result if Mr. X were to borrow to make the additional investment on day 1 and cause the PUC reduction on day 2 in order to finance the purchase of a residence. This would bring the facts close to those in *Lipson* (2007 FCA 113), although I question whether that decision will be upheld by the Supreme Court.

Pending the result of the *Lipson* appeal (the case is scheduled for argument in April 2008), the recent TI seems to me to be incorrect in law, but careful advisers will not ignore it for that reason alone.

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"Principal Place of Residence" in a Province: Owens v. The Queen

Personal rates of income tax vary significantly between the provinces; this variation provides an incentive for

some taxpayers to move income out of a high-tax province into one in which the rates are lower. *Owens v. The Queen* (2007 NSSC 341), a judgment of the Supreme Court of Nova Scotia, is of some interest in this regard. While it does not appear from the reasons for judgment that the taxpayer's move from Nova Scotia to Alberta was motivated primarily (or at all) by tax considerations, it is clear that the move saved him an appreciable amount of provincial tax. (In 2007, the top personal rate in Nova Scotia was 19.2 percent; in Alberta it was 10 percent.) *Owens* is of interest in that it may indicate an emerging trend in the provincial courts on the meaning of "principal place of residence" in regulation 2607 under the Income Tax Act. (For a discussion of two other recent decisions, *Mandrusiak* (2007 BCSC 1418) and *Waring* (2006 BCSC 2046), see "Provincial Residence: Recent Cases," *Tax for the Owner-Manager*, October 2007.)

In *Owens*, the 2002 and 2003 tax years were under appeal. The taxpayer was a pilot with WestJet during those years, having been employed by that company on a full-time basis since 1999. Prior to taking up this employment he resided in Nova Scotia with his wife and two children, and he clearly was resident in that province. After taking the pilot's job, he moved to Calgary on a full-time basis and lived there in rented accommodation. His wife and children continued to reside in the family home in Windsor, Nova Scotia, which the taxpayer owned jointly with his wife. He opened a bank account in Alberta and obtained an Alberta health card and driver's licence. He and his wife maintained a joint bank account in Nova Scotia, and his salary was deposited to that account. He had investments that were managed on his behalf in Toronto and Montreal. He returned to the family for visits periodically, staying about four days in the months that he did so. However, he was unable to visit every month. In 2006, his wife retired from her teaching job in Nova Scotia and joined her husband in Alberta, where they continued to reside on a full-time basis.

The minister assessed the taxpayer on the basis that he was a resident of Nova Scotia, not Alberta. (Because the only amount of tax in issue was the provincial tax, and the specific question was whether the taxpayer was liable to pay tax to Nova Scotia, the appeal was to the Supreme Court of Nova Scotia, not to the Tax Court of Canada, which does not have jurisdiction to hear appeals relating to provincial tax.)

The court held that the taxpayer was resident in Alberta, not in Nova Scotia, and allowed the appeal. The reasons for judgment do very little other than recite the facts; there is no analysis of the law. The court was satisfied that, on the facts, the taxpayer had established residence in Alberta. It was impressed by the fact that the move to Calgary was for the purpose of finding secure, full-time employment and that this move involved significant personal sacrifice on the taxpayer's part.

I think the court may have reached the right conclusion in this case, but the legal route it took in doing so is somewhat unclear. The court cited section 5 of the Nova Scotia Income Tax Act, which provides that an individual is liable for income tax in Nova Scotia if

> (a) [he] was resident in the Province on the last day of the taxation year; or
>
> (b) [he], not being resident in the Province on the last day of the taxation year, had income earned in the taxation year in the Province, as defined in clause 7(c).

Clause 7(c) provides that "income earned in the taxation year in the Province" means income earned in the province as determined by regulations made under subsection 120(4) the federal Income Tax Act. The only regulation relevant to this case appears to be regulation 2607, which provides that if an individual is resident in more than one province on the last day of the taxation year, he is deemed resident only in that province "which may reasonably be regarded as his principal place of residence." The court did not refer directly to regulation 2607, nor did it discuss whether the taxpayer was otherwise a resident of both provinces so as to bring that regulation into play. It merely concluded that he was resident in Alberta.

On the strength of the considerable jurisprudence on the meaning of "residence" and "ordinarily resident," it seems to me that the taxpayer was ordinarily resident in both Nova Scotia and Alberta in 2002 and 2003, and that the real issue in the case was which province was his "principal place of residence." This issue is not discussed in the reasons. Unlike the tie-breaker rules in many of Canada's tax treaties (see article IV.2 of the Canada-US treaty, for example), regulation 2607 specifies only a "principal place" test. The treaty provision typically involves a series of tests to be applied in descending order, involving the place of a permanent home, the centre of vital interests, the place of usual abode, and the country of citizenship. In *Mandrusiak*, the court held that "the test for principal residence is a qualitative one based on all of the relevant factors and in this context means: 'chief, primary, most important.' " The court said, "This involves a consideration of the appellant's social and economic ties to the two jurisdictions [and] . . . there [are] many facts and factors to be considered in reaching the proper conclusion on principal place of residence."

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Often, the place of residence of a spouse and other family members will be the most important factor. The CRA has indicated that "a spouse and children constitute significant residential ties in the absence of strong evidence to the contrary" (see TI 2004-005468117, January 28, 2004). A full-time job and a home (owned or rented) in the other jurisdiction also appears to constitute strong evidence. On facts similar to those in *Owens*, the CRA was prepared to say in the TI that the fact of a full-time job and a residence in the other province was sufficient to make that province the place of "primary residence."

Where a person is resident is a question to be determined on the facts and circumstances of each case. No one case should be read as setting a precedent for other fact situations. That being said, in view of the recent decisions in favour of the taxpayer in *Mandrusiak* and *Waring*, and now the decision in *Owens*, it appears that the provincial courts are willing to downplay the fact that there is a spouse and a matrimonial home in the initial province of residence. A full-time job and a home in the new province may have become the more significant factors in determining the taxpayer's "principal place of residence."

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