TAX FOR THE Owner-Manager

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Professional Corporations for Ontario Doctors and Dentists

Regulation 665/05 to the Ontario Business Corporations Act allows professional corporations (Procos) established by doctors and dentists in Ontario to have shareholders other than the professional who conducts the professional practice through the Proco. In particular, non-voting shares of the Proco can be held by the professional's spouse, children, or parents, and/or by one or more trusts for children of the professional who have not turned 18 years of age. (Apparently, trusts may not otherwise be shareholders. Thus, for example, when a minor child who is the beneficiary of a trust-shareholder turns 18, the child must cease to be a beneficiary. That cessation could, if so desired, be in conjunction with a distribution of shares to that child.)

The major tax benefit of incorporating a Proco is to allow professional income that is not needed for personal living expenses to be left in the Proco to be taxed at the small business rate. A second benefit is the potential to split income by paying dividends to the non-professional shareholders. A third potential benefit is the possibility of multiplying the capital gains exemption on the sale of the shares of the Proco. This article will focus on a taxpayer's ability to arrange for one or more trusts to hold shares for the benefit of minor children.

Where a trust holds shares for minor children, income splitting is essentially obviated by the kiddie tax that is levied on dividends passed through the trust to the children, and the high rate of tax payable by the trust if the dividends are not passed on to the children. (In the latter case there would be some saving, because the trust would not be subject to surtax.) A professional might nevertheless introduce such a trust as a shareholder at the outset in order (1) to avoid having to implement a freeze-type transaction when the children turn 18 and (2) to take into account the possibility of multiplying the capital gains exemption if the shares should be sold before the children turn 18.

A Proco that is in a position to earn $500,000 of professional income after remuneration is paid to the professional will obviously accumulate cash quickly and will likely earn substantial investment income. The Ontario small business deduction begins to be clawed back when the taxable income (not merely the active professional income) of Proco and associated corporations exceeds $500,000. In such circumstances, the professional's spouse can incorporate a corporation (Spouseco) for the purpose of borrowing Proco's excess funds interest-free. The investment income will then be earned by Spouseco. Because, absent other factors, Proco and Spouseco are not associated for income tax purposes, Proco's Ontario small business deduction will not be clawed back. (It should be noted that the corporate attribution rules of section 74.4 of the Income Tax Act will not generally apply to intercorporate loans in such circumstances.)

Because of the associated-corporation rules, this type of planning is hampered when a spouse and/or a trust for minor children holds shares of Proco. By virtue of the rules in subsection 256(1) of the Act, Proco and Spouseco will be associated if the shares of Proco owned by the spouse and/or the trust constitute 25 percent or more of the shares of any class. This will certainly be the case if each shareholder of Proco holds the now popular discretionary shares of a separate class. (Such shares will likely have little value and will likely not allow the capital gains exemption to be multiplied.)

Paragraph 256(1.2)(f) deems shares held by a trust to be owned by its beneficiaries. (In the case of a discretionary trust, the most common type of family trust, all shares are deemed to be owned by each beneficiary.) Except in unusual circumstances, subsection 256(1.3)

In This Issue

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deems each parent to own shares owned by a child who has not turned 18. Therefore, where a trust for minor children holds shares of Proco, the spouse (and the professional) will be deemed to own all of the shares of Proco actually owned by the trust. This will cause Proco and Spouseco to be associated, resulting in a potential clawback, to Proco, of the Ontario small business deduction.

If the professional owns voting preferred shares and all of the shareholders hold the same class of non-voting common shares, the shares owned and deemed owned by the spouse will have to constitute less than 25 percent of the issued and outstanding non-voting common shares in order to avoid association.

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Non-Competition Payments and Proposed Restrictive Covenant Rules

In *Robert Glegg Investment Inc.* (2008 TCC 20), the Tax Court of Canada highlights the importance of giving proper attention not only to the tax consequences of the allocation of the purchase price in a purchase and sale agreement, but also to ensuring that the allocation is appropriately reflected in the relevant written documentation. In this case, the taxpayer unsuccessfully argued that a significant portion of the $54 million proceeds received on the sale of shares in 1999 was allocable to a non-competition agreement. On the basis of the court's decision in the *Fortino* case (97 DTC 55 (TCC)), payments for non-compete agreements were not taxable.

The taxpayer, Glegg Investment, sold its shares in Glegg Industries, a corporation controlled by it, to General Electric Canada in 1999. A condition precedent to the sale was that Robert Glegg, the sole shareholder of Glegg Investment, enter into a non-competition agreement. The agreement of purchase and sale wholly allocated the purchase price of $54 million to the shares sold by the taxpayer. The evidence showed that the taxpayer's professional advisers contemplated an allocation of part of the proceeds of sale to the non-competition agreement signed by Mr. Glegg, but decided against it on the basis of the CRA's assessing policies at the time. It is not clear why the advisers did not consider the 1997 *Fortino* case to be applicable.

In spite of the written agreement to the contrary, the taxpayer argued that the court should make a finding of fact that a portion of the purchase price was attributable to the non-competition agreement. Alternatively, the taxpayer argued that section 68 of the Act should apply to reallocate a portion of the purchase price to the non-competition agreement. Both arguments were unsuccessful. Not surprisingly, the court was unable to conclude on the facts that a portion of the purchase price was allocable to the non-competition agreement. The court was not prepared to look beyond the clear and unambiguous wording of the purchase and sale agreement, and the taxpayer was unable to show any circumstances that would justify such an approach.

Section 68 allows the consideration received on the sale of property to be apportioned on a basis that is reasonable, irrespective of the legal form of the contract. However, the court held that section 68 was not applicable in these circumstances, primarily for the reason that the other shareholders of Glegg Industries were paid the same price for their shares as the taxpayer was. Hence, the allocation in the agreement of purchase and sale could not be considered unreasonable. Further, it was not the taxpayer that gave the non-competition agreement, but its shareholder, Mr. Glegg. Thus, a reallocation of the proceeds received by the vendor was therefore not possible. No amount was received by Mr. Glegg in respect of the non-competition agreement.

The decision in *Glegg Investment* will be directly affected by the proposed amendments to section 68 and new section 56.4 of the Act. Following the decision in *Fortino* and a subsequent case, *Manrell* (2003 DTC 5225 (FCA)), new restrictive covenant rules were announced in an October 7, 2003 news release. These rules introduced a full income inclusion for any amounts received or receivable for the provision of a restrictive covenant, subject to certain exceptions. In addition, the amount received is taxable to the person required to meet the covenant (if different from the recipient of the amount). Changes to section 68 specifically provide that an amount can be deemed to be received or receivable for a restrictive covenant. The new rules have gone through several versions and are now included in Bill C-10, which has received second reading in the Senate. The rules will apply where amounts are received or receivable by a taxpayer, except where amounts are received by the taxpayer before 2005 under a grant of a restrictive covenant made in writing on or before October 7, 2003.

In proposed section 56.4, a "restrictive covenant" of a taxpayer generally means an arrangement entered into, an undertaking made, or a waiver of an advantage or right by the taxpayer that affects the acquisition or provision of property or services by the taxpayer or another non-arm's-length taxpayer. A non-compete agreement would be considered a restrictive covenant.

Some exceptions to the income inclusion rules have been proposed. There are two types of exceptions: (1) exceptions to the income treatment rule, and (2) exceptions to the section 68 reallocation when the value associated with the covenant is received by someone other than the grantor of the covenant. Some of the exceptions will require an election.

The first group of exceptions to the income treatment rule includes exceptions for general goodwill and for an eligible interest. The general goodwill exception provides that where the amount received or receivable is for an amount that would otherwise be in respect of eligible capital property (ECP), the amount will retain ECP treatment. The eligible interest exception applies only to covenants that are non-competes; the non-compete must be provided to an arm's-length purchaser of the eligible interest. (Certain other conditions must also be met.) This exception will maintain capital gains treatment where a covenant is included as part of a sale of an eligible interest. An "eligible interest" includes a capital property of the taxpayer that is an interest in a partnership that carries on business, a share of a corporation that carries on business, or a share of a corporation 90 percent or more of the fair market value of which is attributable to eligible interests in one other corporation.

In the second group of exceptions, section 68 will not allocate an amount to the restrictive covenant, and therefore section 56.4 income treatment is not applicable. There are three instances in which section 68 will not apply:

1) covenants provided by an arm's-length employee (the employee agrees not to compete as part of a sale by the employer);
2) eligible goodwill (where a corporation is selling goodwill and a shareholder agrees not to compete); and
3) a "business interest sale" (a sale that includes shares of a target corporation, and certain parties agree not to compete).

The exceptions in the second group are subject to very detailed conditions, with the result that some common transactions will not be excepted. For example, the eligible goodwill exception partially addresses the common situation in which an owner-manager owns Opco, and Opco sells business assets and goodwill to a purchaser. The owner-manager provides a personal guarantee not to compete for nil consideration. That is, the entire purchase price is payable to Opco, and the value of proceeds not related to tangible property (that is, corporate goodwill and the value of the owner-manager's non-compete agreement) is treated as goodwill at the corporate level.

Under the new rules section 68 could apply, so that the value of the personal non-compete will be carved out of corporate proceeds and attributed to the owner-manager as ordinary income. Actual cash related to the deemed income will still be in Opco and will be taxed again in the hands of the owner-manager as either a dividend or a capital gain on death or sale.

The "business interest sale" exception for non-competes was added in the November 9, 2006 draft of the rules. A situation had been identified in which an individual held shares in Holdco and Holdco sold shares of Opco. Where the individual gave a non-compete for no consideration as part of the sale, it appeared that section 68 could apply to attribute the value of the personal non-compete contained in Holdco's proceeds to the individual as owner. (These are essentially the facts in *Glegg Investment*.) Several conditions must be met, the most notable being that no part of the consideration for the covenant may be paid to a non-arm's-length individual or another taxpayer in which the non-arm's-length individual has an interest. It appears that nothing in this rule precludes "another taxpayer" from being the owner of the target corporation (Holdco). Thus, where the grantor of the covenant has an interest in Holdco and Holdco receives the proceeds, the business interest sale exception is not met and section 68 would continue to apply.

To remedy this result, another amendment was made in the most recent version of the draft legislation: where section 68 applies solely because a non-arm's-length individual or "another taxpayer" received consideration for the covenant, the individual providing the non-compete covenant will be allowed to treat the attributed amounts as proceeds of disposition rather than an income inclusion. This result can be achieved only by joint election between the taxpayer that provided the covenant and the taxpayer that received the consideration.

In *Glegg Investment*, if the transaction had occurred after the new restrictive covenant rules were announced, it would be difficult to say whether an amount would have been carved out of section 68 as being in respect of a restrictive covenant because Glegg Investment received no more proceeds for its shares than the other shareholders that did not provide non-competes. However, if the facts of the case were the same except for the existence of other shareholders, proposed section 56.4 and the amendments to section 68 would likely apply. The business interest sale exception would not be met because Glegg Investment ("another taxpayer in which the non-arm's length individual has an interest") received consideration for the non-compete provided by Mr. Glegg. As a result, Mr. Glegg would have an income inclusion personally for the portion of the proceeds that reasonably related to the non-compete agreement. A joint election could then be filed between Mr. Glegg and Glegg Investment to allow Mr. Glegg to treat the attributed amounts as proceeds of disposition of a capital property rather than income.

The proposed restrictive covenant rules are extremely complex and do not except all situations that one might anticipate would be excepted. Therefore, it is strongly recommended that owner-managers and their advisers review the rules before drafting an agreement in which a non-compete or other restrictive covenant is being considered.

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Unjust Enrichment Claim Reduces Transferee's Tax Liability on a Property Transfer

Under section 160 of the Income Tax Act (ITA), a transferee of property may be assessed for the transferor's income tax liability for the taxation year in which the property was transferred or for any preceding taxation year to the extent that the fair market value of the transferred property exceeds the fair market value of the consideration given for the property. This liability arises if the transferee is the transferor's spouse or common-law partner, a minor, or a person who does not deal at arm's length with the transferor. Section 325 of part IX of the Excise Tax Act (ETA) contains a similar rule in respect of the transferor's liability for GST. Under this provision, the liability is reduced by the amount for which the transferee is assessed under subsection 160(2) of the ITA.

In *Darte v. The Queen* (2008 TCC 66), the appellant's common-law partner transferred a rental property situated in Prince Edward Island to her in 2001. The appellant was assessed in respect of her common-law partner's income tax and GST liability under section 160 of the ITA and section 325 of the ETA, respectively. The common-law partner had acquired the property for the sole consideration of the assumption of two existing mortgages on the property, which had been paid in full out of rents collected prior to the transfer.

Substantial renovations were made to the property prior to the transfer solely as a result of the efforts of the appellant and her family, who performed some of the renovations and donated and purchased materials. During the renovation period, the common-law partner did not assist in looking after their children. The appellant received no compensation for her work from the common-law partner (other than the transfer of property).

The sole issue in the case was whether the appellant had an interest in the property or a right to an interest in the property by virtue of her claim that the property was subject to a constructive trust, which interest or right affected the assessments.

A person who has made a contribution to a property may have a claim for unjust enrichment if three conditions are satisfied: (1) an enrichment, (2) a corresponding deprivation, and (3) the absence of a juristic reason for the enrichment (see paragraph 3 of the decision of McLachlin J in *Peter v. Beblow*, [1993] 1 SCR 980). One of the remedies for unjust enrichment is the imposition by a court of equity of a constructive trust on the property involved. The constructive trust, when granted, comes into existence when the unjust enrichment first arises. The Tax Court of Canada is not a court of equity and therefore cannot grant the remedy of constructive trust.

In the *Darte* case, Webb J held that the appellant's common-law partner had been unjustly enriched by her labour and supply of materials as well as that of her relations, and that there was a corresponding deprivation to the appellant and no juristic reason for the enrichment.

Relying on the decisions of the Supreme Court, Webb J concluded that a claim for unjust enrichment is available in family situations. He found that the appellant (as a common-law spouse) owed no duty to her common-law partner to perform work for him or provide services to him, and therefore had no duty to perform work on the property.

Webb J held that for the purposes of section 160 of the ITA and section 325 of the ETA, the appellant had a right to apply to a court of equity for a declaration that she had an interest in the property at the time the property was transferred to her; that this right was surrendered by her when the property was conveyed to her, and that the surrender of this right was consideration given by the appellant for the transfer of the property to her. He concluded that the fair market value of her right to apply to a court of equity for a declaration of constructive trust was $70,000.

The appeal was allowed, and the CRA was directed to reassess the appellant under section 160 of the ITA on the basis that the appellant gave $70,000 of consideration for the transfer of the property. The effect of the decision was to reduce the original assessment under section 160 from $78,791.76 to $8,791.76. In addition, the assessment under section 325 was vacated because the liability under that assessment was $59,143.92, which was reduced to nil by the $70,000 assessment under subsection 160(2) of the ITA.

Webb J indicated in *Darte* that in earlier decisions Tax Court justices had expressed differing views as to whether the doctrine of constructive trust could affect an assessment under section 160 of the ITA. The *Darte* case provides support for the view that a claim for unjust enrichment and the doctrine of constructive trust can affect an assessment made under section 160 of the ITA and section 325 of the ETA. In dealing with assessments under these provisions, tax practitioners should consider whether a transferee has surrendered any equitable rights as consideration for the transfer of property.

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Dow Chemical: A Gap in the Act

In general terms, subsection 78(1) of the Income Tax Act includes in a taxpayer's income the amount of a deductible expense owing by the taxpayer to a person with whom the taxpayer was not dealing at arm's length at the time that the expense was incurred if, after two taxation years, the amount remains unpaid. The taxpayer in *Dow Chemical* (2007 DTC 1701 (TCC)) successfully avoided the application of subsection 78(1) because, among other reasons, subsection 78(1) does not anticipate the amalgamation of a corporate taxpayer that has incurred but not paid a deductible expense.

In *Dow Chemical*, a Canadian subsidiary (UCCI) of a US corporation (UCC) incurred interest expenses on a loan held by a Canadian financing subsidiary of UCC (UCCFI). UCCI deducted $30,990,627 in interest expenses for the 2000 calendar year that had accrued but were not actually paid by UCCI. Subsection 78(1) would have applied to include the unpaid interest expenses in UCCI's income for its third taxation year after the year 2000.

UCC was acquired by another US corporation (Dow) on February 6, 2001, after which UCCI amalgamated with a Canadian subsidiary of Dow (DCCI) on October 1, 2001 to form a new corporation (Amalco). The acquisition of control and the subsequent amalgamation both resulted in a deemed year-end for UCCI. Consequently, UCCI's interest expenses remained unpaid for two taxation years after the year in which they were incurred. Amalco was subsequently reassessed for its first taxation year (October 1, 2001 to December 31, 2001) in order to include in its income the interest expenses incurred but not paid by UCCI in the year 2000.

Mogan J held that the interest expenses incurred by UCCI could not be included in Amalco's income pursuant to subsection 78(1) because Amalco did not satisfy the non-arm's-length requirement in the subsection at the time that the interest expenses were incurred by UCCI. Three reasons were provided in support of this finding, the most interesting of which is that subsection 78(1) does not anticipate the amalgamation of a corporate taxpayer. In contrast, subsection 78(2) anticipates a winding up of a corporate taxpayer and includes the unpaid expense in the taxpayer's income for the taxation year in which it is wound up. The Act contains no corresponding provision with respect to an amalgamation, and a court should not attempt to fill such a gap. If a textual, contextual, and purposive interpretation of the Act reveals a gap, then it is up to Parliament to fix that gap.

Could a taxpayer rely on *Dow Chemical* to intentionally avoid the application of subsection 78(1)? In other words, could a corporation be formed and amalgamated with an existing corporation for the sole purpose of permitting the existing corporation to avoid the application of subsection 78(1)? Mogan J did not discuss whether the amalgamation of UCCI and DCCI was an intentional attempt to exploit a perceived gap in the Act. However, it is difficult to see how a taxpayer's intention could be a distinguishing fact: the gap in section 78 exists regardless of whether or not a taxpayer intentionally exploits that gap.

Mogan J made the following comment with respect to legislative gaps (at paragraph 40):

> Subsection 78(2) teaches me that the Act has anticipated the winding-up of a corporate taxpayer which has incurred but not paid a deductible expense within the context of subsection 78(1). What is absent from the Act is a corresponding provision to anticipate the amalgamation of a corporate taxpayer which has incurred but not paid a deductible expense within the context of subsection 78(1). There is ample authority for the proposition that the Courts should not attempt to fill a gap in legislation. See *Trans World Oil & Gas Ltd. v. The Queen*, [95 DTC 260] [1995] 1 C.T.C. 2087 at paragraph 32.

The proposition referred to by Mogan J is supported by the following principles of statutory interpretation:

1) courts have no jurisdiction to disregard the intentions of the legislators (no matter how ill-considered such intentions might be);

2) courts have no jurisdiction to cure an under-inclusive provision because doing so would essentially require the courts to legislate; and
3) courts should not correct a legislative gap because doing so would constitute an impermissible attempt to provide a remedy without knowing the nature of the remedy intended by the legislators.

On the basis of these principles, it seems that a corporation could be formed and amalgamated with an existing corporation for the sole purpose of permitting the existing corporation to avoid the application of subsection 78(1). Of course, it is also necessary to consider whether the general anti-avoidance rule (GAAR) could apply to such a transaction. A discussion of GAAR, however, is beyond the scope of this article.

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CRA Publishes "New" Administrative Position on "Safe Income" Calculation

Since the introduction of subsection 55(2) over 28 years ago, taxpayers have faced considerable uncertainty regarding its interpretation and application, particularly with respect to the calculation of a corporation's "safe income" and "safe income on hand." Elaborate administrative positions have been developed as guidelines to address this uncertainty; however, some of these guidelines have been held to have no basis in law. The Federal Court of Appeal's decision in *Kruco Inc.* (2003 DTC 5506) serves as a good example.

Prior to the *Kruco* decision, the CRA's administrative position was that non-deductible expenses reduced a corporation's safe income. However, following *Kruco*, the CRA revised its position in ITTN no. 33:

> [A]n amount will generally only be included in a corporation's safe income to the extent that it has been included in the determination of its net income for tax purposes or is an adjustment specifically set out in paragraph 55(5)(b) or (c). Similarly, an amount that has been deducted in computing a corporation's net income for tax purposes will reduce the corporation's safe income. Otherwise, safe income will generally only be reduced by those cash outflows that occur after the determination of net income, but before the dividend is paid (such as taxes and dividends) to the extent that such disbursements reduce the income to which the capital gain may be attributable.

At the Canadian Tax Foundation's 2006 annual conference, the CRA stated that it was reconsidering this position and suggested that a strict interpretation of *Kruco* could give rise to situations where safe income greatly exceeds a corporation's taxed retained earnings because of the effect of non-deductible expenses.

In ITTN no. 37, the CRA reverted to its initial position for any dividends paid after February 15, 2008 (other than a dividend paid in a transaction, or as part of a series of transactions, the arrangements for which, evidenced in writing, were substantially advanced on that date), such that non-deductible expenses must again be deducted in the computation of safe income on hand. Adjustments to safe income on hand will not be required in respect of non-deductible expenses for dividends paid on or before that date, or for dividends that are eligible for the transitional relief described in the ITTN.

The CRA stated that its revised position is based on the Tax Court's decision in *Gestion Jean-Paul Champagne Inc.* (97 DTC 155) and on both the Tax Court (2001 DTC 668) and the Federal Court of Appeal decisions in *Kruco*. The CRA's view is that these cases support its position that non-deductible expenses represent cash outlays that are not deducted in the computation of a corporation's net income for tax purposes, but still have the effect of reducing the amount of disposable after-tax income by an equivalent amount, and correspondingly reducing a corporation's safe income on hand. The CRA cites paragraph 38 of *Kruco* (FCA) in support of this conclusion:

> There can be no doubt that this exercise [the determination of "safe income on hand"] calls for an inquiry as to whether "the income earned or realized" was kept on hand or remained disposable to fund the payment of the dividend. It follows, *for instance*, that taxes or dividends paid out of this income must be extracted from safe income. (Emphasis added.)

Apparently relying on the court's use of the term "for instance," the CRA says that taxes and dividends paid are not the *only* amounts that reduce a corporation's safe income on hand. Such amounts also include non-deductible expenses.

It is debatable whether ITTN no. 37 is justifiable, given the decisions cited in support. The issue of non-deductible expenses was not addressed in detail by the Federal Court of Appeal in *Kruco*, and, strictly speaking, the Tax Court contemplated a non-deductible expense "equivalent." Further, it should be noted that the Tax Court decisions in *Gestion Jean-Paul Champagne Inc.* and *Kruco* mandated an approach to the determination of safe income on hand that contemplated "reasonableness," based on the facts of each case. Therefore, it is questionable whether all non-deductible expenses, or their "equivalents," should reduce a corporation's safe income on hand for the purposes of calculating a safe income dividend under subsection 55(2). In addition, as is the case with "phantom income," if non-deductible expenses are removed from the calculation of safe income, one may run into the double taxation problem noted in paragraph 27 of *Kruco*. While non-deductible expenses do not "affect" the calculation of income, as phantom income does, they may nonetheless be relevant for the purposes of "determining" income. Therefore, removing non-deductible expenses from safe income on hand is potentially tantamount to modifying the calculation of income as mandated by subsection 55(5), contrary to the reasoning in *Kruco*.

Given the uncertainty regarding the treatment of non-deductible expenses or their "equivalents" in the calculation of safe income and safe income on hand, it is to be hoped that the courts will consider this issue in greater detail in the future and provide further clarification for taxpayers.

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Transfer of Legal Title Not Subject to Section 160

Rose (2007 TCC 657) deals with the question of whether a beneficial interest in property is transferred for the purposes of subsection 160(1) of the Income Tax Act when legal title is conveyed to an arm's-length party in order to secure the property against a third party (other than the CRA).

Subsection 160(1) provides that where a person transfers property to a non-arm's-length party (including his or her spouse or common-law partner), the person to whom the property is transferred is jointly and severally liable with the transferor for the transferor's tax liability for the tax year in question or for any preceding taxation year. The transferee's liability under subsection 160(1) is limited to the excess of the fair market value of the property over the consideration provided.

In *Rose*, the transferor, Mr. Rose, had been experiencing financial difficulties, was behind in his tax payments, and consequently was making payments pursuant to a regular payment arrangement with the CRA. Spurred by the threat of a bogus lawsuit, Mr. Rose "transferred" the family home to his wife, Mrs. Rose. The CRA had been preparing to register a lien against the property when the transfer took place. When it was discovered that Mrs. Rose was now the sole registered owner of the property, the minister commenced a section 160 assessment against her in order to make her jointly and severally liable for the tax debt of Mr. Rose. The sole issue before the Tax Court in *Rose* was whether Mr. Rose had divested himself of his beneficial interest in the property for the purposes of subsection 160(1) when he executed the legal transfer.

Sheridan J noted that the question of whether a transfer had occurred was one of fact and that the credibility of the parties would therefore be integral to her analysis. She drew on evidence of Mr. Rose's relative lack of sophistication to reach the conclusion that he had not intended to thwart the CRA's collection efforts; rather, he had not realized that the CRA would seek to register a lien against his property at all. The fact that Mr. Rose had been cooperating with the collections officer throughout the relevant period to pay down his tax debt imbued his testimony, Sheridan J said, with an air of reality, as did his candour in advising the collections officer of the legal transfer of the property and of his motives for carrying it out. The court also accepted Mrs. Rose's testimony that she had not thought to deal with the property without Mr. Rose's consent and Mr. Rose's testimony that he had no concerns that she would do so. Sheridan J concluded that at the time of the change in title, the Roses understood that a mere change in name was taking place and that Mr. Rose would retain his interest in, and occupation of, the property.

The court cited the decision in *Moss* ([2000] 1 CTC 2828 (TCC)). A husband had deposited funds into his wife's bank account in order to defeat the claims of his creditors. The court rejected the evidence of the taxpayers that they had agreed in advance that the deposits were to be held in trust and would not be used for any purpose other than for making payments to suppliers and tradesmen. The deposits were held to constitute transfers for the purposes of subsection 160(1). Sheridan J distinguished *Moss* on the basis that the evidence of the taxpayers in *Moss* was not credible, while the evidence given by the Roses was.

On the strength of her findings, Sheridan J concluded that the mutual understanding between the parties trumped the legal rights of Mrs. Rose in respect of the property, and that Mr. Rose retained a beneficial interest in the property following the transfer. Accordingly, she found that no transfer of property had occurred and therefore that subsection 160(1) did not apply.

The decision of Sheridan J in *Rose* is important because it emphasizes the importance of the intention of the parties to a legal transfer in determining whether a beneficial interest was transferred for the purposes of subsection 160(1). Even in the absence of evidence that the parties had discussed the creation of a bare trust, an understanding between the parties that the property was not to be dealt with without the consent of the transferor, coupled with evidence that the transferor intended to retain his beneficial interest in the property and that he did not intend to defeat the CRA's claims by virtue of the transaction, may favour a finding that subsection 160(1) does not apply. The key factor in determining whether beneficial ownership has passed for the purposes of subsection 160(1) on facts such as these appears, on the strength of *Rose*, to be the court's assessment of the credibility of the transferor and transferee. However, it is important to note that the result in *Rose* was largely based on the facts of the case. Credibility was key in *Rose* because the intention of the parties was determinative. As the decision in *Moss* shows, if the parties did not intend that the transferor retain beneficial interest, section 160 will apply.

The *Rose* decision is presently under appeal.

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Are Tax Adviser Fees an Eligible SR & ED Expenditure?

Expenditures on scientific research and experimental development (SR & ED) are fully deductible in computing income and earn investment tax credits. In two cases—one recent—the issue was whether fees paid to consultants who assisted in the preparation of the claim for SR & ED benefits were qualified expenditures in addition to the costs incurred in prosecuting the research. In both cases—*Val-Harmon* (97 DTC 551) and *Armada* (2007 DTC 879)—the Tax Court's ruling can be described as a firm "maybe." In *Val-Harmon*, the pivotal issue was the nature of the professional service provided, while in *Armada* it was the timing of the expenditure in relation to the fiscal period in which the SR & ED was actually carried on.

Unfortunately, it is not possible to tell from the reports of the cases whether the subject claims were made using the traditional or the proxy overhead method. This information is significant factor in this debate; without it, the value of the decisions for deciding other cases is suspect.

Val-Harmon

In *Val-Harmon*, an amount of $20,638 was paid to an SR & ED consulting company, Gessat Inc. It was neither an accounting nor a legal firm. The fees were for services that included the preparation of the T661 form and supporting technical and financial information. The taxpayer claimed the entire fee as a qualified SR & ED expenditure and did not differentiate between the amounts charged for the technical and the accounting aspects of the services.

Somewhat inexplicably, the minister had relied on regulation 2902(a)(i) to support its side of the case. The regulation provides that "a legal or accounting fee" is not an eligible SR & ED expenditure. The taxpayer based its arguments on regulation 2900(2), which allows "other expenditures that are directly related to such prosecution and that would not have been incurred if such prosecution had not occurred." The taxpayer said that Gessat's fees were for engineering services, not legal or accounting advice, and would not have been incurred had no SR & ED been undertaken.

At the opening of the trial, the minister applied for an amendment to its pleadings, adding a reference to regulation 2900(2) in support of an argument that the fees were not in any event "directly related" to the prosecution of the SR & ED. The court refused the amendment on the basis that to amend the pleadings at that late date would unfairly prejudice the taxpayer's case. The court allowed 75 percent of the $20,638 fee as an eligible SR & ED expenditure on the basis that it represented costs necessarily incurred to make the SR & ED claim. The court acknowledged that had the minister pleaded regulation 2900(2) on a timely basis, the result might have been different, although it did not categorically state that this would have been the case.

Armada Equipment

In *Armada*, the taxpayer paid a total of $28,618 to an accounting firm in connection with its SR & ED claim. Some $18,618 of the total was to reimburse the accountants for a disbursement they had made to an engineer retained by them to assist in the identification and description of the SR & ED and the preparation of the claim. Armada included the $18,618 in its SR & ED claim, and the CRA denied it as an eligible expenditure.

The court upheld the minister's position and found that none of the $18,618 claimed by Armada was an eligible SR & ED expenditure. However, the court stopped short of specifically stating that the earlier decision in *Val-Harmon* was incorrect. The court's finding was based on the rationale that the fees were paid for a service rendered after the SR & ED was already complete: "I conclude that a 'qualified expenditure' must be incurred in connection with ongoing research and development, and not incurred after-the-fact because research and development have already taken place" (paragraph 20).

Practical Considerations

Unfortunately, the *Armada* case is more indicative than definitive. On the surface, the court's decision seems to indicate that the professional services fees paid for the preparation of an SR & ED claim are not an eligible expenditure and should not be claimed. However, before one reaches this conclusion, several important factors should be considered.

■ **Are the fees for engineering or technical services or for legal or accounting services?** Legal or accounting services are specifically excluded in the regulations; however, the Act is silent on fees paid to engineers.

■ **Traditional or proxy overhead method?** The traditional overhead method for determining what qualifies as technical work may offer a broader scope than the proxy method. CRA *Application Policy* no. 96-06 contains a table comparing the eligibility of various activities under the traditional and proxy overhead methods. The last row of the table shows "preparation of the T661 for SR & ED projects carried out in the current year by employees," with a tick mark for "eligible" under the "traditional" method.

■ **Were services rendered in the claim period?** The decision in *Armada* was, arguably, based largely on the timing of the services. Armada claimed fees for services that were rendered after the claimed SR & ED work was complete. It is not clear whether the fees claimed were incurred in the same fiscal period as the claimed projects or whether they were claimed in a subsequent year. However, the *Armada* ruling becomes somewhat less relevant if the professional services performed are rendered in the same fiscal period as the SR & ED work being claimed and the amount of those fees is paid out within 180 days of the fiscal period end-date.

Conclusions and Recommendations

There is still no definitive position on the character of professional service fees incurred in preparing SR & ED claims. There seems to be wiggle room for both the CRA and taxpayers in either direction. It is likely that the CRA will review claims for SR & ED preparation fees on a case-by-case basis. While one cannot say how the CRA will react to any specific claim, some steps may help to slant things in the taxpayer's favour in a claim for preparation fees:

- Use the traditional overhead method. Cite *Application Policy* no. 96-06 as grounds.
- Get separate invoices for engineering and technical writing services. Avoid claiming legal and accounting fees.
- Have the professional services rendered in the same time period as the claimed SR & ED projects.
- Claim the professional services fees in the fiscal year in which they are actually rendered—that is, do not claim the cost of preparing the fiscal year 2006 SR & ED claim in fiscal year 2007.
- Ensure that the fees are paid within 180 days of the fiscal year-end.

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GAAR: Meaning of "Avoidance Transaction"

The very recent decision of the Federal Court of Appeal in *MacKay* (2008 FCA 105) clarifies that even though a series of transactions is carried out to achieve a legitimate commercial purpose, GAAR may nonetheless apply if any step in the series is undertaken primarily to achieve a tax benefit. The Tax Court had reached the contrary conclusion (2007 TCC 94) on the basis that the non-tax purpose of the overall series purified the primary purpose of any individual step in the series otherwise implemented for tax reasons.

By way of background, in a series of transactions very similar to those considered by the Supreme Court in *Mathew* (2005 SCC 55), the taxpayers acquired an interest in a partnership formed to take over a non-performing mortgage on a shopping centre. The mortgage secured a debt of about $16 million, but was worth about $10 million at the time it was acquired. The taxpayers (MacKay was one member of a group who became involved in the transactions) were in the real estate business. Their primary purpose was to make a profit on the acquisition and resale of the shopping centre. An arm's-length bank held the mortgage in question. When the taxpayers realized that the purchase of the shopping centre might be structured in a way that also allowed them to take over the accrued loss on the mortgage, the purchase of the centre and the acquisition of the mortgage were rerouted through the partnership.

In the Tax Court, the trial judge held that the primary purpose of the series of transactions was the purchase for resale of the shopping centre. She said that this primary purpose infused the purpose for each of the individual steps in the series of transactions. Practitioners read the decision as support for the proposition that GAAR might not apply to transactions undertaken primarily for non-tax reasons, as long as the tax-reduction motive was an incidental

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one. (See "GAAR: 'Avoidance Transaction' Revisited," *Tax for the Owner-Manager*, April 2007.)

In an earlier article, I questioned whether the Tax Court was taking too narrow a view of the meaning of "avoidance transaction" in subsection 245(3). (See "Practice Notes," *Tax for the Owner-Manager*, April 2007.) As a matter of statutory interpretation, the subsection refers to *any* transaction that is part of a series, and provides that the series is an "avoidance transaction" unless that transaction (and every other transaction in the series) is undertaken primarily for a non-tax purpose. In *Canada Trustco* (2005 SCC 54), The Supreme Court seemed to say as much when it said that "if at least one transaction in a series of transactions is an 'avoidance transaction,' then the tax benefit that results from the series may be denied under the GAAR." GAAR is unduly restricted if the overall commercial purpose for the series may be attributed to the primary purpose of each step in it. Such an interpretation would sanction abusive tax results in transactions undertaken primarily for commercial purposes. In effect, the analysis of abusive tax avoidance in such cases would stop at the avoidance-transaction level, and would not extend to the more appropriate abuse-test level in subsection 245(4).

The Federal Court of Appeal has clarified the proper approach to GAAR in cases of this kind. Where a series includes a step that is taken primarily for tax reasons, that step is an avoidance transaction and taints the series. It is immaterial that the primary purpose of the overall series is a non-tax one. As a consequence, GAAR will apply in such a case if the series results in a misuse or abuse under subsection 245(4). In *MacKay*, the court said that the result of interposing the partnership was the transfer of a pregnant loss between parties dealing at arm's length, a result held to be abusive in *Mathew*. Accordingly, the court upheld the GAAR assessment disallowing the deduction of the accrued loss on the mortgage receivable.

MacKay stands for the proposition that a primary non-tax purpose for the series will be tainted if at least one step in the series fails the primary purpose test when examined on its own. With due respect for the contrary view expressed by the trial judge, this seems to be the correct reading of the law. The decision does not deal with the converse situation—that is, the case in which each step in the series meets the primary purpose test for non-avoidance, but the purpose of the overall series is primarily one of avoidance. The CRA argues that this is the situation in *Lipson*, which will be argued in the Supreme Court in April 2008. In that case, both the Tax Court and the Federal Court of Appeal said there was no misuse or abuse of any of the statutory provisions relied on to achieve the tax benefit. Nonetheless, the overall purpose of the series was found to be abusive so that GAAR applied. In my view, neither court provided a clear analysis of this finding, and practitioners have been left to speculate about the implications in other circumstances. One expects that the Supreme Court decision will address this question.

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