TAX FOR THE Owner-Manager

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The Replacement Property Rules: Some Quirks

The replacement property rules in section 44 and subsection 13(4) of the Income Tax Act offer some interesting planning options. For example, consider the following set of facts.

- The taxpayer owns real property ("the former property"), other than rental property, which is used for the purpose of earning income from a business.
- The former property was acquired for $1.2 million (land, $400,000; building, $800,000). The undepreciated capital cost of the building is $600,000.
- In need of more space, the taxpayer sells the former property for $3.5 million (land, $1 million; building, $2.5 million).
- The taxpayer finds rental premises ("the replacement property") to replace the former property. The landlord is willing to make improvements to the replacement property. The cost of those improvements would be built into the monthly rental payments; alternatively, the taxpayer could make the improvements and pay less rent.

Pursuant to the formula in subsection 44(1), the taxpayer can elect to defer the entire gain on the sale of the former property by acquiring a "replacement property" (as defined in subsections 44(5) and 13(4.1)). Replacement land will have to be acquired for at least $1 million and replacement depreciable property (not necessarily a building) for at least $2.5 million. Those amounts represent the proceeds of sale of the component parts of the former property.

Pursuant to the formula in subsection 13(4), the taxpayer can elect to defer recognition of the recapture by spending at least $200,000 on the replacement property. Obviously, if enough is spent to defer the gain on the building, the recapture will also be deferred. Subsection 44(4) provides that an election pursuant to subsection 44(1) results in a deemed election under subsection 13(4), and vice versa.

If the landlord improves the rented premises, the taxpayer cannot defer taxation of the gains and recapture. However, as described below, the taxpayer can achieve a deferral by incurring the cost of the improvements rather than having the landlord do so. The amounts deferred will then reduce the tax value of the leasehold improvements.

Soon-to-be-amended paragraph 44(1)(d) provides that the replacement property must be acquired before the date that is 12 months after the end of the year of disposition, at the latest. It is important to note that this does not preclude acquiring the replacement property before the former property is disposed of. The only constraint in this regard is that the replacement property must not be disposed of before the former property is disposed of. Therefore, the taxpayer can enter into the lease and make the improvements before the former property is actually sold.

The taxpayer will be acquiring depreciable property, not land. Were it not for subsection 44(6), the gain on the land component of the former property could not be deferred. Subsection 44(6) allows the proceeds of the former property to be reallocated, for the purposes of the capital gains rules only, between land and building. This provision allows the taxpayer to elect the proceeds of the land to be its cost of $400,000. The $600,000 difference between this amount and the actual proceeds of $1 million is then treated as proceeds of the building component. The proceeds of the building will thus be $3.1 million rather than $2.5 million.

The taxpayer will not have to acquire land but will have to spend $3.1 million on the leasehold improvements rather than $2.5 million on replacement depreciable property in order to defer the entire gain. Interestingly, the entire gain can now be deferred if the taxpayer spends $3.1 million in total rather than the $3.5 million that it would have been required to spend if the replacement property had comprised land and building.

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Note that the election under subsection 44(6) can only be made after the disposition of the former property and in the taxpayer's tax return for the year in which the replacement property is acquired. That is, the election cannot be made if the replacement property is acquired in a taxation year before the year of disposition of the former property. Note also that regulation 600(b) allows the taxpayer to late-file the subsection 44(6) election.

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Limitation Period for Reassessments

The facts in *Savard* (2008 TCC 62) are rather unusual, but the case confirms several important principles with respect to the circumstances in which the CRA is permitted to reassess after the normal reassessment period under subparagraph 152(4)(a)(i) of the Act.

The taxpayer was a shareholder and employee of Savard. Between November 1985 and March 1988, the taxpayer made false accounting documents and submitted them to financial institutions on behalf of Savard to obtain financing for the company. On March 20, 1998, the Court of Quebec (Criminal and Penal Division) found the taxpayer guilty on 15 counts of making false documents and uttering forged documents, contrary to sections 366 and 368 of the Criminal Code.

Throughout 1998 and 1999, the taxpayer was the president and a director of FDS. His employment contract provided that professional fees incurred by him for legal proceedings involving him personally would be paid by FDS. His spouse was the sole shareholder of FDS. FDS paid legal fees relating to a number of legal proceedings, including the taxpayer's trial, his appeal to the Quebec Court of Appeal, and his application to the National Parole Board. The fees totalled $72,244 in 1998 and $4,167 in 1999. The taxpayer did not include those reimbursed fees in his income when he filed his income tax returns for 1998 and 1999.

The CRA assessed the taxpayer's spouse in 2002 on the basis that she had received a shareholder benefit in the 1998 and 1999 taxation years; the CRA subsequently vacated that assessment after receiving her notice of objection and disclosure of the employment contract. The CRA then reassessed the taxpayer, and the taxpayer made an assignment of property. It is not clear what happened to the 2002 assessment, but in 2005 the CRA again reassessed the taxpayer's spouse, vacated the reassessment, and reassessed the taxpayer instead on the basis that he had received a taxable benefit from employment. The CRA took the position that it was permitted to assess beyond the normal reassessment period because of the application of subparagraph 152(4)(a)(i).

Subparagraph 152(4)(a)(i) reads as follows:

> The Minister may at any time make an assessment, reassessment or additional assessment except that an assessment, reassessment or additional assessment may be made after the taxpayer's normal reassessment period in respect of the year only if . . .
>
> (a) the taxpayer or person filing the return . . .
>
> (i) has made any misrepresentation that is attributable to neglect, carelessness or wilful default or has committed any fraud in filing the return or in supplying any information under this Act.

The Tax Court agreed with the CRA that the taxpayer had received a taxable benefit from employment; but in a surprising decision the court found that the reassessment was statute-barred. In reaching its conclusion, the court first noted that the burden of proving that an assessment made after the prescribed time is valid under subparagraph 152(4)(a)(i) of the Act rests on the CRA (*Bigayan v. The Queen* (2000 DTC 1619 [TCC])). Second, not only must there be a misrepresentation or error in order for the minister to assess after the expiry of the time allowed, there must also be a finding that the misrepresentation is attributable to neglect, carelessness, or wilful default on the part of the taxpayer (*Boucher* (2004 FCA 46)). In other words, there must be evidence of a more serious wrongdoing than mere error.

In spite of the taxpayer's somewhat controversial past history, the court appeared to accept that he had made a mere error:

> [I]f things were as clear as they are said to have been, if the facts were so undeniable, why did the Minister, in the second attempt, after investing time in the first tax case, first issue an assessment against the Appellant's spouse, as a benefit to a shareholder, and then change his mind and issue a reassessment against the Appellant? . . .
>
> I do not believe that the evidence submitted justifies a finding that the requirements for assessing the Appellant beyond the normal assessment period have been met.
>
> Having found that there is no evidence that would permit assessment after the time allowed had expired, and given that the requirements for doing so are less stringent and rigid than the requirements for imposing penalties, there is no need to analyze the evidence in respect of gross negligence under subsection 163(2) of the Act relating to penalties.

In other words, the court was of the view that the taxpayer's obligation to include the legal fees in his income was not obvious, since the CRA had first issued reassessments against the taxpayer's spouse. Accordingly, the Tax Court allowed the taxpayer's appeal.

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Alberta Overintegration Tax

On December 2, 2008, Alberta Bill 48 received royal assent. The bill includes an amendment to the Alberta Corporate Tax Act that establishes a new tax called the overintegration tax (OI tax). The OI tax is imposed on corporations that pay eligible dividends after December 31, 2008 where the corporation has claimed the Alberta small business deduction on active business income that exceeded the federal small business deduction limit for post-2008 income. In general, the OI tax is the lesser of 10 percent of eligible dividends paid and 6.7 percent of active business income that has benefited from the Alberta small business deduction but not the federal small business deduction after 2008.

Since 2001, Alberta has gradually increased its annual small business deduction limit to a higher amount than the federal small business deduction. Effective April 1, 2009, the Alberta small business deduction limit will be $500,000 per year; the federal small business deduction limit will be $400,000 per year. This means that for Alberta active business income earned after 2008 there are essentially three combined federal and provincial corporate tax brackets. The OI tax applies to eligible dividends that are deemed to be paid out of the middle corporate bracket. Table 1 shows that as the federal corporate rate declines for high-rate active business income, the middle corporate bracket also reduces.

Although high corporate tax rates are declining, the current definition of "general-rate income pool" (GRIP) in the Act includes only 68 percent of the pre-tax income that is subject to tax at the high rate. Accordingly, unless there are further amendments to the Act, a significant amount of income taxed at the high rate will not qualify for eligible dividend treatment. Also, personal income tax rates on eligible dividends are increasing as the corporate rates decrease.

The OI tax comes into force on January 1, 2009. It requires a yearly calculation of the corporation's OI tax adjustment, which is to be maintained on a cumulative basis, much like the federal GRIP and low-rate income pool (LRIP) accounts. The formulas for the OI tax and the OI tax adjustment are such that post-2008 middle corporate bracket income will be treated as the first pool of eligible dividends paid, akin to LIFO tracking. Alberta officials have indicated that an information circular and a form and worksheet are being prepared to assist corporations in keeping track of the OI tax adjustment.

The OI tax applies even if the eligible dividend is paid to recover federal RDTOH or to avoid a federal part IV tax liability, and it is not limited to dividends paid to individuals. In other words, an intercorporate eligible dividend paid to a holding corporation will trigger OI tax. Special allocation rules apply when the corporation carries on business in more than one province.

The impact of the OI tax on middle corporate bracket income and tax "integration" using Alberta rates is illustrated in tables 2 and 3. The base case for comparison purposes is the 39 percent top Alberta personal tax rate, for after-tax proceeds of 61 percent.

There may still be significant personal tax savings even after the OI tax if the recipient of the eligible dividend is an individual who is in the low or middle personal bracket. Another planning idea is to have one corporation earn active business income up to $500,000 to claim the full federal and Alberta small business deduction. This corporation will be subject to the OI tax adjustment, and a different associated corporation will earn active business income on which

Table 1 Federal Rates

Active business income	2009	2010	2011	2012
	percent			
$0 to $400,000	14.0	14.0	14.0	14.0
$400,000 to $500,000 (middle corporate bracket)	22.0	21.0	19.5	18.0
Over $500,000	29.0	28.0	26.5	25.0

Table 2 Middle Corporate Bracket Before OI Tax

	2009	2010	2011	2012
	dollars			
Earnings	100.00	100.00	100.00	100.00
Federal and Alberta corporate tax	(22.00)	(21.00)	(19.50)	(18.00)
After-tax distributable earnings	78.00	79.00	80.50	82.00
GRIP-eligible dividend	68.00	68.00	68.00	68.00
Non-GRIP ordinary dividend	10.00	11.00	12.50	14.00
Personal tax on eligible dividend	(9.89)	(10.95)	(12.66)	(14.18)
Personal tax on ordinary dividend	(2.77)	(3.05)	(3.46)	(3.88)
Personal after-tax funds	65.34	65.00	64.38	63.94
Base case	61.00	61.00	61.00	61.00
Overintegration	4.34	4.00	3.38	2.94

Table 3 Middle Corporate Bracket After OI Tax

	2009	2010	2011	2012
	dollars			
Earnings	100.00	100.00	100.00	100.00
Federal and Alberta corporate tax	(22.00)	(21.00)	(19.50)	(18.00)
OI tax	(6.70)	(6.70)	(6.70)	(6.70)
After-tax distributable earnings	71.30	72.30	73.80	75.30
GRIP-eligible dividend	68.00	68.00	68.00	68.00
Ordinary dividend	3.30	4.30	5.80	7.30
Personal tax on eligible dividend	(9.89)	(10.95)	(12.66)	(14.18)
Personal tax on ordinary dividend	(0.91)	(1.19)	(1.61)	(2.02)
Personal after-tax funds	60.50	60.16	59.53	59.10
Base case	61.00	61.00	61.00	61.00
Underintegration	0.50	0.84	1.47	1.90

no small business deduction is claimed. Eligible dividends will be paid out of this second corporation. The corporate group obtains the benefit of the full Alberta small business deduction and the payment of eligible dividends without incurring the OI tax. In order to recover RDTOH and avoid part IV tax, it is advantageous to have such income earned in the second corporation or in a holding corporation that owns the shares of the eligible-dividend-paying corporation. This enables RDTOH (including part IV tax) to be recovered by using eligible dividends without incurring OI tax.

It remains to be seen whether other provinces that have small business deduction levels that exceed the federal small business deduction level will follow Alberta's lead in taxing back what is perceived to be excessive integration benefits.

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Estate Freeze Survives Valuation Attack

The Tax Court's decision in *Laflamme* (2008 DTC 4829) is an interesting example of the court's approach to a valuation issue involving preferred shares with a conversion feature. The taxpayer was successful in maintaining the integrity of an estate freeze transaction, but the decision also serves as a reminder that, where possible, simple is better in tax-planning matters.

The facts of the case are complex, but can be summarized as follows. The taxpayer indirectly held 50 percent of the shares of a successful operating company (Opco) through a holding corporation. The taxpayer's son indirectly held 25 percent of the shares of Opco through a separate holding corporation (Holdco). The remaining 25 percent of the shares of Opco were held by an arm's-length party.

As part of a plan to step back from the business, the taxpayer implemented an estate freeze by transferring the shares of his holding corporation (which represented 50 percent of the value of the Opco shares) to a new holding corporation (Newco). A discretionary family trust acquired 100 common shares of Newco. The trust was established for the benefit of the taxpayer's five children, but not the taxpayer himself. In addition to retaining voting control and preference shares representing the value of his interest in Opco at the time of the freeze, the taxpayer also acquired a class of shares of Newco (the class D shares), which were convertible into 10 million common shares of Newco. The shares with the conversion feature were presumably issued to give the taxpayer the right to participate in all or some of the future growth of Opco, should he choose to do so. However, other methods were available to him, should that have been his intention.

Several years later, the taxpayer's son took steps to acquire his proportionate share of the shares held by the trust. A related-party butterfly was implemented under which Holdco (the son's corporation) acquired one-fifth of the common shares of Newco held by the trust. The trust transferred 20 of its 100 common shares of Newco, having an estimated fair market value of $15 million, to the son's holding corporation under section 85. Newco also transferred to Holdco shares of Opco, having a fair market value of $15 million, under section 85. The 20 common shares of Newco and the shares issued by Holdco on the second transfer were cross-redeemed by the issuance of promissory notes that were subsequently extinguished by setoff.

The minister assumed that the 20 common shares of Newco transferred by the trust to Holdco had a nominal value and reassessed the taxpayer under subsection 56(2) for having conferred a taxable benefit of $15 million on Holdco. In the minister's view, the common shares of Newco were worth a nominal amount at the time of the transfer because the entire value of Newco accrued to the outstanding class D shares. The minister argued that the taxpayer's right to convert his 10 class D shares into 10 million common shares of Newco essentially diluted or stripped the value out of all of the remaining shares of Newco.

The taxpayer argued that the value of the common shares should not be discounted as a result of the conversion rights attached to the class D shares, since an arm's-length purchaser would not acquire the common shares of Newco without obtaining a waiver or a guarantee of non-conversion. The taxpayer further submitted that conversion rights typically have value in the context of minority shareholdings—for example, where the minority shareholders have the power to block a sale desired by the majority shareholder—and this was clearly not the situation before the court. Finally, the taxpayer emphasized that it was his intent and desire to have the future value of Opco accrue to the benefit of the trust through the common shares of Newco issued on the freeze; therefore, exercising the conversion right associated with the class D shares would run counter to the purpose for which the trust was created.

Somewhat surprisingly, the Tax Court agreed with the taxpayer and held that the conversion rights attached to the class D shares of Newco did not have any value in the context of the transactions that took place. The court noted that the conversion feature of the class D shares did not affect the control of Newco, which the taxpayer already held by virtue of his voting shares. Therefore, it was possible for the taxpayer to veto or effect a transfer of the common shares without having to convert his class D shares into common shares. Furthermore, the court agreed that the purpose of the estate freeze was to enable the taxpayer to withdraw from the business and allow the future increase in the value of the business to accrue to his family. In reaching its conclusions, the court held that "share valuation is not a theoretical exercise. One must place oneself in the context and use a certain amount of common sense." The court held that if the intent had been to sell the common shares to a third party, the taxpayer "would have had no problem waiving the conversion right attached to his Class D shares so that the [common] shares could be given their full value." Therefore, the court held that the common shares should be given their full value and no value should be accorded to the conversion rights attached to the class D shares.

It is somewhat surprising that the court relied on the taxpayer's intention to freeze his interest in Opco in favour of his children, notwithstanding that he retained the legal right to dilute the children's interest by converting the class D shares. In this respect, the case may be some support for the argument that in valuation matters one should look to the practical realities of the situation rather than the legal technicalities; but one should proceed very carefully in making this sort of argument.

Laflamme also shows the desirability of avoiding unnecessarily complicated transactions. The taxpayer was successful, but the resolution of the case undoubtedly cost him a significant amount in legal fees. The estate freeze was implemented under the laws of Quebec. From the perspective of lawyers practising in Ontario, the level of control that the taxpayer desired did not seem to require the issue of the class D shares, since the taxpayer owned the control shares in Opco. The unusual nature of the conversion feature attached to the class D shares is what ultimately resulted in the need to litigate the valuation issue. It may be that the particular circumstances of the taxpayer's situation dictated the issue of the class D shares. Nonetheless, one sees with hindsight how this was provocative to the CRA, and one should be wary of adopting a similar approach in other cases.

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Source of Income: A Tale of Two Cases

In *Stewart* ([2002] 2 SCR 645), the Supreme Court of Canada set out a two-part test for determining whether a taxpayer had a business or property source of income under the Act. The first part of the test requires a determination of whether the activity of the taxpayer is undertaken in pursuit of profit or is a personal endeavour. This analysis is required only in situations where there is some personal or hobby element to the activity in question; in that case, it must be shown that the taxpayer intended to carry on an activity for profit.

Two recent cases decided by the Tax Court of Canada under the informal procedure, *Kaegi* (2008 TCC 566) and *Graham* (2008 TCC 580), deal with the deductibility of business losses relating to activity in the music industry.

In *Kaegi*, the CRA allowed the taxpayer's business losses for the first three years of the business, but disallowed the taxpayer's losses for 2003 to 2005 on the basis that the taxpayer was not carrying on a business but was operating a personal endeavour whose purpose was to make his spouse happy. Therefore, he had no source of income. In the CRA's view, the taxpayer was involved for years in an activity that had shown no profit. Consequently, he could not be engaged in a business.

The taxpayer had a full-time job. He and his spouse entered into an arrangement in which he acted as the financier and manager and his spouse as the songwriter and musician in their music business. They had a written understanding regarding payment of expenses and sharing of profits. The taxpayer's research into the music industry indicated that it would take 10 to 20 years for them to break into the music industry in Canada.

In *Kaegi*, Miller J concluded that there were sufficient indices of commerciality (11 in total) to make it unnecessary for him to delve into the pursuit-of-profit factors. The indices of commerciality included the production from 1998 to 2006 of four CDs of songs created by the taxpayer's spouse, the releasing of songs for airplay on radio stations, the preparing of promotional material for performances and CDs, and the placement of advertising.

Miller J also refused to apply the "enough is enough" principle enunciated by Bowman CJ in *Donyina v. The Queen* ([2001] 3 CTC 2741 (TCC))—namely, that if yearly business losses continue for an inordinate period, then the activity ceases to be a business. The application of this principle was rejected because of the long time it takes to break into the music industry, and because the taxpayer and his wife tried to shift gears in 2002 to capture a different market, which could be viewed as a startup of a new musical venture. Therefore, Miller J concluded that the taxpayer had a business that constituted a source of income.

In *Graham*, Boyle J reached the opposite conclusion in connection with the business losses claimed by the taxpayer in 2003 to 2005 from his musical performance and disc jockey activities. The taxpayer was a full-time employee of a Canadian bank in the relevant years. He had a long background in music, and in the 1980s and 1990s had played in a band that was largely successful and occasionally modestly profitable. After the band broke up, the taxpayer took a break from his musical pursuits between 1998 and 2002 and started up again in 2003. For the years in question, the taxpayer registered his business as a sole proprietorship, obtained a business licence, and had a business phone and business cards. In each of the years in dispute, the modest revenues from the activity declined, reflecting a decline in the number of performances. The taxpayer stopped pursuing this activity once it was challenged by the CRA.

In this case, Boyle J concluded that the taxpayer was unable to provide sufficient credible evidence to establish on a balance of probabilities that his musical pursuits were a business pursued for profit in a commercial manner. This conclusion was based on Boyle J's concerns about the evidence presented. In particular, he noted the following points. The taxpayer's testimony that he took a break from business between 1998 and 2001 was not consistent with his letter to the Chief of Appeals. He was unable to justify why, if he was undertaking the activity for profit, it was discontinued when the CRA challenged the losses. There was insufficient evidence of a businesslike approach to pursuing performance contracts, and the activity had never been profitable. Boyle J was also troubled by the lack of business planning. Accordingly, the taxpayer's appeal was dismissed.

These two cases indicate that if a taxpayer is pursuing an activity on a part-time basis, it is vitally important that the taxpayer have sufficient support and evidence to show the commercial nature of the activity. With such evidence, a taxpayer will have a reasonable opportunity to prove that he or she has a source of income and therefore is entitled to deduct losses arising from the activity.

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Foreign Pension Plan Contributions May Reduce RRSP Room

A taxpayer who is resident in Canada near the US border may be employed in the United States and participate in a US retirement arrangement such as a 401(k) plan or an individual retirement account (IRA). Can such a Canadian resident then make a contribution to his RRSP without a reduction of his RRSP deduction limit? Several provisions of the Act are relevant to this question, as is a useful CRA technical interpretation on the subject (2004-0083571E5, October 19, 2004).

The definition of "RRSP deduction limit" in subsection 146(1) of the Act reduces the deductible amount of an RRSP contribution by a "prescribed amount" in respect of the taxpayer for the year. This provision is intended to put the Canadian resident on the same footing as a Canadian employed in Canada who participates in a Canadian retirement plan. In other words, in policy terms the prescribed amount can be equated to the "pension adjustment" applicable in computing the reduction of the RRSP deduction limit for participation in Canadian registered pension plans.

In combination, regulation 8308.1(1), regulation 8308.2(1), and the definition of "retirement compensation arrangement" in subsection 248(1) provide that the calculation of a "prescribed amount" is required when an individual has become and continues to be entitled at the end of the year to benefits under a pension plan that is a "foreign plan" in respect of services rendered to an employer outside Canada.

A plan is considered a foreign plan if

- contributions are made to it by an employer or former employer of a taxpayer for benefits that may be received by a person after the retirement of the taxpayer, or the loss of the employment of the taxpayer; and
- the plan is maintained by the employer primarily for the benefit of non-residents in respect of services rendered outside Canada.

It is a question of fact whether a 401(k) or an IRA qualifies as a foreign plan for Canadian tax purposes.

If the conditions set out above are met, the prescribed amount is calculated as being the lesser of (1) the amount by which the "money purchase limit" exceeds the "PA offset" for the particular year and (2) 10 percent of the portion of the compensation from the employer for services rendered outside Canada for the particular year.

Subsection 147.1(1) defines the "money purchase limit" for 2008 generally to mean $21,000. The "PA offset" is defined in regulation 8300(1) to mean $600 for a particular calendar year after 1996. As can be seen from the formula, the impact of the prescribed amount can be minimal in the reduction of the RRSP contribution room when the Canadian-resident individual's foreign-source employment income is quite small.

A taxpayer's RRSP room is calculated by the CRA on the notice of assessment for the year, but it is important to note that this calculation does not take into account the prescribed amount. Therefore, the taxpayer's adviser has to manually reduce his RRSP room by the prescribed amount. The major practical difficulty in doing so is often the uncertainty regarding the precise amount of the foreign-source employment income for the particular year. In such circumstances, a prudent taxpayer will delay making his RRSP contribution for the year until the prescribed amount for that particular year can be properly computed, always keeping in mind that the contribution must be made within 60 days after the year-end.

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CRA Requirements for Third-Party Information

Under sections 230, 231.1, and 231.2 of the Act, the CRA has broad powers to inspect the records and accounts of a taxpayer in the course of carrying out its audit function. At the same time, the Act limits the minister's right to conduct a fishing expedition with respect to information relating to unnamed third parties. In particular, subsection 231.2(2) provides that

> [t]he Minister shall not impose on any person (in this section referred to as a "third party") a requirement under subsection (1) to provide information or any document relating to one or more unnamed persons unless the Minister first obtains the authorization of a judge under subsection (3).

In its recent decision in *Redeemer Foundation* (2008 SCC 46), the Supreme Court of Canada has severely limited the scope of section 231.2. The decision may indicate that the CRA can avoid obtaining judicial authorization if it makes its request for information in the course of an audit. If this turns out to be the case in practice, the safeguards in section 231.2 may be of little protection to many taxpayers.

Redeemer Foundation, a registered charity, was affiliated with Redeemer University College. The foundation operated a forgivable loan program under which parents of children attending the college made donations to the foundation with the expectation that those donations would be used to finance their children's education.

The CRA, concerned that some donations were not valid, began auditing the foundation in 1998. In 2001, the CRA changed its tactics and served the foundation with a requirement under subsection 230(3), asking it to maintain proper records, including the identity of each donor and the name of the student who was to receive credit for that donor's donation. During the 2003 audit, the CRA made an oral request for certain information, including a list of donors, and the foundation complied with it. Subsequently, the CRA reassessed a number of the donors, disallowing their claims for charitable donation credits.

In 2004, the CRA again asked the foundation to provide the list of donors; the foundation refused, apparently on the basis of advice that the CRA could obtain such information only if it first obtained a judicial order pursuant to section 231.2. The foundation then brought an application for judicial review, seeking a declaration that the CRA's 2003 request for donor information was improper.

The application for judicial review was allowed by the Federal Court (2005 FC 1361). The reviewing judge held that the CRA required prior judicial authorization for such a request, and that subsections 231.2(2) and 231.2(3) were "intended to protect third parties from having information relating to their activities obtained from other persons audited by the Minister, who then will use it for taxation purposes." The Federal Court's decision was reversed by the Federal Court of Appeal, which concluded that the CRA was entitled to obtain the donors' information from the foundation without first obtaining a judicial order. That ruling was upheld by the Supreme Court in a 4-3 decision.

According to the majority, the foundation was required by subsection 230(2) to collect donors' information as part of its requirement to keep proper books and records. Looking at subsection 230(2) together with the provisions of sections 231.1 and 231.2, the majority found that the minister was entitled to the donors' information without judicial authorization. In the Supreme Court's view, the judicial authorization described in subsection 231.1(2) could still serve a useful purpose in circumstances where the minister required information about taxpayers outside a formal audit. Regardless of whether the donors' information was used to reassess the donors and not the foundation itself, the majority found that the donors' information was requested for a legitimate purpose—it was required to assist the CRA in establishing the legitimacy of the program run by the foundation, and thus fell under section 231.1. Having decided that the program was not a valid charitable program, the majority found that it was appropriate for the CRA to reassess the donors.

It is arguable that this decision substantially broadens the reach of the CRA's audit powers. It now seems to be the case that any third-party information that is in the possession of a taxpayer and that relates in any way to its business may be requested by the CRA without a court order. Businesses that keep personal information about their customers on file should be concerned about the risk of a CRA request to disclose that information. With respect to GST matters, it appears that the *Redeemer* decision also expands the CRA's powers in the context of GST audits (see section 289 of the Excise Tax Act). Taxpayers who receive such a request for information from the CRA should not treat it lightly, although it will be a question in each case whether the request is being made in the course of auditing the taxpayer's affairs, as opposed to those of the third-party customers.

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Loss on Securities: Income or Capital?

The case law on the appropriate treatment of gains and losses on securities transactions tends to be fact-specific and difficult to apply in individual cases. In the recent decisions in *1338664 Ontario Limited* (2008 TCC 350) and *Empire Paving Limited* (2008 TCC 355), Woods J, in an attempt to provide more certainty to taxpayers in making the determination between income and capital, applied a "tie goes to the taxpayer" principle, referencing the statement of Estey J in *Johns-Manville Canada Inc.* (85 DTC 5373 (SCC)):

> Such a determination is, furthermore, consistent with another basic concept in tax law that where the taxing statute is not explicit, reasonable uncertainty or factual ambiguity resulting from lack of explicitness in the statue should be resolved in favour of the taxpayer.

In the absence of a bright-line test in the Act regarding the distinction between transactions on income and capital account, the courts have developed a number of factors to be weighed when determining whether a gain (or loss) is one or the other. These include (1) the number of transactions, (2) the intention of the purchaser when buying shares, (3) the length of time that the shares are held, (4) the quality of the shares, (5) the time devoted to stock market transactions, (6) the extent of borrowing, and (7) the taxpayer's expertise or special knowledge in the securities market. The jurisprudence suggests that no single factor is determinative of the issue; the courts will look to the taxpayer's whole course of conduct in reaching its decision.

In the *1338664 Ontario Limited* and *Empire Paving Limited* cases, Woods J suggested that the "tie goes to the taxpayer" principle should apply when the factors do not lean heavily in the direction of income or capital, or where the distinction is "close to the line." In both cases, Woods J deferred to the "tie goes to the taxpayer" principle in ruling for the taxpayer on the basis that a presumption in favour of the taxpayer "can be helpful in promoting certainty where the legislation does not provide much guidance." However, in doing so she made arbitrary distinctions which, although favourable to the taxpayer in the case, are likely to add to the uncertainty in other cases.

In *1338664 Ontario Limited*, Woods J concluded that the taxpayer's gains on the disposition of publicly traded securities held for more than 7 days would be treated on capital account, while those held for less than 7 days would be on income account—admittedly an arbitrary distinction. In the earlier case of *B.W. Strassburger Limited* (2004 TCC 614), Rip J, as he then was, rejected the minister's attempt to apply a 365-day test in deciding whether proceeds on the sale of publicly traded securities were on capital or income account. Rip J concluded that the 365-day test was "arbitrary and without any reasonable basis." It is not clear how *Strassburger* can be reconciled with *1338664 Ontario Limited*; if the minister in *Strassburger* had set a 7-day test, as applied by Woods J, it would certainly have been rejected by Rip J.

In *Empire Paving Limited*, Woods J reiterated the "tie goes to the taxpayer" principle in allowing the taxpayer's appeal to characterize losses on the disposition of securities as being on income account, despite the fact that the taxpayer held securities for long periods of time—much longer than 7 days. In examining the long holding period, Woods J accepted that the taxpayer's intention all along was to be a trader in securities, and that the extended holding period was a result of the taxpayer simply "hanging on for the ride" with the hopes of a market upturn, which never materialized. As well, there was evidence that the taxpayer organized its investing activities in a businesslike way.

The question of when securities transactions are on income or capital account is a difficult one to answer in practice. Finance has chosen not to legislate a bright-line test for distinguishing between capital and income transactions. As a consequence, the distinction continues to turn on a balancing of the factual circumstances of each case. *1338664 Ontario Limited* and *Empire Paving* were both decided under the general procedure and are of precedential value. However, given the fact-specific nature of cases of this kind, it seems unlikely that the other courts will feel bound by the 7-day holding period that found favour with the court in *1338664 Ontario Limited.* While the court's resort to the "tie goes to the taxpayer" principle in the context of securities transactions will be encouraging to some tax practitioners, it is not likely to provide more certainty in determining whether proceeds are on capital or income account in other cases; instead, it is more likely to leave many clients "hanging on for the ride."

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EDITOR'S NOTE

"The Subsection 185.1(2) Election: A Solution Fraught with Problems" (*Tax for the Owner-Manager*, October 2008) has been the subject of comment by two of our readers. The archived version of the October 2008 issue has been updated to take account of their observations. In summary, the updates clarify that the GRIP dividend was designated as an eligible dividend, and that subsection 185.1(2) provides for an election 90 days after the date of mailing of the notice of assessment. As well, the author of the note reports on his discussions with Finance about the legislative intent underlying the filing timeline.

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