Canadian Tax Highlights

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TCC Costs Awards

Litigants must consider cost implications at every stage of litigation. Generally, a cost-benefit analysis is required at the outset, at different stages in the litigation proceedings, and before and during settlement negotiation. In tax litigation, the cost-benefit analysis can be a fairly simple exercise—an analysis of the anticipated cost of litigation, the chance of success at trial or on appeal, consideration of the assessed amount in dispute, and the ongoing effect of a judicial decision on the taxpayer's position. Historically, awards of costs by a court usually have not been factored into this analysis because they have been negligible. Recently, however, three awards of costs by the TCC to successful taxpayers on GST/HST appeals (each involving unique facts) seem to suggest that the TCC is adopting a new approach—namely, to reward a successful taxpayer with true and proper costs awards that reflect at least a substantial part of the actual legal costs.

In *Invesco* (2015 TCC 92), Invesco brought a motion for 60 percent of its actual costs after winning a TCC appeal on the correct value of consideration paid by various mutual fund trusts to it for management services. The Crown argued for costs in accordance with the tariff or, alternatively, 15 to 20 percent of Invesco's actual costs. The TCC said that the tariff amounts suggested by the Crown were an unsatisfactory starting point because the tariff generally represents only a small percentage of the taxpayer's actual costs. The TCC exercised its discretion to award costs in light of the factors in rule 147(3) of the Tax Court of Canada Rules (General Procedure), including (1) the large amount at stake in the current and pending appeals (almost $24 million with interest and penalties); (2) the moderate complexity of the matter and the significant volume of work given the number of trust funds involved; (3) the lack of inordinate delays or improper conduct by the Crown; and (4) the lack of settlement offers to consider. The first two factors favoured a high award; the last two factors favoured a lower award. In the result, the TCC awarded Invesco 40 percent of its actual costs.

In *Sun Life* (2015 TCC 171), Sun Life brought a motion for 80 percent of its actual costs from the date of its settlement offer because it had obtained a more favourable result on a successful appeal. (The appeal concerned whether its ITC allocation methodology for leased office space was "fair and reasonable.") The settlement offer of about $1 million included an explanation for the amount based on a proposed allocation methodology; Sun Life obtained judgment at trial for more than $1.25 million worth of reversed assessments. The TCC noted the existence of the settlement offer and rules 147(3.1) to (3.8), and it awarded default costs equal to 80 percent of solicitor and client costs. The TCC had discretion to deviate from awarding those costs in "unusual (in the sense of exceptional or extraordinary) circumstances," but no unusual circumstances existed. However, the court reduced Sun Life's actual costs because the special contingency fee arrangement for legal fees included an embedded risk premium.

In *Ford* (2015 TCC 185), the TCC considered written submissions on costs arising out of the Crown's failed motion to strike portions of Ford's appeal: the notice of objection did not reasonably or sufficiently describe the issue or question to be decided as required by the "specified corporation" rules. Ford requested $50,000 in costs (about 80 percent of its actual costs for the motion). As it had in *Invesco*, the Crown took the position that tariff costs were appropriate because there was "no reprehensible, scandalous, or outrageous conduct on [the Crown's] part." The TCC somewhat perfunctorily rejected the Crown's position that tariff costs were an appropriate starting point, and it awarded Ford $40,000 in costs (63 percent of its actual costs) and additional costs related to Ford's submissions on the costs matter itself. (These latter costs appear to have been incurred because the Crown refused to consider any costs above tariff.) The TCC observed that the tariff is no longer the default costs award in the TCC: rule 147(3) factors should be taken into account. In arriving at the $40,000 costs award, the TCC emphasized that (1) jurisprudence against the Crown's position on the dismissed motion was consistent, clear, and recent; (2) Ford's costs increased because the Crown failed to provide written submissions in advance of or after the motion in order to potentially narrow the issues (even though the Crown had "clearly and unequivocally committed at least twice to file written submissions" at a case management conference); and (3) the Crown had tried to use the "specified corporation" rules as a sword rather than as the shield they were intended to be.

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These decisions represent a sea change in the TCC's willingness to consider costs awards. The decisions are welcome and should reduce the chilling effect of unreimbursed costs for a taxpayer that is weighing the option of an appeal to the TCC. The new focus of costs awards reflects the purpose of the settlement offer rules, but the TCC is now willing to award a higher percentage of actual costs to a successful taxpayer if the Crown took a position clearly contrary to existing law and/or otherwise improperly conducted itself during litigation.

The TCC's approach in these decisions should assist in settling matters on fair and reasonable terms and thus reduce legal costs and the use of court resources. A taxpayer should also take advantage of the fairly recently enacted settlement offer rules (rules 147(3.1) to (3.8)) and make principled settlement offers wherever practical. But will the TCC award costs against a taxpayer whose TCC appeal is unsuccessful? A number of policy reasons may support a more moderate approach to costs claims against a taxpayer, but only time will tell how the TCC deals with this issue.

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Head of Revenu Québec Summoned

On September 17, 2015, the Quebec ombudsman, Raymonde Saint-Germain, tabled in the National Assembly her 2014-15 annual report on the public service. Complaints involving Revenu Québec featured even more prominently than in past years. Quebec's finance minister, Carlos Leitão, quickly issued a press release that was sympathetic to taxpayers and demanded an action plan from Florent Gagné, the president of Revenu Québec.

As reported earlier ("Quebec Ombudsman Lambastes Revenu Québec," *Canadian Tax Highlights*, October 2014), the ombudsman's 2013-14 annual report was an indictment of a wide range of abusive audit, collections, and customer service practices by Revenu Québec. Most of the problems identified last year appear not to have been addressed, and the situation has generally deteriorated. The report says that Revenu Québec's attitude toward taxpayers has "become more intransigent," and the number of substantiated complaints has risen.

The report said that, among other things, Revenu Québec

- applied rigid interpretations of the law, despite being aware of jurisprudence contrary to its position, and provoked "needless court action to resolve disputes with taxpayers";
- assumed that certain taxpayers were guilty by association;
- did not provide adequate information to taxpayers in support of its assessing positions, thus causing needless confusion;
- employed inadequate and even abusive auditing methods and refused to consider taxpayer submissions;
- systematically reassessed statute-barred years on the grounds of fraud without any individualized examination of the facts, and used "the general description of the fraud scheme to meet its burden of proof [of fraud]";
- refused to admit and correct its own mistakes (for example, it refused to take appropriate measures to make auditors aware of their discretion to waive interest when the agency's error or negligence had caused unduly long processing); and
- generally failed to rectify the shortcomings noted in past annual reports.

The 2014-15 report cited a large number of actual cases in which Revenu Québec's practices lacked due respect for citizens and their rights, including and in particular a taxpayer's "inalienable right to be heard." Many examples call into question Revenu Québec's commitment to the principles of natural justice and the right of a taxpayer to unbiased decision making.

In the press release, the finance minister said that he was very troubled by the abusive practices highlighted in the report. The minister also immediately summoned the president of Revenu Québec and demanded that he submit—by the end of September—"a concrete plan of action designed to correct, in a structural and durable manner, the situations described in the report and to ensure that the basic rules are applied uniformly." (Authors' translation.) According to the press release, the action plan will be released publicly and will be closely followed up.

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Professional Fees Incurred for Voluntary Disclosure

Are professional fees deductible if they are incurred for the preparation of income tax returns, objections, or appeals? The CRA's position, set out in *Interpretation Bulletin* IT-99R5 (Consolidated), "Legal and Accounting Fees," allows the deductibility of those expenses but excludes, arguably incorrectly, professional fees incurred for making a voluntary disclosure.

A threshold question is whether the expenses were incurred for the purpose of producing income from a business or property. A taxpayer generally may deduct expenses under subsection 9(1) if the deduction is not prohibited by paragraph 18(1)(a), which disallows an expense not made or incurred to gain or produce income from business or property. Alternatively, professional fees not incurred for the purpose of producing income from a business or property may be deductible under paragraph 60(o) if they were incurred in preparing, instituting, or prosecuting an objection or appeal. For example, an

employee may not be able to deduct fees incurred in preparing a personal income tax return in respect of employment income, but he or she can deduct professional fees incurred to object to a reassessment of employment income. In contrast, a taxpayer that carries on a business can generally deduct under section 9 its tax return preparation fees and any fees incurred in objecting to a reassessment of that return because all those fees are incidental to the carrying on of the business.

The CRA's position on professional fees in IT-99R5 allows a deduction under section 9 for reasonable professional fees incurred for advice on preparing and filing income tax returns; the deduction is allowed in computing business or property income related to those returns and is not prohibited by paragraph 18(1)(a). The IT also says that a taxpayer may deduct expenses incurred for professional advice and assistance in making representations after being informed that a taxation year is to be reviewed (paragraph 60(o)); otherwise, a taxpayer might impede the administrative process by making representations to the CRA only after a reassessment was issued. In TI 2014-0532121E5 (October 17, 2014), however, the CRA confirmed that professional fees incurred in making a voluntary disclosure are not deductible under section 9 (because they are prohibited under paragraph 18(1)(a)) or under paragraph 60(o), even if the income voluntarily disclosed arises from a business or property. This position is difficult to reconcile with the deductibility of professional fees related to the preparation and filing of a return in accordance with the underlying income's characterization; similarly, as noted above, a taxpayer can deduct fees incurred in making representations after being informed that a taxation year will be reviewed.

In TI 2014-0532121E5, the CRA was asked whether the fees paid to advisers for filing a voluntary disclosure are deductible under either paragraph 60(o) or section 9. The CRA said that a voluntary disclosure was not an objection or appeal, and thus the taxpayer was unable to deduct related fees under paragraph 60(o). The CRA's position on section 9 was that the professional fees incurred in the making of a voluntary disclosure were not incurred to produce income but to correct omissions; thus, the taxpayer was prohibited under paragraph 18(1)(a) from deducting those amounts in calculating its income from a business or property. However, the CRA suggested that a deduction may be available under section 9 for professional fees incurred in the preparation of tax returns resulting from voluntary disclosure. (The CRA's position on both provisions is consistent with TI 2012-0437831E5, June 5, 2012.)

The correctness of the CRA's position on professional fees incurred in making voluntary disclosure is doubtful. In *Symes* (1993 CanLII 55), the SCC majority (per Iacobucci J) set out a non-exhaustive list of factors to be considered in determining whether an expense was incurred for the purpose of earning business income. One of those conditions was whether an expense would have been incurred if the taxpayer had not engaged in the pursuit of business income; if an expense would have been incurred whether or not the taxpayer was so engaged, then the expense may not be deductible. The voluntary disclosure of unreported business income occurs only because the taxpayer pursued and subsequently realized business income. Furthermore, in *65302 British Columbia Ltd.* (1999 CanLII 639), the SCC concluded (per Iacobucci J) that expenses did not have to be unavoidable to be considered made for the purpose of producing business income. Fees incurred in making a voluntary disclosure are avoidable, but they flow from the income-generating activities of a business and are thus similar to the taxpayer's penalties and fines in *65302 British Columbia*. Therefore, in accordance with SCC cases, professional fees incurred in making a voluntary disclosure of business income should be deductible under section 9 and not prohibited under paragraph 18(1)(a).

Even if professional fees are not deductible under the general principles of section 9, a deduction may be available under paragraph 20(1)(cc). In TI 2014-0528451C6 (May 22, 2014), the CRA said that a taxpayer may deduct under that provision the fees incurred in a voluntary disclosure related to the taxpayer's income from business—but not if the fees relate only to its income from property. Paragraph 20(1)(cc) is broadly worded and allows a deduction for expenses related to a business carried on by the taxpayer and incurred in making any representation to a government entity. For example, the cost of making a patent application may be deductible rather than added to the cost of the patent. The CRA rightly considers itself to be a government entity described in paragraph 20(1)(cc); IT-99R5 also says that professional fees incurred in making a ruling request are deductible under that provision.

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Amending Partnership Returns: Three-Year Limitation

A recent TI (2014-0562271I7, April 23, 2015) says that a partnership can file an amended partnership information return after its statute-barred date only if the designated partner waives the normal determination period within three years of the original filing. (A partnership return is not assessed, but the income or loss is determined.) If the partnership files a waiver within the three years, the CRA may redetermine the partnership income or loss. Although the CRA notes that the rule that allows a partnership waiver does not specify a filing-due date, it says that the three-year time limitation for an assessment waiver also applies to a determination waiver.

In general, the CRA is prohibited from assessing, reassessing, or making an additional assessment of tax, interest, or penalties for a taxation year after the "normal reassessment

period" under subsection 152(4), unless an exception applies. The "normal reassessment period" is defined generally in subsection 152(3.1) to be the period that ends three years (or four years for a non-CCPC and a mutual fund trust) after the earlier of the day that a notice of an original assessment is sent under part I for the year and the day that an original notification is sent that no tax is payable by the taxpayer for the year.

The CRA can reassess a taxpayer at any time after the normal reassessment period if the taxpayer has filed a waiver in prescribed form within the normal reassessment period for the taxation year (subparagraph 152(4)(a)(ii)). Generally, the CRA can determine a partnership's income or loss within three years after a partnership information return is filed (subsection 152(1.4)). A designated partner may file a waiver for the period during which the CRA may make a determination (subsection 152(1.9)). Subsection 152(1.2) states that, subject to certain exceptions, the rules applicable to an assessment or a reassessment also apply to the determination or redetermination of an amount under divisions I and J (sections 150 to 168 and 169 to 180, respectively). A taxpayer can thus object to a determination or appeal a determination to the TCC in the same manner that it can for a reassessment.

In the example given in the TI, a partnership files its partnership information return by its due date and the CRA issues a notice of determination within three years. The partnership files an amended return after the statute-barred date—that is, after the three years. The TI says that the CRA will not accept the amended return after the statute-barred date because the partnership did not file a waiver within the three years after the original filing.

The CRA is of the view that as a result of subsection 152(1.2), the time limitations in subsections 152(3.1) and 152(4) apply to returns that are either determined or assessed, mutatis mutandis. Thus, the determination of a partnership's income or loss is considered to be the equivalent of an assessment for the purposes of subsection 152(4).

The CRA says that even though subsection 152(1.9) does not specify the time within which the designated partner must file a waiver, the rule must be read in conjunction with subsection 152(1.2). Thus, subparagraph 152(4)(a)(ii) applies both to an assessment waiver and to a determination waiver. If a determination waiver was not intended to be covered, the legislation would have expressed that intention; this interpretation is supported by the fact that subsection 152(1.2) expressly excludes subsection 164(4.1) but does not exclude subparagraph 152(4)(a)(ii).

Although the matter is not addressed in the TI, the CRA may at any time determine or redetermine the income or loss of a partnership that has not filed a partnership return (subsection 152(1.4); see TI 2008-0285421C6, October 10, 2008). The CRA may then assess or reassess the partners' income or loss under paragraph 152(1.7)(b) within one year after the partnership's right to object to or appeal the determination or redetermination has expired. Because a determination of income or loss must be issued to a partnership to commence the partners' three-year determination period, the partnership may want to file an information return even if it is not required to do so under CRA administrative policy.

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Subsection 75(2) and the 21-Year Rule

In order to avoid the deemed disposition of trust assets on the trust's 21st anniversary, trust property is usually transferred beforehand to Canadian-resident beneficiaries on a tax-deferred basis. Subsection 107(2) generally provides that a trust may distribute property to a beneficiary in full or partial satisfaction of the beneficiary's capital interest at the trust's ACB—that is, on a tax-deferred basis. Previously unrealized gains are not taxable upon distribution to a Canadian-resident beneficiary. Capital gains are recognized in the beneficiary's hands when he or she disposes of or is deemed to dispose of the property, or when the beneficiary (or the beneficiary's spouse, if there was a further spousal rollover deferral) dies. If subsection 75(2) has applied to a trust, however, subsection 107(4.1) prevents a distribution of trust property to the beneficiaries on a tax-deferred basis. Subsection 107(4.1) applies at the time of the distribution.

Subsection 75(2) applies when an individual has transferred or loaned property, whether directly or indirectly, in any manner, and the transferor may receive or direct who could receive any of the trust property (as a beneficiary) from the trust. If the settlor is the trust's sole trustee and the trustee has the discretion to distribute income and capital to one or more beneficiaries, it is clear that subsection 75(2) applies.

If subsection 75(2) applies, all of the trust income is attributed to the transferor and the trust property can be distributed tax-deferred only to the transferor-settlor during his or her lifetime. After his or her death, the provision no longer applies and the trust property may be distributed tax-deferred to the beneficiaries.

If subsection 75(2) applies and the terms of the trust permit, the trustee may consider indefeasibly vesting all the trust interests before the deemed disposition date. Indefeasible vesting converts a beneficiary's discretionary interest into a fixed interest that is the beneficiary's property. If the trust property is indefeasibly vested in interest in the beneficiaries in desired percentages, the tax otherwise payable on a 21-year deemed disposition may be avoided, assuming that not more than 20 percent of all the vested interests are not vested in nonresident beneficiaries. "Indefeasibly vested" means that the beneficiary has the right to all incidents of the property's

ownership. The beneficiary is entitled to all income derived from the vested interest and to all interests in the property. If the indefeasibly vested beneficiary dies, his or her estate is entitled to the interests whenever it becomes vested in possession.

The Act stipulates that in certain circumstances when all trust interests have indefeasibly vested in the beneficiaries, the trust is no longer a trust for the purposes of the 21-year deemed disposition rule. The trust continues to exist as a matter of trust law and can remain in place until subsection 107(4.1) (which prevents the trustees from distributing tax deferred to the beneficiaries) no longer applies—that is, when the settlor dies. After the settlor's death, the beneficiaries can actually receive possession and title to the trust assets that indefeasibly vested in them.

Title to the property is not transferred to the beneficiaries when it indefeasibly vests in them. The trustees pass a resolution that irrevocably exercises their power to encroach on trust capital by vesting the property in the beneficiaries in interest only: the transfer of possession is deferred until the settlor's death.

The vested interests become each beneficiary's property; the interest's monetary value equals the value of the beneficiary's share of the trust property and the cost base is equal to the trust's, which is typically low. Thus, a capital gain equal to the inherent gain is crystallized if the beneficiary dies or leaves Canada after the interest has vested; tax of about 25 percent of the gain is payable. A capital gain is also crystallized if the beneficiary dies before receiving the trust property that has been indefeasibly vested in him or her. The gain is realized in the vested interest and not in the underlying property. A beneficiary may bequeath his or her vested interest to a family member under his or her will; without a will, the interest passes to the beneficiary's intestate heirs. It is not clear that a family member can benefit from the vested interest's high ACB as a result of the crystallization of the capital gain, and thus double tax may be a concern. If a beneficiary of an indefeasibly vested interest is terminally ill, the problem may be mitigated by distributing to the beneficiary the trust property that is indefeasibly vested in him or her. The distribution triggers a capital gain in the trust if it is a subsection 75(2) trust, but the distributed property's high ACB may allow planning to mitigate double taxation.

While the property is retained in the trust on behalf of the indefeasibly vested beneficiaries, any dividend income received in respect thereof is allocated to those beneficiaries proportionately. Shares sold or purchased for cancellation before the trust's ultimate windup trigger a capital gain or deemed dividend that is allocated to the beneficiaries proportionately.

Pursuant to *Saunders v. Vautier* ((1841), 49 ER 282 (Rolls Ct.)) (applicable in Ontario but not in Alberta), a beneficiary with an indefeasibly vested interest can require the trust to distribute the property to him or her. If the trust property is so distributed before the death of a subsection 75(2) trust's settlor, the resulting capital gain may be allocated by the trustee to the particular beneficiary, and tax is payable thereon by that beneficiary.

As mentioned above, indefeasible vesting converts a beneficiary's discretionary interest into a fixed interest that is the beneficiary's property. No other person can thereafter claim any entitlement to that interest, but the property can be seized by a creditor of the beneficiary. Family-law implications also arise: the interests can have a significant value and form part of the beneficiary's net family property if there is a claim for equalization thereof or for spousal support on separation. This result can be prevented by the terms of a domestic contract entered into by a married or about to be married beneficiary to exclude the interest from net family property. Alternatively, a freeze may be implemented before the interests vest in order to limit the beneficiary's entitlement to the current property value and to preserve the settlor's control over a future increase in value.

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Covered Expatriates: IRS Proposed Regs

On September 9, 2015, the IRS issued proposed regulations (REG-112997-10, 2015-39 IRB 422) under Code section 2801, which taxes US citizens and residents who receive a "covered gift" or "covered bequest" from a "covered expatriate." The rule was added to the Code as part of the HEART [Heroes Earnings Assistance and Relief Tax] Act of 2008 and is an estate and gift tax consequence of relinquishing US citizenship or terminating long-term permanent resident status, in addition to section 877A's well-known exit tax. Reporting and payment of tax due under section 2801 is deferred until final regulations are issued.

For both sections 877A and 2801, a "covered expatriate" is an individual who, after June 16, 2008, relinquished US citizenship or terminated long-term permanent resident status and (1) meets either a US income tax liability test (in 2015, an average US income tax liability of $160,000 over five years) or a net worth test ($2 million) and does not meet a "dual citizen from birth" exception to those tests or (2) fails to certify compliance with US federal income tax obligations for the five preceding tax years.

Section 2801 imposes a tax, at the highest gift or estate tax rate (now 40 percent), on any US citizen or resident who receives a covered gift or a covered bequest from a covered expatriate who acquired the transferred property either before or after expatriation. The definition of a "covered gift" incorporates the Code's gift tax definition; the gift must be received directly or indirectly from a covered expatriate. A "covered bequest" means any property (1) that is acquired, directly or

indirectly, because of a covered expatriate's death and (2) that would have been includible in his or her gross estate if he or she had been a US citizen at death. The terms "covered gift" and "covered bequest" do not include (1) a charitable donation that would qualify for the estate or gift tax charitable deduction and (2) a gift or bequest to a covered expatriate's US-citizen spouse that would qualify for the gift or estate tax marital deduction if the transferor was a US citizen or resident. A broad range of transfers are subject to section 2801, and the US tax implications of expatriating may persist long after an individual relinquishes US citizenship or terminates long-term permanent resident status.

Unlike traditional US gift and estate taxes imposed on the donor or the estate, respectively, the tax under section 2801 is imposed on the US-citizen or US-resident recipient of the covered gift or bequest. For this purpose, a domestic trust that receives a covered gift or bequest is treated as a US citizen and is thus liable for the tax. A foreign trust generally is not liable for the tax imposed under section 2801: the US-citizen or US-resident recipient of a foreign trust's distribution is generally liable for the tax on receipt to the extent that the distribution is attributable to covered gifts or bequests to that trust. A foreign trust, however, may elect to be treated as a domestic trust for the purposes of section 2801, and in that case it is taxed thereunder on its receipt of a covered gift or bequest: the tax on a US-citizen or US-resident recipient is eliminated.

Under the proposed regulations, a gift's or bequest's recipient bears the burden of determining whether he or she received a covered gift or bequest. The preamble to the proposed regulations acknowledges the difficulty of this task. The proposed regulations provide that the recipient may request, with the expatriate's consent, the IRS's disclosing of certain information about the donor's or deceased's return that may assist in determining whether he or she is or was a covered expatriate. It is unclear how such consent can be obtained, especially from a decedent's estate. According to a US Treasury representative, Treasury is actively working on a Revenue procedure that will explain the process for requesting disclosure. If authorized, the IRS may disclose returns and return information upon request, but it will not determine covered expatriate status. The proposed regulations further provide that if the expatriate donor does not authorize the IRS to release the relevant return information to the recipient, then a rebuttable presumption exists that the expatriate donor is a covered expatriate and that each gift from him or her to a US citizen or resident is a covered gift. The proposed regulations do not offer guidance on how the presumption may be rebutted.

The IRS intends to release form 708, "United States Return of Tax for Gifts and Bequests from Covered Expatriates," when the proposed regulations are finalized. Final regulations will establish the due date for the form's filing and the section 2801 tax's payment. Consistent with Announcement 2009-57 (2009-29 IRB 158), a US recipient will be given a reasonable time to file form 708 after the final regulations are issued and pay the section 2801 tax on all covered gifts and bequests received after June 16, 2008.

Because expatriations are on the rise for US-citizen Canadian residents, the proposed regulations should be carefully reviewed. A Canadian-resident covered expatriate should be aware that generally any gift or bequest that he or she made after June 16, 2008 to a US person will eventually be subject to tax and reporting under section 2801, and therefore all such gifts and bequests must be analyzed.

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Packaging Rule in Regulation 5907(2.01) Deficient

Regulation 5907(2.01) was introduced as part of the August 19, 2011 proposals. This relieving provision allows the recognition of surplus when an FA (the disposing FA) transfers an asset to another FA (the receiving FA) in exchange for the receiving FA's shares, followed by a sale within 90 days by the disposing FA of the receiving FA's shares to a third party. Under regulation 5907(2.1)(a), the "only consideration received" by the disposing FA upon the asset transfer must be the receiving FA's shares. According to TI 2014-0550451E5 (April 22, 2015), if the receiving FA assumes any liabilities of the disposing FA as part of the transfer, then that liability assumption is consideration received, and thus no surplus is recognized. Although the CRA's interpretation is technically correct, it is not clear that it reflects the regulation's underlying policy.

The technical notes to regulation 5907(2.01) (released with the August 19, 2011 draft legislation) say that "[t]his new rule is intended to apply to transactions that would otherwise be structured as direct asset sales but that are instead, for foreign commercial reasons, structured as share sales." We understand that the provision may have been intended to accommodate a sale in circumstances where, for example, an FA that is formed in the United States as a US C corporation (USco) and that owns more than one business wants to sell one business to a third party. The sale must be structured as an asset sale for US tax purposes and as a share sale for commercial purposes. To achieve these results, USco transfers the target business assets and related liabilities to a newly formed wholly owned disregarded LLC in exchange for the LLC shares and then sells the LLC shares. Thus, USco "packages" or "drops down" its business assets by first transferring them to an LLC for the LLC shares and then selling the LLC shares to a third party.

For US tax purposes, the transfer of the business assets to the LLC is a non-event, and the LLC share sale is treated as a sale by USco of the underlying assets. For Canadian surplus purposes, in the absence of regulation 5907(2.01), any accrued income or capital gain on the disposed-of business assets is

not recognized by USco on the transfer to the LLC because that income or gain is not recognized under US tax law (regulations 5907(2)(f)(ii) and 5907(5.1)). Moreover, no provision in the Act suppresses USco's ACB in the LLC shares; thus, the ACB of those shares equals the FMV of the net assets transferred. When USco sells the LLC shares, under US tax law USco realizes income or gain on the assets, but this US tax law fiction is ignored for Canadian surplus purposes: the sale is legally a share sale, and for Canadian tax purposes USco has no gain or loss (and thus no hybrid surplus) because its ACB in the shares was stepped up to FMV. As a result, for Canadian tax purposes no income or gain is recognized on either the sale of assets to the LLC or the sale of the LLC shares to a third party. We believe that regulation 5907(2.01) is intended to provide relief in these circumstances by allowing USco to recognize the income or gain in its surplus on the sale to the LLC and should operate even if the LLC also assumes some liabilities of USco on the asset sale.

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Owner-Manager Year-End Tips, Part 1

An owner-manager should start to focus now on year-end planning. Tactics to optimize the salary-dividend mix for an owner-manager follow.

- Determine the optimal salary-dividend mix for the owner-manager and family members to minimize overall taxes. Consider their marginal tax rates; the corporation's tax rate; provincial health and/or payroll taxes; RRSP contribution room (in 2015, $140,944 of earned income is required to maximize the 2016 RRSP contribution); CPP contributions; and other deductions and credits (such as donations and child-care expenses). If an owner-manager earns dividends (especially eligible dividends), alternative minimum tax (AMT) exposure may increase.
- To be deductible, salaries and bonuses must be reasonable, accrued before and properly documented as being legally payable at the business's year-end, and paid within 179 days of the year-end. Remit appropriate source deductions and payroll taxes on time. It may be beneficial to pay a reasonable salary to a spouse or child who provides services to the business and is in a lower tax bracket; the reasonableness of the salary is generally determined in relation to the value of the services performed.
- Consider dividend distributions in the following order: (1) eligible dividends that trigger a refundable dividend tax on hand (RDTOH) refund; (2) non-eligible dividends that trigger an RDTOH refund; (3) eligible dividends that do not trigger an RDTOH refund; and (4) non-eligible dividends that do not trigger an RDTOH refund. Depending on the province or territory of residence, the payment of non-taxable capital dividends is the first, second, or third preference.
- A CCPC can designate and pay eligible dividends only to the extent that it has a positive general rate income pool (GRIP) at the end of the year of payment. Generally, a CCPC's GRIP is the portion of its taxable income that has not benefited from any preferential corporate tax rates: taxable income taxed at small business or investment income rates is excluded. A dividend must be designated as eligible when or before it is paid. A dividend paid and inadvertently designated as eligible (because the CCPC had insufficient GRIP) attracts part III.1 tax to the payer on the excess designation; an election to treat all or part of the excess designation as a separate non-eligible dividend should be considered.
- An owner-manager in any Canadian province or territory should be aware that non-eligible dividend tax rates increase after 2015 (from 2016 to 2019) in all jurisdictions (except in British Columbia for taxable income exceeding $151,050). Consider accelerating non-eligible dividends to 2015 to take advantage of lower non-eligible dividend tax rates in 2015 (except in British Columbia, as noted above).
- An owner-manager in Alberta or in Newfoundland and Labrador should ensure that his or her remuneration strategies account for the personal income tax rate increases in those provinces on taxable income over $125,000. In both provinces, the rates increased in 2015, with further increases in 2016. Consider accelerating taxable bonuses and discretionary dividends to 2015 to avoid the higher tax rates after 2015. Note that this strategy accelerates the payment of tax and may increase an owner-manager's AMT exposure in 2015.
- An owner-manager in British Columbia should be aware that for 2016, British Columbia's personal tax rate on taxable income over $151,050 will drop to 14.7 percent (from 16.8 percent). Ensure that the owner-manager's remuneration strategy accounts for this rate decrease. If the owner-manager's income is expected to exceed $151,050 in 2015, consider delaying taxable bonuses and discretionary dividends until 2016. Note that this strategy defers the payment of tax, but may increase an owner-manager's AMT exposure in 2016.
- An owner-manager in New Brunswick should ensure that his or her remuneration strategies contemplate New Brunswick's personal income tax rate increase on taxable income over $150,000. Starting in 2015, the province's top 2014 rate of 17.4 percent increases to

(1) 21 percent on taxable income over $150,000 and up to $250,000, and (2) 25.75 percent on taxable income over $250,000.

- An owner-manager in Nova Scotia should be aware that if the province tables a budget surplus in its 2016-17 fiscal year, in 2016 the province will eliminate the top $150,000 personal tax bracket and 21 percent rate and will reinstate the 10 percent surtax on personal provincial income tax exceeding $10,000. Thus, in the event of a provincial budget surplus next year, an owner-manager should anticipate a potential personal tax rate decrease in 2016 and make appropriate adjustments to his or her strategy for the payment of salary and/or dividends.
- An owner-manager in Yukon should ensure that his or her remuneration strategies account for Yukon tax rate changes. Starting in 2015, Yukon's personal income tax on taxable income of (1) $500,000 or less decreases (due to tax rate reductions and/or the elimination of the 5 percent surtax, which applied on territorial tax exceeding $6,000) and (2) over $500,000 increases (from 12.76 percent plus 5 percent surtax, to 15 percent and no surtax).
- Forgoing bonus payments and/or dividend distributions out of excess cash may create doubt about the status of a CCPC's shares as QSBC shares: substantially all of the CCPC's assets are arguably not used in an active business, and thus the shareholder's claim to the $813,600 (indexed after 2015) lifetime capital gains exemption (LCGE) on the sale of the shares is jeopardized. The ratio of a CCPC's redundant or investment assets to total assets should be monitored. Note that the LCGE is $1,000,000 for dispositions of qualified farm or fishing property made for federal tax purposes after April 20, 2015 and for Quebec tax purposes after 2014.
- Forgoing bonus payments in respect of 2015 may cause a CCPC's taxable income in 2015 to exceed $500,000 on an associated basis, and thus in 2016 both render a CCPC's SR & ED investment tax credits (ITCs) non-refundable and also attract the lower ITC rate. If ITCs are non-refundable, consider other planning to create a federal corporate income tax liability that is sufficient to use the ITCs in 2016.
- If the owner-manager does not need to extract cash, consider whether the retention of income by the corporation ultimately yields a tax saving (or cost) when the after-tax corporate income is paid out as a dividend. Retention defers tax because the corporation's tax rate is less than the individual shareholder-employee's rate. The table shows the income tax deferral associated with a corporation's retention of active business income (ABI) that is not paid out as salary to the shareholder-employee, and the tax saving (or cost) when the corporation pays out a dividend out of after-tax income.

Determining the Optimal Salary-Dividend Mix[a] (Based on a December 31, 2015 Year-End and $10,000 ABI)

	Eligible for small business deduction[b]		Not eligible for small business deduction[c]	
	Deferral	Saving/(cost)	Deferral	Saving/(Cost)
	dollars			
Alberta[d]	2,625	(27)	1,424	(131)
British Columbia	3,230	(56)	1,980	(142)
Manitoba	3,652	23	2,052	(303)
New Brunswick[e]	3,975	(10)	2,775	(19)
Newfoundland and Labrador				
General	3,041	181	1,541	(701)
M & P	3,041	181	2,441	(85)
Northwest Territories	3,005	394	1,855	178
Nova Scotia	3,600	(1)	1,900	(588)
Nunavut	2,750	99	1,550	(462)
Ontario[f]				
General	3,499	108	2,399	(87)
M & P	3,499	108	2,549	12
Prince Edward Island	3,187	(87)	1,637	(344)
Quebec				
General	3,301	78	2,511	(64)
M & P	3,652	290[g]	2,511	(64)
Saskatchewan				
General	3,100	63	1,700	(111)
M & P	3,100	63	1,900	39
Yukon[h]				
General	3,000	(25)	1,400	50
M & P	3,150	72	2,650	1,058

[a] The individual is assumed to be taxed at the top marginal income tax rate. Only federal, provincial, and territorial income tax; the employer portion of provincial health tax; and the employee portion of payroll tax (for Northwest Territories and Nunavut) are considered. Different results may arise in special circumstances, such as for credit unions.

[b] The federal small business threshold of $500,000 applies in all provinces and territories, except for Manitoba (threshold of $425,000) and Nova Scotia (threshold of $350,000).

[c] If there is no SBD, the after-tax corporate income is assumed to be paid out as an eligible dividend.

[d] For Alberta, the figures assume that the individual is taxed at Alberta's personal income tax rate on income over $300,000. For income over $200,000 and up to $300,000, the figures are as follows: Eligible for SBD: deferral 2,600, cost (27); no SBD: deferral 1,399, cost (131).

[e] For New Brunswick, the figures assume that the individual is taxed at New Brunswick's personal income tax rate on income over $250,000. For income over $150,000 and up to $250,000, the figures are as follows: Eligible for SBD: deferral 3,500, cost (9); no SBD: deferral 2,300, cost (15).

[f] For Ontario, the figures assume that the individual is taxed at Ontario's personal income tax rate on income over $220,000. For income over $150,000 and up to $220,000, the figures are as follows: Eligible for SBD: deferral 3,346, saving 110; no SBD: general—deferral 2,246, cost (82); M & P—deferral 2,396, saving 21.

[g] For Quebec, the figures assume that the corporation's small business income is eligible for Quebec's M & P rate of 4.49% for 2015; this is the case if 50% or more of the corporation's activities are attributable to M & P (based on M & P assets and labour). If this percentage is under 50% and more than 25%, the M & P rate increases proportionately (straightline) from 4.49% to 8% for 2015.

[h] For Yukon, the figures assume that the individual is taxed at Yukon's personal income tax rate on income over $500,000. For income over $138,586 and up to $500,000, the figures are as follows: Eligible for SBD: no M & P—deferral 2,780, cost (22); M & P—deferral 2,930, saving 79; no SBD: general—deferral 1,180, saving 42; M & P—deferral 2,430, saving 1,089. The figures assume that the combined federal/Yukon eligible dividend tax rate is 16.257% (federal of 19.293% plus Yukon of −3.036%), and that the taxpayer has other income that can be sheltered by Yukon's negative eligible dividend tax rate. If the taxpayer has no other income, the combined federal/Yukon eligible dividend tax rate is 19.293% (federal of 19.293% plus nil for Yukon).

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Sports Blogger's Business Losses

In *Berger* (2015 TCC 153; informal procedure), the TCC concluded that a taxpayer (Mr. B) who started a blog after losing his job as a sports journalist was entitled to claim business losses for related travel expenses. The CRA disallowed about $65,000 of business losses for the 2011 and 2012 taxation years, saying that Mr. B did not conduct any business activities. The TCC said that the taxpayer did not make direct attempts to solicit advertisers, but his predominant intention was to make a profit and he behaved "in a reasonable businesslike manner."

Mr. B was a professional sports journalist who lost his job in 2011 and subsequently started a blog; he intended to sell advertising to sponsors to generate revenue. Mr. B paid for a professionally created website; to promote his blog, he also sent 500 e-mails to major players in the sports media. Although Mr. B did not directly approach potential sponsors, he acquired one advertising sponsor in July 2011.

In the course of working on his blog, Mr. B travelled with a professional sports team and claimed business losses of approximately $27,000 and $38,000 in his 2011 and 2012 taxation years, respectively. He reported no revenue in 2011 and $7,500 of revenue in 2012. Mr. B paid for his expenses, largely composed of travel costs, out of his severance package from his former employer. The CRA denied these losses on the basis that Mr. B was not conducting business activities.

Mr. B argued that his blog was a commercial venture that had no personal element, and the TCC had to determine only the commerciality of the blogging. However, the CRA argued that for a sports fan such as Mr. B, travelling across North America to follow a professional sports team indicated a strong personal element. The CRA further said that Mr. B had no active plans for soliciting advertisers and had done no financial planning. Instead, Mr. B paid for expenses out of his severance package in the hope that advertisers would come to him, which was not a businesslike course of action.

The TCC's decision relied on the tests established in *Stewart* (2002 SCC 46), in which the SCC used a two-stage approach to determine whether a taxpayer's activities constituted a source of income for the purposes of section 9: (1) Is the nature of the activity clearly commercial? (2) If there is a personal element to the activity, did the taxpayer also intend to carry on the activity for profit, and is there evidence to support that intention?

The SCC said that even if the activity is a personal pursuit, a venture is considered to be a source of income if it is undertaken in a sufficiently commercial manner. For an activity to be classified as commercial, the taxpayer must have the subjective intention to profit and there must be evidence of businesslike behaviour that supports that intention. The SCC stipulated that the taxpayer must establish that his or her predominant intention was to make a profit from the activity, and that the activity had been carried out in accordance with objective standards of businesslike behaviour. Citing the SCC's decision in *Moldowan* (1977 CanLII 5), the court in *Berger* said that the objective factors to be considered included the following:

> (1) the profit and loss experience in past years; (2) the taxpayer's training; (3) the taxpayer's intended course of action; [and] (4) the capability of the venture to show a profit.

The TCC said that Mr. B's venture was not blogging in isolation, but attending games, practices, and conferences; taking photos; blogging reports and photos; attracting readers; and selling advertising. Although the TCC recognized the commercial aspect of these activities taken together, it concluded that for a sports fan, travelling to games and blogging do have a personal element. The TCC then considered whether Mr. B had established that his predominant intention was to make a profit and whether he had carried out his activities in accordance with objective standards of businesslike behaviour.

In considering the profit and loss experienced in past years, the TCC noted that in this case there were no past years to address: the first 18 months of Mr. B's activities were in 2011 and 2012. Mr. B's business was in a startup phase, and the TCC said that immediate profits were unlikely.

The TCC also looked at the taxpayer's training. Mr. B did not have any education or experience related to selling advertising or running a media business, but he had experience as a sportswriter "for which he got paid for 20 years and used that experience to attempt to continue to get paid."

The TCC also considered Mr. B's intended course of action, and found that Mr. B had no formal business plan or any financial projections; he simply intended to write a quality blog and gain enough readers to attract advertising sponsors. To this end, Mr. B paid for a professionally created website and contacted the sports media to promote his blog.

In considering Mr. B's failure to solicit advertisers, the TCC concluded that, on balance, it appeared that Mr. B intended to pursue a profit and took commercial steps to do so. The TCC noted that the blog was a fledgling business and was aimed at establishing a readership (as evidenced by Mr. B's paying for a professional website designer), and that in fact Mr. B's idea

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and product did attract a sponsor. The TCC found that Mr. B's approach showed some commercial reasoning, but it cautioned that "[t]here will come a time, however, where continuing on this course without any sponsors knocking on his door can only lead to a conclusion that a commercial expectation has been overtaken by personal dreams."

The TCC noted that Mr. B was unable to provide projections, comparisons, or readership numbers to indicate the venture's capability to make a profit. Nonetheless, the TCC said that it "simply [had] not been convinced one way or the other that this venture is capable of showing a profit."

In considering these factors, including the early stage of the blog venture, the TCC concluded that Mr. B's activity went beyond a hobby. The TCC found that Mr. B had a predominant intention to make a profit, and had behaved in a reasonable, businesslike manner to pursue that end in the years at issue, which covered the first 18 months of the venture. Therefore, Mr. B was entitled to claim business losses in 2011 and 2012.

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