TAX FOR THE Owner-Manager

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Opportunity To Address Integration of FAPI Gains in Light of Budget 2022

The foreign accrual property income (FAPI) rules force the Canadian shareholder of a controlled foreign affiliate (CFA) to report on a current basis its "participating percentage" of FAPI in income. Without these rules, individuals could defer Canadian taxation by simply moving investment assets into foreign corporations. Foreign income tax paid on FAPI is recognized through the foreign accrual tax (FAT) deduction mechanism in subsection 91(4)—a deduction equal to FAT multiplied by the "relevant tax factor" (RTF). The RTF is currently 4 if the Canadian shareholder is a corporation; it is 1.9 for all other cases. The RTF of 4 allows a full offset of FAPI when at least 25 percent of foreign income tax has been paid—a proxy for the Canadian combined federal and provincial general corporate tax rate. The RTF does not distinguish between a CCPC and another type of corporation. As is well known, investment income earned by a CCPC is subject to immediate corporate tax at a rate considerably higher than 25 percent.

Budget 2022 Proposal

The 2022 federal budget announced a major amendment to the FAPI regime, effective for taxation years beginning on or after April 7, 2022. This amendment will reduce the RTF for CCPCs and substantive CCPCs from 4 to 1.9 (throughout this article, we will use "CCPC" to refer to both actual and substantive CCPCs). The rationale for this amendment is that if the same investment income had been earned by a CCPC, the refundable corporate tax regime would apply, and this would result in 46.7 percent to 54.7 percent of immediate corporate tax, depending on the province. Accordingly, the existing RTF of 4 provides a deferral opportunity because it allows for the full offset of FAPI with only 25 percent of foreign income tax paid. If RTF is reduced to 1.9, FAPI earned by a CCPC will be subject to Canadian tax whenever the foreign tax rate is lower than 52.63 percent.

The government recognized that a reduced FAT deduction would throw off tax integration, and therefore the 2022 budget proposed to use the capital dividend account (CDA) to prevent double taxation when profits are ultimately repatriated to individual shareholders. Specifically, the budget proposes to include the following in the CDA of a CCPC:

- the amount of the section 113 deduction on a hybrid surplus dividend less withholding tax paid on that dividend;
- the amount of the section 113 deduction on a taxable surplus dividend, as determined on the basis of the new RTF; and
- the amount of the section 113 withholding tax deduction less withholding tax paid in respect of taxable surplus repatriations.

Correspondingly, such foreign dividends will no longer be added to the general rate income pool (GRIP). As of this writing, no legislative details of this proposal have been released.

The reduced RTF also reduces the amount of the taxable surplus dividend deduction under paragraph 113(1)(b) when the underlying FAPI is repatriated back to the Canadian corporate shareholder. It does so because this deduction is the product of the underlying foreign tax multiplied by the RTF minus 1. However, this should generally be offset by an increased subsection 91(5) deduction resulting from the reduced FAT.

How the Proposal Will Work

Below, we will show how the new rules work (and where they don't work) in the context of a CFA that owns a foreign rental property that is not an excluded property.

Assume that an individual wholly owns Canco, which, in turn, wholly owns a CFA. The CFA's foreign rental income is \$100, and it paid foreign income tax of \$25. Canco is required to report \$100 as FAPI in respect of the CFA. Under the existing FAPI rules, Canco would be entitled to a \$100 FAT deduction (\$25 multiplied by an RTF of 4), which fully offsets the FAPI.

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When the CFA repatriates its $75 of after-tax earnings to Canco, Canco reports $75 of foreign dividend income but should be entitled to a fully offsetting paragraph 113(1)(b) deduction of $75, which is the $25 of underlying foreign tax multiplied by 3 (that is, the RTF minus 1). Foreign withholding tax is ignored. The $75 is added to Canco's GRIP.

Under the proposed rules, Canco still reports $100 of FAPI. Its FAT deduction becomes only $47.50—that is, $25 of foreign income tax multiplied by the new RTF of 1.9. This means that Canco will have a net inclusion in income of $52.50 with respect to the FAPI subject to the CCPC refundable tax regime. When Canco receives the $75 of dividend from the CFA, it reports the $75 as income, but this amount should be offset by a $22.50 deduction (that is, $25 multiplied by 0.9) under paragraph 113(1)(b) and a $52.50 deduction under subsection 91(5). Under the proposed regime, the $22.50 paragraph 113(1)(b) deduction is added to the CDA, which Canco can distribute tax-free as a capital dividend. The net result is close to integration, depending on the province.

An Old Integration Problem

However, integration would still fall significantly short if the CFA were to sell the rental property for a capital gain. This is primarily because the non-taxable portion of a CFA's capital gain on property that is not excluded property is added to the CFA's exempt surplus. This exempt surplus, although not taxable in the hands of Canco, would still be subject to personal tax as an eligible dividend when paid out to the individual shareholders. In other words, the non-taxable portion of a capital gain is subject to tax as a dividend. The same issue is exacerbated where individuals own the shares of the CFA directly and the CFA recognizes a capital gain on non-excluded properties. On the repatriation of the funds from the CFA to the individual, the individual must—because there is no CDA mechanism—recognize all of the after-foreign-tax earnings as ordinary income. Even if the individual repatriates the funds via a redemption, the result is still far from integration because the addition to the ACB on the CFA shares does not reflect the non-taxable portion of the CFA's capital gain.

The lack of integration for FAPI capital gains is not a new problem. However, given the government's announced intention to address integration by amending the CDA formula, it would be a missed opportunity for the government if it does not address capital gains on the sale of non-excluded property by CFAs at the same time. Below are our recommendations for addressing integration.

Recommendations

CFA owned by a CCPC. The budget proposes that a CCPC should include an amount equal to the paragraph 113(1)(b) deduction in its CDA. We recommend the additional inclusion of the subsection 113(1)(a) deduction in the CDA, but only for the portion of exempt surplus from paragraph (a) of the definition of "exempt earnings" in regulation 5907(1). This additional change would preserve the non-taxable treatment of the non-taxable portion of the capital gain earned by the CFA, all the way through to the individual shareholders of the CCPC.

If the shares of the CFA were to be disposed of by the CCPC (instead of through dividend repatriation from the CFA), the CCPC could elect under section 93 to recharacterize the gain as a dividend from the CFA. The CDA inclusion from the resulting paragraph 113(1)(b) deduction and (if our recommendation is adopted) from the paragraph 113(1)(a) deduction derived from the non-taxable portion of the FAPI capital gain should achieve the same integration result.

CFA owned by an individual. Because an individual does not have the benefit of a CDA system, we believe that the most appropriate solution for individuals who own shares of CFAs would be to modify the section 92 ACB rules. Currently, paragraph 92(1)(a) adds FAPI to the ACB of the shareholders' shares of the CFA. Accordingly, only the taxable portion of a FAPI capital gain is added to the ACB. Our recommendation would be to modify paragraph 92(1)(a) so that it also includes the non-taxable portion of a FAPI capital gain where the CFA is owned directly by an individual.

A corresponding amendment would also be required for paragraph 92(1)(b) in this situation. Currently, paragraph 92(1)(b) provides a reduction in the ACB of CFA shares based on the FAT deducted in subsection 91(4). As explained above, the subsection 91(4) deduction is the amount of FAT multiplied by the RTF (currently 1.9 for individuals). If paragraph 92(1)(a) were amended to reflect the entire FAPI capital gain (taxable and non-taxable portions), paragraph 92(1)(b) should be amended to reflect the actual FAT paid without gross-up.

An individual with a CFA that earns foreign capital gains of $100 and paid foreign tax of $25 would report FAPI of $50 and a subsection 91(4) deduction of $47.50. With our recommendation, the individual would have a net ACB addition of $75—that is, the paragraph 92(1)(a) amount of $100, which reflects both the taxable and non-taxable portions of the gain, and the paragraph 92(1)(b) deduction of $25, which reflects the amount of foreign taxes paid. This is consistent with the CFA's $75 of after-tax funds from the capital gain. If the CFA repatriates this by way of a dividend, subsection 91(5) (as allowed by regulation 5900(3)) would provide an offsetting deduction of $75, given that the individual should not have to pay any additional Canadian tax beyond the FAPI. If the individual were to dispose of the CFA shares, including by way of a share redemption, the net ACB addition of $75 from section 92 should equal the cash proceeds. Accordingly, it should also result in no further capital gains and tax. A provision may be needed to prevent double dipping in tax benefits such as the non-taxation of dividends received from subsection 91(5) and a subsequent realization of capital losses (owing to a higher ACB). This could be done by modifying the stop-loss rules in subsection 112(3).

Our recommended amendment of section 92 for individuals may also apply to other types of FAPI, such as rental income, and should result in better integration.

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Quebec Mandatory Disclosure of a Specified Transaction

On February 4, 2022, the federal government released draft legislative proposals to introduce new requirements to report notifiable transactions. If these proposals are adopted, taxpayers, promoters, and advisers will have to disclose to the CRA, on a timely basis, information on avoidance transactions and other transactions of interest. In May 2019, the Quebec government had introduced similar requirements; they came into force on March 17, 2021, upon the publication of the "determined transactions." In this context, we thought it would be useful to better understand the Quebec rules. As will be evident, the Quebec rules—while they address some of the concerns that the Joint Committee on Taxation of the Canadian Bar Association and CPA Canada raised about the federal proposals in their letter of April 5, 2022—may produce uncertainties similar to those facing the federal proposals. This extensive and far-reaching piece of legislation puts extraordinary discretionary powers in the hands of Revenu Québec (RQ) and will significantly alter the day-to-day tax practice of Quebec practitioners.

Under the Quebec Taxation Act (QTA), a taxpayer who carries out a transaction whose facts are significantly similar in form and substance to those of a "transaction determined by the Minister and published in the *Gazette officielle du Québec*" (section 1079.8.1 of the QTA) is required to disclose such a "specified transaction" to RQ not later than 60 days after the occurrence of a specific event in the series of transactions described in the regulation (sections 1079.8.6.2 and 1079.8.10.1 of the QTA). A member of a partnership that carries out such a transaction also has this obligation. As of this writing (June 15, 2022), the list of "determined transactions" includes the following:

- the avoidance of the deemed disposal of trust property in order to defer the 21-year disposition (similar to one of the federal "notifiable transactions"),
- payment to a non-treaty country,
- multiplication of the capital gains deduction, and
- tax-attributes trading.

The regulation defines each "determined transaction" (for details, see Jérémie Caillé and Raphael Barchichat, "Impact of Quebec's Required Planning Disclosure Reaches Beyond the Province" (2021) 11:2 *Canadian Tax Focus* 7-8). For failing to disclose such a transaction on time, a taxpayer "may" incur a penalty of $10,000, plus $1,000 per day up to a total of $100,000 (section 1079.8.13.1 of the QTA), along with a suspension and an extension of the limitation period (section 1079.8.15 of the QTA). If the form is never filed and the Quebec general anti-avoidance rule (QC GAAR) is found to apply to the "specified transaction," the taxpayer may suffer an additional penalty of 50 percent of the tax benefit denied and be forbidden to contract with the Quebec government and its related entities for five years (section 1079.13.1 of the QTA and section 21.1.1 of the Act Respecting Contracting by Public Bodies [CPB]).

To provide more clarity, RQ publishes on its website a list of "included transactions" that are examples of "determined transactions." In providing these examples, RQ refers to the tax planning (1) in tax cases listed by name (*Laplante*, 2008 TCC 335; *Gervais*, 2018 FCA 3; *Birchcliff Energy Ltd.*, 2019 FCA 151; and *Deans Knight Income Corporation*, 2021 FCA 160), and (2) in CRA administrative positions listed by document number (CRA document nos. 2017-0693321C6, June 13, 2017; and 2016-0669301C6, November 29, 2016, on the subject of 21-year planning). In addition to describing "included transactions," the website describes an "excluded transaction," which either "does not fall under the general definition of a determined transaction or is excluded from its application." If a transaction appears on the list of "excluded transactions," one need not disclose it even though the "form and substance" of its facts are similar to those of a determined transaction. An example of an "excluded transaction" is the transfer of property by an estate to a testamentary trust in certain circumstances, or a transfer of tax attributes between related taxpayers.

The Quebec legislation does not include any "de minimis" rule, except for payments to a non-treaty country that should be at least $1 million for the year, and, unlike the federal proposal (subsection 237.4(8)), this legislation does not prescribe different penalty levels according to the taxpayer's asset value.

At the latest annual conference of l'Association de planification fiscale et financière (APFF), held in October 2021, RQ made an administrative concession (orally; no written version of this round table was published) regarding multiple reporting. When a trust transfers property on a rollover basis to another trust, the law requires both trusts, in certain circumstances, to disclose the transaction or the series of transactions. In such a case, RQ accepts that the disclosure by one of the trusts would avoid penalties for both. However, if neither trust files an information return on a timely basis, they will both be subject to a penalty.

An adviser or a promoter who commercializes or promotes a similar transaction is required to file a disclosure of his or her own not later than 60 days after having commercialized or promoted the transaction for the first time (sections 1079.8.6.3 and 1079.8.10.2 of the QTA). Late-filing by the adviser or promoter may incur the same monetary penalty as for the taxpayer. In addition, the adviser or promoter may face a penalty of 100 percent of the fees received, or entitled to be received, for the implementation of any transaction so commercialized or promoted (section 1079.8.13.2 of the QTA). If the client doesn't file the prescribed form and if the QC GAAR applies to the transaction in question, the promoter could also become ineligible to contract with the Quebec government and its entities for a five-year period (section 21.1.1 of the CPB).

For Quebec purposes, an adviser or promoter is someone who "commercializes" or "promotes" a transaction similar to a "determined transaction" (section 1079.8.6.3 of the QTA). This definition seems narrower than the definition in the federal proposals (subsection 237.4(1)). An RQ official said at the 2021 APFF conference that a corporate lawyer who is dealing only with the corporate legal work of a tax plan has no disclosure obligation unless he or she encourages, favours, or supports the growth of a tax-planning idea or maintains interest in it. The official added that reproducing a corporate structure for the benefit of another client could be considered "commercialization."

The most worrying aspect of the Quebec rules relates to tax certainty. The detection of aggressive tax planning and the identification of aggressive taxpayers may be the prime objectives of these rules, but many non-aggressive tax plans are caught by them and required to be disclosed. For example, RQ said at the 2021 APFF conference that a trust should disclose the distribution of taxable capital gains to a beneficiary by the issuance of a promissory note if the beneficiary claims his or her capital gain exemption (CGE) and if the proceeds of disposition of the shares are kept in the trust account to generate further income in the future—income that may be paid to other beneficiaries, including a shareholder of the corporation sold. This could be considered an indirect transfer of the proceeds of disposition of the shares, exempted by the CGE, to a shareholder of the corporation. Another example would be a corporation's acquisition of control of an active business corporation for $50 million, an acquisition that involves a substantial goodwill value and a non-capital loss of $500,000 that will be used by the merged corporations to reduce their future taxable income. This could qualify as tax-attributes trading that should be disclosed. In that case, RQ's goal is to ensure the upholding of the acquisition-of-control rules and to improve its knowledge of the tax environment, so as to better suggest legislative amendments.

Although we share the tax policy objectives of this new Quebec regime and appreciate RQ's efforts to inform taxpayers about the regime, we have two concerns about the broad scope of these rules. First, they catch many non-aggressive, day-to-day transactions while imposing short filing deadlines and significant monetary consequences on taxpayers and their advisers. Second, they confer broad discretionary powers on RQ, which can effectively decide what should be disclosed and can establish the circumstances in which the penalty should apply. Up to now, RQ has exercised this discretion on its website and via policy statements in tax conferences, which have been provided in spoken rather than published form. These unpublished administrative concessions could be misinterpreted, modified, or cancelled at any time. All of this leaves taxpayers and their advisers in an uncomfortable position, facing increased uncertainty and higher compliance costs. This discomfort seems unjustified in a non-aggressive tax-planning context. The Quebec government should more clearly delineate the "determined transactions" and establish a solid legislative framework that everyone, including practitioners from across Canada, can rely on. Let's hope that Parliament will be more specific in its new legislation regarding notifiable transactions.

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Employee Ownership Trusts: A New Canadian Succession Option on the Horizon

The 2022 federal budget included a commitment to introduce employee ownership trusts to Canada. Though no specific timeline has been provided, it is expected that Finance will release draft legislation in the near future.

Finance is likely drawing on the US and UK experiences of employee ownership trusts to develop the applicable policy and legislative framework, and the experiences of these countries can give us some insight into what we can expect here in Canada. The US model, known as the employee stock ownership plan (US-ESOP), is more than 50 years old. The National Center for Employee Ownership notes that there are currently almost 6,500 US-ESOPs, with 14 million employees sharing in US$1.6 trillion in wealth. The United Kingdom introduced its framework for the employee ownership trust (UK-EOT) in 2014. According to the United Kingdom's Employee Ownership Association, the UK legislation spurred significant growth, with UK-EOTs increasing in number from 17 in 2014 to approximately 700 today.

In general terms, under a US-ESOP, employees receive individual allocations of shares in trust that are repurchased when they leave or retire. By contrast, employees in a UK-EOT are paid annual bonuses out of the company's profits (similar to profit-sharing models), some of which they can receive tax-free.

In the discussion that follows, "underlying corporation" is the corporation whose shares become owned by the employee ownership trust and is the employer of the employees; "employer shares" are shares of the underlying corporation; and "vendor employer" is the current shareholder of the underlying corporation who sells their shares to the employee ownership trust.

Trust Considerations

For employee ownership trusts to be effective, we expect that the draft legislation will need to permit the trust to

- borrow money to purchase employer shares on behalf of employee beneficiaries;
- invest exclusively in employer shares;
- hold employer shares indefinitely, without causing tax events until beneficiary employees receive cash proceeds from the shares; and
- not impair the vendor employer's tax result by the sale of the vendor employer's shares to the employee ownership trust instead of to (as is usual) a third party.

These core features would ensure that the vendor employer, the beneficiary employees, the underlying company, and the lenders have certainty about their commercial and tax result.

Tax Considerations for Beneficiary Employees

For beneficiary employees, the tax treatment when shares are granted (or the entitlement arises) and when shares are sold (or the entitlement ceases) is crucial. The hope is that, as with US-ESOPs (or Canadian CCPC stock option plans), employees will be taxed when they sell the shares (or interest therein) that they have accumulated over the course of their employment, rather than when shares are allocated. Taxing employees when they do not have cash to pay the tax would make an employee ownership trust a non-starter for most employees.

Another key tax consideration is whether and when shares held by the trust are taxed—in particular, whether the trust will be subject to the 21-year deemed disposition rule under subsection 104(4) of the ITA. The 21-year rule could create a significant tax liability for employees, the trust, or the company before cash proceeds are available, and it may force a premature sale of the company to a third party. There is precedent for exempting certain trusts from the 21-year rule—for example, RRSP trusts or unit trusts (including mutual fund trusts). Exemption from the 21-year rule would not necessarily result in an indefinite tax deferral, so long as the government uses a share-based model such as the US-ESOP. Under this approach, employees would be taxed when they cease their employment.

One would hope that the increase in value to the employee would receive capital gains treatment (and, if otherwise applicable, entitlement to the lifetime capital gains exemption), but that remains unclear. Depending on what approach is taken to these trusts, Finance may permit the tax to be deferred and the value transferred to an employee's RRSP, which may or may not depend on the employee having sufficient RRSP contribution room.

Tax Considerations for Vendor Employers

Vendor employers and their advisers will, at a minimum, be looking to ensure that these transactions do not prejudice their tax outcome by comparison with a third-party sale. In particular, they will want to ensure that sale proceeds receive capital gains treatment, and that those who qualify maintain access to the lifetime capital gains exemption.

Among the hurdles that vendor employers face are that they (1) often provide a significant portion of the financing for these transactions, (2) typically receive less cash at closing, and (3) can have a tax liability due before they receive cash proceeds. Partly in recognition of these issues, the United States and the United Kingdom have introduced tax incentives to encourage sales to employee ownership trusts. Experts in both countries cite these incentives as a key to encouraging growth in the sector. In certain circumstances, the United States allows qualifying vendor employers that sell to US-ESOPs to defer capital gains on reinvested proceeds. The United Kingdom exempts from capital gains tax vendor employers who sell to UK-EOTs, so long as the UK-EOT owns at least 51 percent of the company as part of the initial transaction.

We can only speculate as to whether Finance will introduce tax incentives similar to the US or UK incentives, but there are many options available. Finance could consider introducing a new exemption or deferral, or could amend existing provisions by increasing the lifetime capital gains exemption applicable to these transactions, lengthening the capital gains reserve, or enhancing the rollover rules applicable to small business investments. The 2022 federal budget briefly mentioned, for example, the possibility of broadening the application of the small business investment rollover. Whatever approach or combination of approaches (if any) is taken, vendor employers and their advisers will be paying close attention.

Tax Considerations for the Company Post-Transaction

Most employee ownership trust conversions are leveraged, and in the United States and the United Kingdom, that debt ultimately becomes a liability of the operating company. As a result, it is important for Finance to ensure that transaction debt used by the trust can be repaid with income from the operating company, and that the applicable interest is deductible.

In addition, Finance might consider additional tax incentives for companies owned by employee ownership trusts. For example, US-ESOP-owned companies have significant corporate tax incentives. A blanket corporate income tax exemption is unlikely, but other options could be considered—a time-limited tax holiday that coincides with the repayment (or partial repayment) of the transaction's loan, or perhaps the application of the small business tax rate during that period, regardless of the nature and taxable capital of the corporation.

Conclusion

The 2022 federal budget's commitment to introducing employee ownership trusts presents new opportunities for tax professionals and their clients. Given the wave of business transitions that is expected in Canada as baby boomers retire, these trusts would expand the available exit alternatives. In addition, employee ownership trusts offer significant social benefits by keeping businesses local, improving employee retention, and increasing the wealth of individual employee owners. It is hoped that the draft legislation, when announced, will include the necessary core tax features to ensure that these trusts are widely adopted in Canada, as they have been in the United States and the United Kingdom.

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GAAR Amendment Targets Tax Attributes Before They Are Used

In recent cases, the courts have confirmed that the creation of tax attributes that have not yet resulted in any tax savings, but may do so in the future, does not give rise to a "tax benefit" for the purposes of GAAR in subsection 245(2); as a result, it is premature to deny such attributes by using GAAR. These recent cases include *1245989 Alberta Ltd. v. Canada (Attorney General)*, 2018 FCA 114; *Rogers Enterprises (2015) Inc. v. The Queen*, 2020 TCC 92; and *Gladwin Realty Corporation v. Canada*, 2020 FCA 142. The 2022 budget describes the federal government's view of these cases:

> The limitation of the GAAR to circumstances where a tax attribute has been utilized runs counter to the policy underlying the GAAR and the determination rules. This limitation also reduces certainty for both taxpayers and the CRA, as they could have to wait several additional years to confirm the tax consequences of a transaction.

The budget proposes to amend the definitions of "tax benefit" and "tax consequences" in subsection 245(1) to provide that GAAR can apply to transactions that affect tax attributes that have not yet become relevant to the computation of tax. However, these proposals leave unanswered certain key questions about how they will operate.

When GAAR was introduced in 1988, "tax benefit" was broadly defined, in subsection 245(1), as "a reduction, avoidance or deferral of tax or other amount payable under this Act or an increase in a refund of tax or other amount under this Act." This definition was expanded in 2005 to include tax benefits in the tax treaty context, but otherwise the definition has remained substantially the same for over 30 years. The definition of "tax consequences" in subsection 245(1), unchanged since 1988, refers to "the amount of income, taxable income, or taxable income earned in Canada of, tax or other amount payable by or refundable to the person under this Act, or any other amount that is relevant for the purposes of computing that amount."

The budget proposes to amend the definition of "tax benefit" so that it also includes a "reduction, increase or preservation of an amount that could at a subsequent time" be relevant for the purpose of computing a "reduction, avoidance or deferral of tax or other amount payable" under the Act or a tax treaty, including a result with that effect. The budget also proposes to amend the definition of "tax consequences" in a similar manner. Within the ambit of the amended "tax benefit" definition are concepts such as paid-up capital, capital dividend account, adjusted cost base, safe income, surplus accounts in respect of a foreign affiliate, general rate income pool, and eligible and non-eligible refundable dividend tax on hand.

Importantly, the abuse analysis involved in an application of GAAR could be significantly different for a case in which a tax attribute is unused than it would be for a case in which the use of an attribute has resulted in an actual reduction of tax. The abuse analysis requires (among other things) a factual analysis to determine whether the avoidance transaction at issue is consistent with—or frustrates—the object, spirit, and purpose of relevant provisions. The use of a particular tax attribute could be abusive in one context and non-abusive in another context, even if the attribute in both situations is created through the use of identical mechanics, and in equivalent circumstances. If the tax attribute in question has not been used, are provisions that potentially could be frustrated—but only if the "bad use" were to occur in the future—relevant? Can a tax attribute be reduced on the basis of the potential for, rather than the existence of, future abusive tax avoidance?

A GAAR analysis presumes that the transactions under review comply with the technical provisions of the Act. How can technical provisions be frustrated or circumvented if they have not yet been engaged or avoided? Consider a variation of the circumstances in *Canada v. Deans Knight Income Corporation*, 2021 FCA 160—that is, the circumstances at a time after transactions to avoid an acquisition of de jure control have been entered into but before any non-capital losses have been utilized. Can transactions frustrate subsection 111(5) if non-capital losses are not yet utilized? Could the reasonable tax consequences include a reduction of the available non-capital losses balance if such losses might be utilized by "a same or similar" business? Is the possibility of carrying on a same or similar business enough, or must that be probable or even certain? What if there are reasonable arguments that the "re-started" corporation carries on a same or similar business, but, owing to the technical subsection 111(5) risk, the corporation structured the transactions to provide additional comfort on the availability of the non-capital losses? In our view, it is far from certain that tax attributes can be successfully eliminated through the new proposals unless it is impossible to articulate a credible non-abusive future use of those attributes, and it may well be that GAAR will generally continue to apply only where actual tax benefits have arisen from the utilization of the tax attributes in question, in which case the amendments may have limited practical application.

Tax dispute resolution and litigation in the GAAR context can be complex and costly. Although GAAR disputes generally occur after a taxpayer has realized an economic advantage by using a tax attribute, a tax dispute involving an unused tax attribute represents an unusual timing mismatch between the realized economic benefits associated with the tax attributes and the costs of funding a GAAR dispute. However, a dispute over an unused tax attribute may be preferred by large corporations because, as far as tax consequences are concerned, it does not appear that these corporations will have to pay half of the potential savings, given that the amount of tax in dispute in respect of an unused tax attribute should be nil for the purposes of subsection 225.1(7).

Although, in some instances, a tax dispute over an unused tax attribute may be preferable to a dispute over a realized tax attribute, a taxpayer has no means of compelling the minister of national revenue to issue a notice of determination in respect of unused tax attributes, and taxpayers cannot self-assess under GAAR. Furthermore, if the CRA audits an unused tax attribute and concludes that its creation is not abusive, it remains to be seen whether taxpayers may be able to persuade the minister to issue a favourable GAAR notice of determination to prevent a duplicative tax audit in the future.

Nevertheless, the proposed GAAR amendments may introduce additional flexibility for a taxpayer when it comes to reaching a principled settlement of a GAAR dispute with the CRA. For example, there are situations where the CRA may consider the creation of certain tax attributes to be abusive, but the principled settlement options are limited. In CRA document no. 2020-0860991C6 (October 27, 2020), for example, the CRA considered certain transactions that allegedly resulted in an "undue" ACB increase and an abuse of subsection 55(2). In that situation, the application of the tax consequences dictated by subsection 55(2) generally would not be attractive (that is, a deemed capital gain), but up to now there has been no principled basis on which the taxpayer and the CRA could agree to reduce the unused basis. With the amended definitions of "tax benefit" and "tax consequences," there may now be a mechanism for reducing the amount of certain tax attributes, in a way that not only satisfies the CRA's concern about the potential for abuse but also is tolerable to taxpayers.

To summarize, it remains to be seen how an abuse analysis will be altered where tax attributes have only been created, not used, particularly if there are credible non-abusive future uses of the attributes. In any event, the proposals should increase the scope for resolving GAAR disputes on a more timely basis, and, from that perspective, they are welcome.

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Shareholder Remuneration: Bonus, Dividend, or a Pipeline?

Remuneration planning for an owner-manager has historically focused on optimizing the mix between bonuses (employment income) and dividends. With the advent of eligible dividends, keeping corporate income within the small business deduction (SBD) limits has become less of a priority than it once was. However, other important considerations remain—for example, CPP; provincial payroll taxes; and the ability to access deductions, such as child-care or moving expenses, and to generate earned income for RRSP or IPP planning.

In recent years, the "pipeline" strategy for remunerating a shareholder has become more popular, owing to the growing tax rate difference between capital gains and dividends. It has evolved, from a strategy used only to extract significant equity accumulated over many years, to a strategy considered when a smaller, one-time cash requirement arises, or even considered as an alternative to annual remuneration by way of salary or dividends.

The question then becomes whether a pipeline is an obvious strategy for remuneration, or whether salaries, or even dividends, still merit consideration. The question is not trivial. Quantitatively, overall shareholder costs (personal and corporate tax costs) and secondary factors, such as professional fees and the risk of CRA audits, are important considerations. The broader disclosure rules that have been proposed for reportable transactions, which will pose a much greater risk of capturing a pipeline (although at least one hallmark will still be required—see draft legislation released on February 4, 2022), may affect shareholder risk tolerances, heightening the risk that a CRA audit may subject the transaction to scrutiny under GAAR. All of these factors further muddy the remuneration dilemma.

This is to be a two-part article. In this first part, we discuss the tax cost differences among remuneration scenarios, comparing bonus, dividend, and pipeline strategies of remuneration, from active business income either eligible or ineligible for the SBD. Our objective is not only to determine which approach generates the lowest tax (we already know that the pipeline strategy reduces the overall tax cost) but also to quantify the benefit so as to clarify whether the professional fees and risk of CRA challenge involved in the pipeline strategy are warranted.

The second part of this article, to be published in a subsequent issue of this newsletter, will address further practical aspects relevant to deciding among these different remuneration options.

Salary, Dividend, or Pipeline: Top Tax Rate?

We first compare the overall results of the three remuneration scenarios in the case of a top-rate taxpayer that wants to access additional funds from their corporation—assuming that additional salary will be reasonable (and therefore deductible), and that dividends paid from income ineligible for the SBD will be designated as eligible dividends to a maximum of 72 percent (the GRIP addition) of this income. The tax rates used in our comparison reflect 2021 rates for a calendar fiscal year-end of the corporation. The results for all provinces and territories are set out in table 1.

For the readers of this article, the over- or underintegration in the jurisdiction where they practise will likely be unsurprising. Similarly, the markedly greater value of the pipeline strategy when the underlying corporate income has been subjected to the much lower tax rate applicable to income eligible for the SBD is simply a function of the higher tax cost incurred on the receipt of non-eligible dividends.

For the active owner-manager of a successful business, who has income that exceeds the amount eligible for the SBD, the benefit of a pipeline rather than a simple salary increase may be surprisingly small, ranging from a high of 7.36 percent in Ontario to a low of only 1.26 percent in Nunavut. For the owner-manager who is considering the withdrawal of an extra $500,000, the Ontario tax benefit of $36,800 must be weighed against the added professional fees, and the risk of CRA scrutiny. When the alternative is non-eligible dividends, the benefit of $89,150 seems considerably more persuasive.

Salary, Dividend, or Pipeline: Annual Remuneration

As pipeline planning has become more common, some have considered it as a substitute that will simply cover the ongoing annual drawing of income. Here, the analysis becomes more complex, and so we have made some simplifying assumptions. We first assume that the business generates income of $250,000 before tax, which will be withdrawn for personal spending. We have analyzed both income eligible for the SBD and high-rate active business income. The latter is relevant not only when significant income is retained in the corporation, but also when access to the SBD is restricted (for example, because of the specified partnership income or specified corporate income rules or because of taxable capital).

Personal tax is calculated on the basis of a single individual who is eligible only for the basic personal amount. CPP, EI, and other payroll-related costs are not considered. For high-rate active business income, up to $180,000 of dividends (the 72 percent GRIP addition) are presumed to be eligible dividends. To calculate the personal tax costs, the basic Canadian income tax calculator at the taxtips.ca website was used, and the authors are grateful to the website owners for agreeing to this usage.

The results can be seen in table 2. Over the years, professionals have invested considerable time and effort in assessing the salary-dividend mix. However, for these middle-income business owners, the tax difference between salaries and dividends is considerably less. In most jurisdictions, furthermore, these individuals incur a greater tax cost by taking dividends

Table 1 Benefit (Cost) of Overintegration/Underintegration, Top Marginal Rate Taxpayer

	Dividends versus salary		Pipeline versus salary		Pipeline versus dividends	
Province/territory	SBD	No SBD	SBD	No SBD	SBD	No SBD
			percent			
British Columbia	−1.01	−0.30	18.69	6.97	19.70	7.27
Alberta	−0.66	−1.82	15.64	6.52	16.30	8.34
Saskatchewan	0.02	−1.26	16.89	3.16	16.87	4.43
Manitoba	−1.07	−4.27	18.47	5.00	19.54	9.27
Ontario	−0.59	−2.01	17.83	7.36	18.42	9.37
Quebec	−1.15	−2.78	17.57	7.22	18.72	10.00
New Brunswick	−0.46	0.51	18.21	5.38	18.67	4.87
Nova Scotia	−0.23	−4.52	18.61	5.83	18.83	10.35
Prince Edward Island	−0.76	−3.24	17.51	2.65	18.27	5.89
Newfoundland and Labrador	0.06	−8.53	16.73	3.35	16.67	11.87
Northwest Territories	3.28	−0.40	15.11	3.26	11.83	3.66
Nunavut	−0.76	−6.70	12.92	1.26	13.68	7.95
Yukon	−1.08	−0.27	17.16	3.48	18.24	3.75

SBD = small business deduction.

Table 2 Benefit (Cost) of Pipeline, Taxpayer with Annual Income of $250,000

Province/territory	Small business deduction: Dividends versus salary	Small business deduction: Pipeline versus salary	Small business deduction: Pipeline versus dividends	No small business deduction: Dividends versus salary	No small business deduction: Pipeline versus salary	No small business deduction: Pipeline versus dividends
			dollars			
British Columbia	(2,523)	36,227	38,750	(749)	3,411	4,160
Alberta	(1,578)	30,639	32,217	(4,414)	5,941	10,355
Saskatchewan	37	36,834	36,797	(3,165)	123	3,288
Manitoba	(2,684)	41,121	43,805	(10,679)	5,512	16,191
Ontario	(1,466)	36,898	38,364	(5,035)	8,497	13,532
Quebec	(2,885)	39,443	42,328	(6,982)	11,947	18,929
New Brunswick	(1,272)	38,574	39,846	1,275	3,614	2,339
Nova Scotia	(693)	39,867	40,560	(11,304)	5,086	16,390
Prince Edward Island	(1,896)	38,552	40,448	(8,302)	(1,230)	7,072
Newfoundland and Labrador	162	35,315	35,153	(21,326)	(860)	20,466
Northwest Territories	8,194	31,945	23,751	(2,287)	257	2,544
Nunavut	(1,885)	25,939	27,824	(16,737)	(5,417)	11,320
Yukon	(2,446)	34,216	36,662	(5,172)	(2,984)	2,188

than by taking salaries, especially when they are taken from income not eligible for the SBD.

At these income levels, however, the impact of the pipeline is markedly greater, because the 50 percent inclusion rate avoids the higher marginal tax brackets that would apply on either a salary or a taxable dividend. It bears noting that the total income taxes payable on a salary of $250,000 range from just over $80,000 (Nunavut) to slightly under $104,000 (Quebec): the pipeline reduces the income tax cost at this income level by over one-third in most jurisdictions in Canada. Of course, the added professional fees and the potential CRA scrutiny must also be considered.

Over the years, the CRA and the Department of Finance have regularly expressed concerns that the inter vivos pipeline allows undue tax avoidance. Their concerns have only grown as the pipeline has become better known, and more common. Given the potential for losing one-third of the tax revenues from this sector of the economy, the possibility of legislative change seems quite real.

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Problematic Post-Butterfly Transferee Corporation Dispositions Involving Paragraph 55(3.1)(c): Part II

This is the second part of a two-part article relating to a paragraph 55(3)(b) butterfly. In our previous article ("Problematic Post-Butterfly Transferee Corporation Dispositions Involving Paragraph 55(3.1)(c): Part I" (2022) 22:2 *Tax for the Owner-Manager* 3-5), we provided a technical overview of certain issues associated with the "continuity of interest" rule, which is one of the four "butterfly denial" rules contemplated by paragraph 55(3.1)(c). In this article, we outline some practical challenges in applying the continuity-of-interest rule.

The underlying purpose of paragraph 55(3.1)(c) is to prevent a butterfly when a group of companies engage in a pre-arranged series of transactions that involves the transfer of assets from the distributing company (DC) to one or more transferee companies (TCs), and their intention from the outset is to have the TC immediately sell those assets to an unrelated third party within a short period of time so that the shareholder can "cash out" or otherwise gain some type of benefit.

The complexity of paragraph 55(3.1)(c) creates certain practical issues.

Let us consider a situation where Parent owns a company, Parentco, whose assets consist solely of a portfolio of public company shares. After Parent passes away, the shares of Parentco are left to the three adult children (Sibling 1, Sibling 2, and Sibling 3). Unfortunately, the siblings do not get along, and they desire to split up the assets of Parentco into three separate holding companies and go their separate ways. This can be accomplished with a paragraph 55(3)(b) butterfly. However, it is not clear what is permitted to occur subsequent to the butterfly, given the continuity-of-interest rule.

Change in Investment Strategy

It is conceivable that siblings 1 and 2 may want to pursue the same investment strategy as Parentco, but Sibling 3 may want to pursue a different strategy. Thus, Sibling 3 may cause his

TC to dispose of a significant amount of the butterflied securities in order to "rebalance" the portfolio and meet his strategic objectives. Logically, rebalancing should not be prohibited, because Sibling 3 has legitimate investment reasons for doing so. There is a carve-out from the continuity-of-interest rule for transactions undertaken in the "ordinary course of business," pursuant to subclause 55(3.1)(c)(i)(A)(I). However, the phrase "ordinary course of business" is not defined in the Act, and there is no specific guidance on how to apply it. As discussed in part I of this article, there is a lot of case law on this point. The following two cases were discussed in part I and are revisited here because they are relevant to the interpretation of this phrase.

In *Loman Warehousing Ltd. v. The Queen*, 1999 CanLII 376 (TCC); aff'd 2000 CanLII 16340 (FCA), at paragraph 25 (TCC), it was held that "a determination of just what the taxpayer's 'ordinary business' is" requires consideration of the ways in which the company "as an ordinary part of its business operations earns its income."

In *Re Bradford Roofing Pty Ltd (in liq) & Companies Act*, [1966] 1 NSWR 674 (SC), the court held that

> the transaction must be one of the ordinary day-to-day business activities, having no unusual or special features, and being such a manager of a business might be reasonably expected to be permitted to carry out on his own initiative without making prior reference back or subsequent report to his superior authorities.

It is unclear whether dispositions of butterflied securities by a TC pursuant to a predetermined investment strategy are dispositions in the "ordinary course of business." If they are not, the continuity-of-interest rule would not be met, and (assuming that no other carve-out applies) the butterfly would be offside.

It is also worth noting that the carve-out uses the phrase "ordinary course of business" rather than "ordinary course of *the* business" (emphasis added). In *British Columbia Telephone Company v. MNR*, 86 DTC 1286 (TCC), a point of discussion was whether "ordinary course of business" referred to business in a general sense while "ordinary course of the business" referred to the specific business of the taxpayer. Because subclause 55(3.1)(c)(i)(A)(I) contains the wording "ordinary course of business" and not "ordinary course of the business," it could be argued that this clause refers to trading in general and not necessarily to the past behaviour of the taxpayer.

If siblings 1 and 2 are following the same strategy as Parentco, it seems reasonable that their TCs are permitted to make dispositions without violating the continuity-of-interest rule, because they are following an established pattern. However, if Sibling 3's investment strategy is different from Parentco's, it is less clear that his predetermined strategy satisfies the "ordinary course of business" requirement, because there is no precedent to rely on. Because no specific guidance on this matter exists, the CRA may take the position that a disposition of securities caused by a different investment strategy would be a violation of the continuity-of-interest rule. Because of this uncertainty, it is risky to rely on this carve-out for protection from the continuity-of-interest rule.

There is a further carve-out from the above continuity-of-interest rule for transactions that do not exceed 10 percent of the butterflied property pursuant to clause 55(3.1)(c)(ii)(B). However, although this seems simple, it is also fraught with complications. The 10 percent rule applies at any time after the butterfly and before the end of the series, meaning that if Sibling 3 wants to dispose of butterflied property, he must examine the FMV of the property held by his TC at any point in time between the butterfly and the disposition date. Any fluctuation in value that at any point in time (even if only for a moment) causes the disposed property to exceed the 10 percent threshold could put the butterfly offside. Note that if the underlying property is denominated in a foreign currency, a fluctuation in foreign exchange rates could cause the disposed property to exceed the 10 percent threshold. Thus, despite the fact that a 10 percent level is allowed, a cushion must be factored in to allow for fluctuations in value, and therefore, for practical purposes, the threshold at which Sibling 3 is allowed to dispose of property is much lower than 10 percent.

Change in Life Circumstances

Nobody can predict the future, and even if each sibling had every intention of keeping the butterflied securities invested in their TCs, unforeseen circumstances could necessitate disposing of the butterflied portfolio or significantly changing the investment strategy. For example, suppose that nine months after the butterfly, Sibling 1 lost his job, Sibling 2 got divorced, and Sibling 3 retired.

As discussed in part I of this article, the Supreme Court of Canada in *Canada Trustco Mortgage Co.* (2005 SCC 54, at paragraph 25) stated that "a series of transactions involves a number of transactions that are 'pre-ordained in order to produce a given result,' with 'no practical likelihood that the pre-planned events would not take place in the order ordained.'" Subsection 248(10) expands this test to include transactions that are outside the common-law preordained series. Also, as illustrated by *MIL (Investments) SA v. The Queen*, 2006 TCC 460; aff'd 2007 FCA 236, an unpredictable intervening event, such as the death of a key director and CEO, that prompts the sale of the company could disconnect the sale from previously executed transactions for the purposes of establishing a "series."

In our example, the above-mentioned circumstances were clearly unforeseen, and if, because of these circumstances, any of the siblings decided that their TC should rebalance or liquidate its portfolio, it seems reasonable to expect that the dispositions would not be part of the same series of transactions as the butterfly. As discussed above, however, there is no specific guidance on when a series ends. Therefore, there is apparently some risk that these transactions may be part of the same series as the butterfly, and thus a risk that the continuity-of-interest rule may be violated.

Cashing Out

The intention of the butterfly rules is to prohibit a shareholder from cashing out immediately following the butterfly, but it is not reasonable that this prohibition should last forever; if the siblings want to cash out at some future time, they should be permitted to do so. However, because of the expansive interpretation of "series," there is considerable uncertainty as to when a shareholder would be able to cash out. Absent any guidance, a cashout transaction, even several years after the butterfly, could arguably be considered to be part of the same series as the butterfly and thus be prohibited.

Conclusion

Each of the examples above illustrates legitimate reasons for a TC to dispose or liquidate its investments, and all of these reasons have no connection with the butterfly. However, given the language of paragraph 55(3.1)(c), a TC is running the risk of violating this paragraph if it liquidates its investments or makes large dispositions even in the situations described above. Furthermore, a very conservative interpretation of paragraph 55(3.1)(c) could preclude a TC from ever liquidating its holdings all at one time. Guidance from the CRA would be welcome, because there are no clear answers on these points.

It is also worth noting that section 55 has become one of the most complicated sections in the ITA. Because of its complexity, certain areas of the legislation contain gaps that have been filled by CRA administrative policies. It does not seem to make sense that taxpayers must rely on CRA administrative positions for what could potentially be a very punitive section of the ITA if its conditions are not met. In fact, a comprehensive review of the entire income tax regime, of which this area is only a relatively small part, is long overdue.

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Frye v. Frye Estate: A Refresher

When determining rights to property, many of us hark back to law school and our first-year property law class, where we were constantly reminded of the fundamental legal premise embodied in the Latin phrase *nemo dat quod non habet*, meaning that "no one can give what they don't have."

One would think, then, that in the context of a shareholders' agreement, shareholders would be prohibited from bequeathing their shares by will on terms that contravene the terms of any shareholders' agreement to which they are a party. Not necessarily, as it turns out: in the case of *Frye v. Frye Estate*, 2008 ONCA 606, the Ontario Court of Appeal determined that provisions in shareholders' agreements and constating documents that restrict the transfer of shares may not prevent shareholders from gifting their shares by will.

The release of the *Frye* decision almost 14 years ago prompted a flurry of discussion among succession planners and practitioners who act for shareholders of private company shares. Practitioners came up with strategies to avoid the same fate as the parties in *Frye*, and life went on.

Recently, our legal team dealt with a matter in which the facts were very similar to those in *Frye*. In our examination of the issues, we revisited the case and were reminded of its importance. Because the case is still good law, we thought it might be time for a refresher.

The case involved a family business built by the patriarch, George H. Frye, who had five children, Cheryl, Jack, Donny, Bing, and Cam. Donny was a disabled adult, and Cheryl, Bing, and Cam were trustees of two trusts held for Donny's benefit. After George's passing, his children vied for control of the family business.

The Shareholders' Agreement

The siblings signed a shareholders' agreement in an effort to resolve their disputes. The shareholders' agreement expressed George's overall intention to preserve George H. Frye Holdings Ltd. ("the company") as a family business and to have his children share equally in it. In keeping with that intention, the terms of the shareholders' agreement

- restricted shareholders from transferring or otherwise dealing with their shares except in accordance with the agreement;
- required the approval of at least three of Bing, Cam, Cheryl, and Jack for any transfer of shares; and
- provided that any sale of shares must first be offered to the company, and then to the other shareholders on a pro rata basis.

In addition, the letters patent pursuant to which the company was formed also prohibited any transfer of shares without the express sanction of the directors.

The Gift of Shares by Will and the Trial Court Decision

Cam passed away in April 2002. In his will, he gifted his shares in the company to his sister, Cheryl. Jack challenged the validity of the gift on the premise that the shareholders' agreement prohibited Cam from transferring his shares to Cheryl by will. The trial judge agreed, and determined that the transfer was also prohibited by the letters patent requiring the directors to approve any transfer. The trial judge deemed the provision of Cam's will that gifted the shares to Cheryl to be null and void and severable from the rest of the will.

The Court of Appeal Decision

Cheryl appealed the decision on the basis that the trial judge erred in voiding Cam's bequest of shares to her.

The Court of Appeal held that contractual obligations do not constrain a person's ability to bequeath property by will. Although a breach of a shareholders' agreement may give rise to an action for breach of contract, it does not affect the validity of the provision of the will bequeathing the shares.

Furthermore, it was noted that the trial judge had not been made aware of section 67(2) of the Business Corporations Act (Ontario) (OBCA), which contemplates restrictions on the transfer of shares in corporate articles and shareholders' agreements, and which provides that an estate trustee is entitled to be treated as a "registered security holder entitled to exercise all the rights of the security holder that the person represents." Accordingly, the estate trustees appointed under Cam's will were entitled to be treated as the registered holders of the shares bequeathed to Cheryl.

Writing for a unanimous court, Justice Juriansz stated (at paragraph 22):

> Legal title to the shares is transmitted by the Will to the estate trustees, who hold them in trust for Cheryl. However, the estate trustees are bound by the shareholders' agreement and cannot distribute the shares out of the estate to Cheryl without complying with the requirements of the shareholders' agreement and the letters patent. The estate trustees' inability to transfer the shares to Cheryl immediately does not, however, render the bequest void.

Therefore, on Cam's death, legal title to the shares was transmitted to the estate trustees who thereafter held them as bare trustee for Cheryl, the beneficial owner.

Analysis

Cam was in breach of the shareholders' agreement, and the estate trustees nonetheless had to find a way to complete the transfer of shares to Cheryl. This presented a quandary for the estate trustees, because—absent agreement by the remaining shareholders—completing the transfer of shares to Cheryl would be furthering a breach of contract. Furthermore, the estate trustees could be stuck holding the shares as bare trustee for a very long time, and be prevented from winding up the estate in a timely manner.

An analysis of section 67 of the OBCA may address this issue. The points made below were not argued in *Frye*. In "Speaker's Corner: Frye Ruling a Recipe for Litigation," *Law Times*, October 13, 2009, Clare Burns, Lori Duffy, and Maralynne Monteith argue that if

- a corporation with restrictions on transfers of shares must treat designated people (including executors) as registered security holders of the deceased's shares (section 67(2)), and
- any designated person may designate another person as the registered holder of the deceased's shares (section 67(7) and section 67(8)), and
- the corporation may register the transmittal of the deceased's shares to the designated person and the treatment of the designated person as the registered holder (section 67(9)), and
- designated persons can also include heirs (section 67(2)),

then, upon the instruction by the estate trustee, the company must transfer shares left by will to the named beneficiary under the will ("the heir") notwithstanding any restriction on the transfer of the shares in the constating documents or shareholders' agreement. Furthermore, the corporation is relieved of any duty owed to a third party by a registered holder or any person treated as a registered holder (section 67(4)).

Conclusion

In keeping with the "nemo dat" premise, Cam did not have a right to bequeath his shares in the company by will, and doing so put him in breach of the shareholders' agreement. However, the provision in the will bequeathing the shares to Cheryl was deemed by the court to be valid and resulted in the transfer of beneficial ownership to Cheryl. At the same time, although the estate trustees were bound by the shareholders' agreement and accordingly were unable to transfer to Cheryl legal title to the shares, it appears that section 67 of the OBCA provided a process for the transmission of registered ownership in the shares to Cheryl. As a result, Cam was able, effectively, to give an asset that the shareholders' agreement stated he did not have a right to give. On a practical level, it is unknown whether Cam's shares were eventually registered in Cheryl's name or whether the bare trustee arrangement became a long-term arrangement. *Frye* has not been applied in any subsequent reported cases.

There are a number of drafting considerations that may help to address the issues raised in *Frye*. These considerations include (1) a provision in the unanimous shareholders' agreement giving the corporation the right to purchase any shares transferred (including the transfer of registered ownership as bare trustee) in contravention of the shareholders' agreement, and (2) a call right in favour of the other shareholders.

Since *Frye* remains good law in Ontario, succession planners and practitioners acting for shareholders of private company shares need to be mindful of the issues in the case, and be able to incorporate solutions into their planning and advice.

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Acquisition Date of Donated Converted Life Insurance Policy Depends on Policy Terms

In a recent technical interpretation (TI 2021-0882391E5, November 8, 2021), the CRA advised that the acquisition date of a donated permanent life insurance policy that was converted from a term life insurance policy depends on the significance of the changes involved in the conversion. In this TI, the CRA states that if a term life insurance policy is fundamentally changed when it is converted to a permanent life insurance policy, the policyholder is considered to have acquired a new policy at the time of the conversion, for the purposes of determining whether the deemed FMV rules under paragraph 248(35)(b) apply. If these rules apply, the FMV of the donated policy may be deemed to be equal to its ACB, depending on the circumstances. According to the CRA, this determination must be made on a case-by-case basis, through a review of the policy's terms.

Generally, when a taxpayer has donated a life insurance policy (in respect of which the taxpayer is a policyholder) to a qualified donee, the FMV of that life insurance policy is deemed to be the lesser of its FMV (otherwise determined) and its ACB immediately before the donation is made, if one of the following conditions under paragraph 248(35)(b) is met:

- the taxpayer acquired the donated life insurance policy less than 3 years before the day that the donation is made; or
- the taxpayer acquired the donated life insurance policy less than 10 years before the day that the donation is made, and it is reasonable to conclude that, at that time, one of the main reasons for its acquisition was to donate the life insurance policy to a qualified donee.

The conditions under paragraph 248(35)(b) do not apply when the donation is made as a consequence of the taxpayer's death.

In the TI, the CRA notes that the question at issue—whether the conversion of a term life insurance policy to a permanent life insurance policy results, for the purposes of paragraph 248(35)(b), in a new policy being acquired by the policyholder at the time of the conversion—is a mixed question of fact and law, and can be determined only on a case-by-case basis. The CRA advises, in particular, that when the changes "are so fundamental as to go to the root of the policy," a conversion may result in the acquisition of a new policy at the time of conversion. The CRA advises that in order to determine whether this result has occurred, all of the provisions of a particular life insurance policy should be reviewed.

The CRA also notes that for the purposes of subsection 248(35), two rules do not apply: (1) the rule that may deem a life insurance policy not to have been disposed of or acquired in certain limited situations under paragraph 148(10)(d), and (2) the rule for certain policies issued before 2017 under subsection 148(11).

Paragraph 148(10)(d) provides that a policyholder is generally deemed not to have disposed of or acquired an interest in a life insurance policy (other than an annuity contract) as a result only of the exercise of any provision (other than a conversion into an annuity contract) of the policy, but paragraph 148(10)(d) applies for the purposes of section 148 only. Subsection 148(11) is relevant to the determination of when a life insurance policy (other than an annuity contract) issued before 2017 is to be treated as though it were issued after 2016 for the purposes of certain provisions of the Act and the regulations, other than subsection 248(35).

The CRA states that although the time at which a donated converted life insurance policy was acquired for the purposes of paragraph 248(35)(b) is not affected by paragraph 148(10)(d) and subsection 148(11), these rules may be relevant to the computing of the ACB of the donated converted life insurance policy, and it states that when subsection 248(35) applies, the deemed FMV of the policy may be its ACB.

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The Cliff Case: When Is a Resignation "In Writing" for the Purposes of the OBCA?

The recent case of *Cliff v. Canada* (2022 FCA 16) dealt with the question of what constitutes, for the purposes of the Business Corporations Act (Ontario) (OBCA), a "written resignation" that can give rise to a legally effective director's resignation for the purposes of the ITA and the ETA.

The facts of the case are straightforward. In 2001, the appellant's husband asked his accountant to incorporate a new corporation on his behalf. Pursuant to these instructions, the accountant incorporated Cliff Crucibles Inc. ("Corpco") under the OBCA. The accountant appointed himself as the first director and then stepped down. The appellant's spouse and the appellant, who were the shareholders of Corpco, appointed themselves as Corpco's directors effective May 18, 2001, pursuant to signed documents. The appointments were reflected in the public registry maintained by the Ontario Ministry of Consumer and Commercial Relations ("the ministry") (now the Ministry of Government and Consumer Services).

The appellant, who had been adamant from the beginning that she was willing to be a director of the corporation only on a temporary basis, now informed her spouse that she wanted to be removed as a director. Accordingly, the appellant's spouse contacted his accountant and the accountant's secretary prepared a "Form 1—Initial Return/Notice of Change" ("form 1"). The form 1 stated that the appellant's directorship began on September 4, 2003 and ended on December 12, 2003. At trial, no reason for the discrepancy between the May 18, 2001 appointment and the dates employed on the form 1 was provided. The form 1 was placed in Corpco's minute book. However, there was no evidence as to when the form was sent to the ministry, other than the accountant's testimony that his office had submitted the form to the ministry. Furthermore, the records of the ministry did not reflect the changes reflected in the form 1.

Corpco was dissolved in 2013. At the time of the dissolution, Corpco had outstanding tax liabilities under both the ITA and the ETA. The appellant and her spouse were both assessed by the minister of national revenue for unremitted tax under the ETA and unremitted source deductions under the ITA.

In the earlier TCC decision, it was held, on the basis of the decision in *Canada v. Chriss* (2016 FCA 236), that a valid resignation required, for the purposes of the OBCA, a director's personal signature in order to be effective. Therefore, in the TCC's view, since the form 1 did not have a signature, the appellant remained a director of Corpco.

The FCA reviewed the *Chriss* decision and noted that the facts in that case involved a resignation letter, prepared by the corporation's solicitor, that was neither dated nor signed and remained in a file at the solicitor's office awaiting signature. The FCA concluded that the TCC in *Chriss* had held that "where the decision to resign is to be communicated by means of a letter, signed by the director, it must be signed to be effective." However, the FCA also held that the decision in *Chriss* "does not require that all resignations must have a personal, physical signature to be effective." In fact, the court held that a director may validly resign by e-mail or text. The court analogized the scenario in *Chriss* to an e-mail that contains a resignation but remains in the draft folder unsent. The FCA also concluded that (1) regardless of the facts, a valid resignation must involve no ambiguity about whether a written resignation was received by the corporation, and (2) there must be certainty about the resignation's effective date. In this case, the FCA found that the TCC had erred in its understanding of the decision in *Chriss* by imposing a requirement that a legally effective resignation must have a physical signature.

The FCA went on to hold that a form 1 is not a resignation but a communication by the corporation to the ministry (not, importantly, to the corporation itself). Furthermore, the FCA noted that there is no place on a form 1 for a director's signature—physical or digital. Finally, examining the form 1 at issue in this case, the FCA noted that although the document showed that the appellant ceased to be a director on December 12, 2003, there was no evidence as to when the form 1 was completed. The FCA held that for a resignation to be effective, there must be evidence that the corporation received a written resignation confirming that the appellant had resigned. The FCA concluded by noting that although a form 1 may reflect something that may have happened, it is not a substitute for a written resignation. Accordingly, the appeal was dismissed.

This case serves as a reminder that for a director's resignation to be effective, it must be done in compliance with corporate law, and therefore be in writing (whether physical or digital). Finally, it should be noted that Ontario has enacted the Electronic Commerce Act, 2000, which deals with, among other things, the legal recognition of electronic information and documents and the use of electronic signatures.

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Challenges with Electronic Commerce GST/HST Rules

With the rise of e-commerce, the GST/HST regime in Canada's ETA needed a significant update. In 2020, the Canadian government proposed amendments to the ETA, addressing three general areas of e-commerce transactions:

- specified supplies of intangible personal property and services as defined in subsection 211.1(1) of the ETA, which generally include digital products and services that are usable in Canada or relate to real property or tangible personal property situated in Canada;
- supplies of qualifying tangible personal property as it is defined in subsection 211.1(1) of the ETA, which generally includes most tangible personal property delivered in Canada, unless it is sent by mail or courier to an address in Canada from an address outside Canada; and
- supplies of short-term accommodation through an accommodation platform.

These new rules came into effect on July 21, 2021 with the addition of subdivision E, "Electronic Commerce," to division II of part IX of the ETA ("the e-commerce rules"). The e-commerce rules introduced a simplified GST/HST regime ("the simplified regime") and imposed registration requirements on certain distribution platform operators (DPOs), accommodation platform operators (APOs), and specified non-resident suppliers (which are defined in subsection 211.1(1) as non-resident persons who do *not* make supplies in the course of a business carried on in Canada and are *not* registered under the normal GST/HST regime in subdivision D of division V ["the normal regime"]).

Today, it is almost a year since these rules came into effect, with over 347 businesses registered under the simplified regime and the CRA's transitional administrative discretion set to end on June 30, 2022. This article considers some common challenges that businesses have faced in applying the new e-commerce rules.

Charging Tax to "Specified Canadian Recipients" Only

The e-commerce rules generally require that GST/HST be charged when specified supplies are made to "specified Canadian recipients," which are defined in subsection 211.1(1) of the ETA as recipients whose usual place of residence is situated in Canada, and who have *not* provided to either the supplier or the DPO "evidence satisfactory to the Minister" that the recipient is registered under the normal regime.

Since a recipient's status as a "specified Canadian recipient" depends on the knowledge of both the supplier and the DPO, it requires open communication between the two. Otherwise, the DPO might mistakenly charge GST/HST in circumstances where the supplier has evidence that the recipient is registered under the normal regime.

Even if the supplier has such evidence and has confirmed the recipient's inclusion in the CRA's GST/HST registry, the supplier may find it difficult (if not impossible) to "turn off" the GST/HST for a single recipient in its electronic checkout system. Similarly, the supplier will likely have to manually retain the "evidence satisfactory to the Minister" to substantiate its decision not to collect GST/HST.

What Information Do DPOs and APOs Need To Report to the CRA in Their Information Returns?

Under the e-commerce rules, DPOs and APOs are required to file by June 30 an information return for the previous calendar year. The first information return was due to be filed by June 30, 2022, but the CRA deferred this requirement. Instead, the first information return required under the e-commerce rules will be for the calendar year 2022, to be filed by June 30, 2023.

As of June 1, 2022, the CRA has yet to release the prescribed form of the information return, leaving DPOs and APOs uncertain as to whether they are collecting the type of information they will need to complete these returns for the 2022 calendar year.

The CRA has indicated that detailed instructions and the prescribed form of information return are expected in the coming months. For the time being, the agency has said that the data required for the information return *should be* the same type of information that DPOs and APOs are already collecting under the ETA (for example, the names, addresses, and GST/HST registration numbers of suppliers).

Refunding Tax Charged Under the Simplified Regime in Error

When a specified non-resident supplier registered under the simplified regime charges and collects GST/HST in error from a recipient registered under the normal regime, the recipient is *not* entitled to claim an input tax credit (ITC) or a rebate for the tax charged and collected in error. Instead, the recipient must provide its GST/HST number to the non-resident supplier and request that the supplier credit or refund the tax charged.

For this process to work, the non-resident supplier that is registered under the simplified regime needs to be comfortable enough in its understanding of Canadian sales tax to agree to credit and refund the tax charged. Some non-residents, not wanting to take that risk, may default to a "when in doubt, charge tax" approach, which risks creating unrecoverable Canadian GST/HST for recipients registered under the normal regime.

Transitional Administrative Discretion Coming to an End on June 30, 2022

When first introducing the e-commerce rules in April 2021, the Canadian government announced that the CRA would take a "practical approach" during the 12-month transitional period and exercise discretion in administering these measures (for example, by deciding not to assess a business for non-compliance) if a business could demonstrate that it had taken reasonable measures to comply with the e-commerce rules but had been unable to meet its obligation for "operational reasons" (for example, shortcomings with its current computer systems).

On July 28, 2021, the CRA announced that businesses that wanted to access this administrative discretion had to obtain *written approval* from the CRA. Practically speaking, this meant that businesses had to proactively make submissions to the CRA requesting administrative discretion and setting out their operational challenges, and then wait for the CRA to review and approve the submissions in writing. This 12-month transition period, and the CRA's administrative discretion, comes to an end on June 30, 2022.

Commentary

Some challenges have accompanied the new e-commerce rules, as evidenced by (1) the 12-month transition period, (2) the more than 75 entities that submitted applications for the CRA's transitional administrative discretion, and (3) the CRA's deferral of the first DPO and APO information returns.

Unfortunately, after June 30, 2022, the CRA's administrative discretion ends, and from then on the CRA will expect all businesses to fully comply with the e-commerce rules—regardless of any operational challenges they may face.

Like it or not, businesses affected by these rules will likely have to reach out for professional advice to help them navigate the new e-commerce rules and get things right—before the CRA shows up to audit their compliance.

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Budget 2022: The "Substantive CCPC" Proposals

The federal budget was tabled in the House of Commons on April 7, 2022. The budget introduces a new concept into the ITA—the "substantive CCPC"—in a proposal aimed at halting certain planning techniques perceived as circumventing the refundable tax regime applicable to Canadian-controlled private corporations (CCPCs). The substantive CCPC proposals will apply to taxation years that end on or after April 7, 2022, although no draft legislation has been released as of this writing.

In general terms, a CCPC is a Canadian-resident corporation, governed by a Canadian, provincial, or territorial corporate statute, that is not controlled directly or indirectly by non-residents or public corporations (or any combination thereof). For Canadian tax purposes, a CCPC that earns investment income is liable to pay an additional refundable tax on such income. The additional tax is refundable to the CCPC when it pays sufficient taxable dividends to a shareholder.

The budget states that the objective of the additional refundable tax regime for CCPCs is to remove any advantage for a Canadian-resident individual to earn investment income through their CCPC where the investment income—but for the additional refundable tax—would be subject to a lower (corporate) tax rate than if the income had been earned personally by the individual. Thus, this regime is intended to create "neutrality" by taxing investment income earned by a CCPC at roughly the same rate as investment income earned directly by a Canadian-resident individual.

Despite being subject to an additional refundable tax on investment income, a corporation that is a CCPC benefits from several advantages under the ITA. For example, it can claim the small business deduction and pay a lower tax rate on active business income (up to a certain threshold). In addition, a CCPC is subject to a normal reassessment period of three years as opposed to the four-year normal reassessment period applicable to corporations that are not CCPCs ("non-CCPCs"). Shareholders of a CCPC may also benefit indirectly from the CCPC status of their corporation. For example, individual shareholders of a CCPC are entitled to claim their lifetime capital gains exemption on a disposition of their shares of the CCPC if such shares constitute "qualified small business corporation shares." Shareholders that receive stock options of a CCPC may also obtain a tax deferral on the exercise of their stock options. It is also worth noting that the "allowable business investment loss" regime applies only to the shares or debt of a CCPC.

Unlike a CCPC, a non-CCPC is not subject to the additional refundable tax regime in respect of investment income. A non-CCPC is essentially a corporation resident in Canada that does not meet the requirements of a CCPC. The non-CCPC category includes, for example, a public corporation, and a private corporation that is governed by the laws of Canada, a province, or a territory and is controlled by non-residents or public corporations (or any combination thereof). This category would also include a private corporation that is resident in Canada but is governed by the laws of a foreign jurisdiction.

Although a non-CCPC is not subject to the additional refundable tax on investment income, it faces certain disadvantages, the main one being an inability to access the advantages afforded to CCPCs, as summarized above. For example, a non-CCPC is subject to a higher corporate tax rate on its business income because it is not entitled to the small business deduction. A non-CCPC is also subject to a four-year normal reassessment period (as opposed to the three-year normal reassessment period that applies to CCPCs). In addition, shareholders of a non-CCPC are not entitled to claim the benefits only available to shareholders of CCPCs.

Practically speaking, because the additional refundable tax regime does not apply to investment income earned by non-CCPCs, the investment income earned by CCPCs is initially taxed at approximately double the rate of investment income earned by non-CCPCs. This disparity creates a tax-deferral advantage for investment income earned by non-CCPCs. The substantive CCPC proposals set out in the budget seek to prevent certain non-CCPCs from obtaining this deferral.

In particular, the budget proposes to amend the ITA to eliminate the tax-deferral advantage for investment income earned by corporations that are not CCPCs but are otherwise considered to be "substantive CCPCs." The budget describes a "substantive CCPC" as a private corporation resident in Canada (other than a CCPC) that is ultimately controlled—in law or in fact—by one or more Canadian-resident individuals.

Thus, under the budget proposals, investment income earned by a substantive CCPC will be treated and taxed as if the corporation were a CCPC. Such income will therefore be

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subject to the additional refundable tax regime. For all other purposes of the ITA, however, the budget provides that the substantive CCPC will continue to be treated and taxed as a non-CCPC. This means that a substantive CCPC will be taxed as a CCPC on its investment income but will not otherwise enjoy any of the benefits available to a regular CCPC.

To add some context to the substantive CCPC proposals, the budget states that taxpayers have been "manipulating" the status of their corporations in order to avoid CCPC status and thereby to obtain a tax-deferral advantage for investment income earned in their corporations. The budget notes, for example, that some planning can avoid CCPC status by continuing a corporation under foreign corporate law (while maintaining residence in Canada) or by introducing a non-resident shareholder into the structure. This type of planning has recently been challenged by the CRA under GAAR, and many taxpayers are bringing such challenges to the Tax Court of Canada.

The budget notes that such challenges can be time-consuming and costly and that, as a result, the federal government is introducing the substantive CCPC proposals into the ITA to bring an end to "non-CCPC planning."

The budget also mentions that "genuine" non-CCPCs are not intended to be affected by the substantive CCPC proposals. The budget provides two examples of a "genuine" non-CCPC, which is a private corporation that is ultimately controlled by non-resident persons or a subsidiary of a public corporation. However, the concept of "genuineness," which connotes sincerity or authenticity, is a fluid and subjective term that creates doubt as to what a "genuine" non-CCPC is. For example, a CCPC that continues to a foreign jurisdiction must navigate and comply with all domestic and foreign requirements to achieve such a continuance and will incur significant costs in doing so. Following the continuance, such a corporation is subject to the corporate and regulatory laws of the foreign jurisdiction on an ongoing basis and must attend to all obligations related to these laws, such as annual filings, registrations, declarations, and fees. Perhaps more importantly, such corporations lose all of the benefits associated with CCPC status and, on a fully integrated basis, are subject to a higher rate of taxation when funds are extracted from the corporate structure. Thus, the suggestion that those corporations are not "genuine" non-CCPCs is frankly incoherent and, at the very least, open to debate.

As mentioned above, the new substantive CCPC regime will apply to taxation years that end on or after April 7, 2022. Many corporations are undoubtably already subject to this regime without the benefit of any draft legislation. Taxpayers and their advisers should be mindful of the uncertainties associated with the substantive CCPC proposals until further guidance is provided.

Finally, it should be noted that, before the release of the 2022 budget, the federal government had identified non-CCPC planning as one of the new "notifiable transactions" that would need to be reported to the CRA. It is not clear whether the federal government will continue to require non-CCPC planning to be a notifiable transaction, given that the substantive CCPC proposals have shut down such planning. The interplay between the substantive CCPC proposals and the notifiable transaction regime should be monitored closely.

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