TOP TECHNICAL BILL ISSUES FOR OWNER-MANAGERS

by

BRYANT D. FRYDBERG

Miller Thomson LLP
30th Floor, 700 – 9th Avenue S.W.
Calgary, Alberta T2P 3V4

TABLE OF CONTENTS

TOP TECHNICAL BILL ISSUES FOR OWNER-MANAGERS[1]

BRYANT FRYDBERG[2]

1. Introduction

The Department of Finance released a prolific amount of proposed legislation in the last quarter of 2012 and the first quarter of 2013. More specifically, from October 2012 to December 2012, the Department of Finance released one Notice of Ways and Means Motion to implement certain provisions of the Federal 2012 Budget on October 15, 2012 and a Second Notice of Ways and Means Motion on October 24, 2012, which sought to move forward numerous proposals to implement various technical amendments, some of which were first announced as far back as January 2009.

The Department of Finance continued to turn out additional proposals, the first of which was the release of a Legislative Proposal Relating to the *Income Tax Act* (Canada) (the "**Act**")[3] and Regulations on November 27, 2012 which focused on rules applicable to Canadian banks with foreign affiliates. Additionally, on December 21, 2012, the Department of Finance released a Legislative Proposal Relating to the Act and Regulations which was a response to issues brought forth by taxpayers and their representatives.

Finally, in the first quarter of 2013, the Department of Finance released another Notice of Ways and Means Motion on April 22, 2013 in respect of the Federal 2013 Budget ("**NWMM – April 22**").

While this paper is by no means a comprehensive review of all of the proposed technical amendments, the objective of this paper is to review certain proposed changes to the Act of particular importance to the "owner-manager".

More specifically this paper considers the following ten technical amendments:

1. Increase in lifetime capital gain exemption to $800,000 for 2014 and indexing of the exemption for inflation starting in 2015;
2. Failure to Report a Capital Gain;
3. Definitions of Related Persons, etc.
4. Dividend tax credit decrease for Non-Eligible Dividends;
5. Taxable Benefits under subsection 6(1);
6. Deductibility of Legal Expenses of an Employee;
7. Changes to the Employee Stock Option Rules;
8. Benefits Conferred on a Shareholder;

---

[1] The author gratefully acknowledges the contributions of Andrea Lamy, Associate, Victoria Hockley, Student at Law, the editorial support and guidance provided by William J. Fowlis, CA and the research and editing provided by Melissa Pearson, all of Miller Thomson LLP in the preparation of this paper.

[2] Bryant Frydberg is a partner with Miller Thomson LLP in Calgary, Alberta.

[3] *Income Tax Act,* RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

9. Subsection 88(1) and the Bump Rules in Respect of a Partnership Interest; and

10. The Prohibited Investment Rules in respect of Registered Retirement Savings Plans and Tax-Free Savings Accounts.

2. Increase in lifetime capital gain exemption from $750,000 to $800,000 for 2014 and indexing of the exemption for inflation starting in 2015

Beginning in the 2014 taxation year, the Federal Budget proposes to increase the lifetime capital gains exemption ("**LCGE**") by $50,000, to $800,000. The Act currently provides for a LCGE of $750,000 in respect of capital gains realized on the disposition of eligible property (e.g. qualified small business corporation shares and qualified farm property). The new $800,000 limit will apply to all individuals, even those who have previously used their then available LCGE. The LCGE will also be indexed for inflation for taxation years after 2014.

Provided that the proposed increase is implemented, individuals will have an additional $50,000 lifetime capital gains exemptions on qualified property to use. This exemption increase will reward and encourage further investments in qualified small business corporation shares, qualified farm and qualified fishing property.

This amendment was not included in the April 22, 2013 Notice of Ways and Means Motion, however, there is no indication from the Department of Finance that this measure is not still proceeding.

3. Failure to Report a Capital Gain – Subsection 110.6(6)

Proposed Amendment to Subsection 110.6(6) Failure to Report a Capital Gain

Subsection 110.6(6) of the Act denies a capital gains exemption for certain unreported gains, notwithstanding the amount that could otherwise be claimed as a capital gains exemption under subsections 110.6(2) to (2.3).[4] Subsection 110.6(6) applies where an individual has realized a capital gain on a disposition of capital property in a taxation year and knowingly or under circumstances amounting to gross negligence fails to report the disposition in his return of income for that taxation year or fails to file a return for that taxation year within one year following the taxpayer's filing-due-date for the taxation year and the Minister of National Revenue establishes the facts justifying the denial.[5]

The proposed draft legislation amends the preamble to subsection 110.6(6) to clarify that a failure to report a capital gain in a taxation year will result in a denial of the lifetime capital gains exemption against that gain in any subsequent taxation year.[6]

The proposed amendment will revise the preamble to subsection 110.6(6) and reads as follows:[7]

---

[4] Ibid., at subsection 110(6)(6).

[5] Canada, Department of Finance, *Explanatory Notes Relating to the Income Tax Act, The Excise Tax Act and Related Legislation* (Ottawa: Department of Finance, October 2012), clause 240 (http://www.fin.gc.ca/drleg-apl/nwmm-amvm-1012n-05-eng.asp) [Explanatory Notes Clause 240].

[6] Ibid.

[7] Canada, Department of Finance, Notice of Ways and Means Motion to Amend the Income Tax Act, the Excise Tax Act and Related Legislation, October 2012 (http://www.fin.gc.ca/drleg-apl/nwmm-amvm-1012l-05-eng.asp) [NWMM October 2012].

> (6) Notwithstanding subsections (2) to (2.3), no amount may be deducted under this section in respect of a capital gain of an individual for a particular taxation year in computing the individual's taxable income for the particular taxation year <u>or any subsequent year</u>, if

Under the proposed draft legislation, the denial of the lifetime capital gains exemption is no longer limited to the taxation year when the disposition of property took place. The original wording of the provision included the words "or any subsequent taxation year" until May 2006 when the provision was inadvertently amended. Therefore the effect of the proposed amendment is to restore the provision to its original wording.[8]

Implications of Proposed Amendment to Subsection 110.6(6)

By virtue of subsections 150(1) and (1.1)[9], an individual is required to file a tax return for each taxation year in which the individual has a taxable capital gain or has disposed of a capital property. Where an individual knowingly or under circumstances amounting to gross negligence, fails to file the requisite tax return in respect of a capital gain within one year after the date on or before the return is required to be filed, or fails to report the capital gain in that tax return, subsection 110.6(6) will deny the deductibility of any amount under section 110.6 in respect of that capital gain for that or any subsequent taxation year. These provisions prevent gambling with respect to realized capital gains: If a taxpayer fails to report a capital gain and is caught, the capital gains exemption is permanently unavailable.[10]

Subsection 110.6(6) would be applicable, if for example, a taxpayer after initially failing to report any capital gain in the year of a disposition of a capital property tried to claim a reserve in respect of the capital gain for the year of disposition, such that a portion of the capital gain would instead be reported in a subsequent year. The amendment ensures that a claim for a capital gains exemption in the subsequent year will not be available.[11]

The Canada Revenue Agency (the "**CRA**") answered a question posed at the CGA Round Table with respect to whether it was the CRA's administrative policy to disallow the capital gains deduction for life to an individual who has failed to report a capital gain for a previous year.[12] At the time of writing, subsection 110.6(6) included the words "or any subsequent taxation year". The CRA responded that the capital gains deduction on a gain realized in a taxation year and not reported can be disallowed in the year of the gain or any subsequent year. However, the CRA clarified that other capital gains realized in subsequent taxation years are still eligible for the capital gains deduction provided in section 110.6 of the Act. It is anticipated that the CRA's administrative policy with respect to the amended subsection 110.6(6) will remain consistent with the views expressed at the Round Table.

---

8 Explanatory Notes Clause 240, supra note 5.

9 *Act,* supra note 3 at subsections 150(1) and 150(1.1).

10 Canada Tax Service, "Capital Gains Deduction - Analysis on Section 110.6 of the Act", (2012) (Taxnet Pro) [Capital Gains Deduction].

11 Explanatory Notes Clause 240*,* supra note 5.

12 CRA document no. 9122207, January 10, 1992.

Status of Proposed Amendment

The first and second reading of Bill C-48 (Part 5) - *Technical Tax Amendments Act*, 2012 was heard before the House of Commons of Canada on November 21, 2012 and March 8, 2013, respectively.[13]

This amendment applies to taxation years for which a return of income has not been filed before October 31, 2011 except in respect of gains realized in taxation years for which a return of income was filed before October 31, 2011.[14]

4. Related Persons Etc.– Subsection 110.6(14)

Proposed Amendment to Subsection 110.6(14) – Related persons, etc.

As discussed in section 1 of this paper, individual taxpayers may claim a deduction in computing taxable income in respect of net taxable capital gains realized from the disposition of eligible property. Qualified small business corporation shares disposed of after June 17, 1987 is one form of eligible property. Subsection 110.6(14) of the Act provides certain rules that apply for the purposes of the definition "qualified small business corporation share" ("**QSBC**") in subsection 110.6(1) and the capital gains exemption in respect of such shares.

To meet the definition of a QSBC share certain tests with respect to the type of assets owned by the corporation and the length of the period during which the shares are held must be satisfied. The definition of a QSBC share requires that the share pass the following three (3) tests: (1) the small business corporation ("SBC") test; (2) the holding period ownership test; and (3) the holding period asset test. A detailed analysis of the QSBC share tests is beyond the scope of this paper.[15] Briefly, at the time of disposition the shares must be shares of a SBC and must not have been owned by anyone other than the individual or a person or partnership related to the individual, throughout the 24 months immediately preceding the disposition time. This requirement prevents access to the capital gains exemption where an individual buys qualified small business corporation shares from an unrelated person and sells them, realizing a gain, within a short period of time. Subsection 110.6(14) provides rules to determine who is a related person for purposes of the definition of a QSBC share.[16]

The proposed draft legislation amends subsection 110.6(14) by adding a new paragraph 110.6(14)(d.1) which provides another rule applicable in determining what constitutes a QSBC share for purposes of the capital gains exemption. The new paragraph 110.6(14)(d.1) will deem a person who is a member of a partnership that is a member of another partnership (ie, a lower-tiered partnership) to be a member of the lower-tiered partnership.

---

[13] Income Tax Act Legislative Developments April 30, 2012 (Taxnet Pro); Bill C-48, An Act to Amend the Income Tax Act, the Excise Tax Act, the Federal-Provincial Fiscal Arrangements Act, the First Nations Goods and Services Tax Act and Related Legislation, first reading, November 21, 2012, second reading, March 8, 2013, section 5 [Bill C-48].

[14] Explanatory Notes Clause 240*,* supra note 5.

[15] For a detailed discussion of the QSBC rules the reader is referred to Byron Beswick and Beau Young, "The Use of Holding Companies in the Private Business Context" in Pearle E. Schusheim and Gina Katz, eds, "Personal Tax Planning" (2012) 61:1 Can Tax J 169; Manu Kakkar and Nancy Yan, "Practical Considerations in Claiming an ABIL or the Capital Gains Exemption" (Delivered at the 2012 Ontario Tax Conference, October 29, 2012); Craig K. Hermann, "The Capital Gains Exemption: A Comprehensive Review", Report of Proceedings of Fifty-Second Tax Conference (Toronto: Canadian Tax Foundation, 2001), 29:1-54.

[16] *Act,* supra note 3 at subsection 110.6(14).

The proposed new paragraph reads as follows:[17]

> (d.1) a person who is a member of a partnership that is a member of another partnership is deemed to be a member of the other partnership.

Implications of the Proposed New Paragraph 110.6(14)(d.1)

This amendment will permit a taxpayer to have access to the deduction for taxable capital gains arising on the disposition of a QSBC share by the lower-tiered partnership.[18] This paragraph is intended to ensure that the transfer of shares of an otherwise qualified company to a holding company will not affect the individual's entitlement to the capital gains exemption.[19]

The Act allows persons to transfer property into a partnership on a tax-deferred basis and to transfer property out of a partnership to its members in certain circumstances on a tax-deferred basis. As a result, it is possible to transfer a business into a partnership or out of a partnership and into another entity, such as a corporation, on a tax-deferred basis. Once transferred into a corporation, income from the business is eligible for the small business deduction. Furthermore, the partners may be able to sell all or part of their interests in the business by way of a share sale in a manner which is eligible for the lifetime capital gains exemption.[20] The lifetime capital gains exemption is only available on the sale of QSBC shares, however, the Act contains rules which facilitate the claiming of the capital gains exemption on shares of a corporation which acquired a qualifying business from the partnership.[21] For example, treasury shares issued to a partner in consideration for his or her interest in the partnership, or in connection with the transfer of all or substantially all of the assets used by the partnership in a business to the corporation, will not be deemed to have been held by an unrelated person prior to the time of issuance.[22] Consequently, the capital gains exemption may be claimed by a partner who becomes a shareholder of a newly incorporated small business corporation on the transfer of the partnership business to the corporation, despite the corporation having been in existence for less than 24 months. This rule also applies to shares of a corporation held by a partnership. Paragraph 110.6(14)(d) deems a partnership to be related to a person for any period through which the person was a member of the partnership. As a result, when a partnership disposes of QSBC shares the individual partners may claim the capital gains exemption on their proportionate share of the proceeds. Furthermore, proposed paragraph 110.14(d.1) will deem a person who was a member of a partnership that is a member of another partnership to be a member of the first mentioned partnership so that the capital gains exemption can be claimed where an individual is a member of a partnership which sells the QSBC shares.

Status of Proposed Amendment

The first and second reading of Bill C-48-(Part 5) *Technical Tax Amendments Act*, 2012 was heard before the House of Commons of Canada on November 21, 2012 and March 8, 2013, respectively.[23]

---

17 NWMM October 2012*,* supra note 7.

18 Explanatory Notes Clause 240*,* supra note 5.

19 Capital Gains Deduction*,* supra note 10.

20 Lorne H. Beiles, "Partnerships: A Review of Tax Planning Strategies", September 12, 2006 (http://www.davis.ca/en/publication/Partnerships-A-Review-of-Tax-Planning-Strategies).

21 Ibid.

22 *Act,* supra note 3 at paragraph 110.6(14)(f).

23 Bill C-48, supra note 13.

This amendment applies to dispositions that occur after December 20, 2002 and, if a taxpayer so elects in writing and files the election with the Minister of National Revenue on or before the taxpayer's filing-due date for the taxpayer's taxation year in which this amendment is assented to, to dispositions made by the taxpayer after 1999.[24]

5. Dividend Tax Credit Decrease for Non-Eligible Dividends

Proposed Amendments to Paragraph 82(1)(b) and Section 121

The "gross-up" factor and dividend tax credit ("DTC") applicable to non-eligible dividends was introduced to achieve tax "integration" between income earned by an individual directly, and income earned by a corporation and distributed to an individual as a dividend. Perfect tax integration would mean that the total amount of tax paid in each situation would be the same. According to the Federal Government, the current integration mechanism over-compensates individuals for income taxes presumed to have been paid at the corporate level on active business income, and the DTC on non-eligible dividends places an individual who receives this dividend income from a corporation in a better tax position than if the individual had earned the income directly.

The Budget proposes to adjust the current DTC and gross-up factor applicable to non-eligible dividends in an effort to achieve integration.

In NWMM – April 22, it is proposed to amend paragraph 82(1)(b) of the Act by changing the gross-up factor applicable to non-eligible dividends from 25% to 18% and the corresponding DTC from 2/3 of the gross-up amount to 13/18 as provided in section 121.

Expressed as a percentage of the grossed-up amount of a non-eligible dividend, this adjusts the effective rate of the DTC in respect of such a dividend from 13.3% to 11%. As a result, the effective federal tax rate on non-eligible dividends will increase by 1.64% from 19.58% to 21.22%.

Pending an announcement of changes (if any) to dividend tax credits by the provinces, the combined federal and provincial tax rate on non-eligible dividends in 2014 and the full impact on the integration mechanism is unknown.

For the owner-managers with a mixed salary and dividend remuneration strategy, tax planning strategies may have to be adjusted to account for the increase to the personal income tax rates applicable to non-eligible dividends.

Status of Proposed Amendments

The first reading of Bill C-60 (Budget 2013) was heard before the House of Commons of Canada on April 29, 2013. While this measure has not yet been implemented, once passed, it will apply to non-eligible dividends paid after 2013.

---

[24] Explanatory Notes Clause 240, *supra* note 5.

6. <u>Taxable Benefits Under Subsection 6(1)</u>

Paragraph 6(1)(a) –Value of Benefits

In addition to cash remuneration, vacation pay, medical and dental benefits, employees may receive other ancillary benefits from their employer. The purpose of section 6 is to ensure that the value of these ancillary benefits associated with an office or employment and which are mainly of a non-cash nature are also included in the computation of the income of an employee. Paragraph 6(1)(a) of the Act provides for the inclusion in an employee's income of the value of board, lodging and other benefits of any kind received or enjoyed in respect of employment, with a number of specified exceptions.[25]

Proposed Amendment to Paragraph 6(1)(a)- Value of Benefits and Addition of Subparagraph 6(1)(a)(vi)

The draft legislation proposes to amend paragraph 6(1)(a) to clarify that all employment benefits received by a person who does not deal at arm's length with the employee are included in the employee's income, other than those benefits specifically excluded. The draft legislation also proposes to add a new subparagraph 6(1)(a)(vi) to exclude from employment income any benefit received or enjoyed by a person who is not the employee under a program provided by the employer that is designed to assist individuals to further their education. This exception only applies, however, if the benefit is not a substitution for salary, wages or other remuneration of the employee, and only if the employee deals at arm's length with the employer.[26]

The proposed amendment to paragraph 6(1)(a) and new subparagraph 6(1)(a)(vi) read as follows:[27]

> (a) Value of Benefits – the value of board, lodging and other benefits of any kind whatever received or enjoyed by the taxpayer, <u>or by a person who does not deal at arm's length with the taxpayer</u>, in the year in respect of, in the course of, or by virtue of the taxpayer's office or employment except any benefit….
>
> (vi) that is received or enjoyed by an individual other than the taxpayer under a program provided by the taxpayer's employer that is designed to assist individuals to further their education, if the taxpayer deals with the employer at arm's length and it is reasonable to conclude that the benefit is not a substitute for salary, wages or other remuneration of the taxpayer;

Implications of Proposed Amendment to Paragraph 6(1)(a) and Addition of New Subparagraph 6(1)(a)(vi)

The proposed amendment to the preamble of paragraph 6(1)(a) broadens the scope of employment income by including in the employee's employment income all benefits received by any person who does not deal at arm's length with the employee. The impact of this change is that all benefits received by family members or closely held corporations of the employee will be included in the employee's employment income, subject to the specific exceptions set out in subparagraphs (i) – (iv).

---

25 *Act,* supra note 3 at paragraph 6(1)(a).

26 Canada, Department of Finance, *Explanatory Notes Relating to the Income Tax Act, The Excise Tax Act and Related Legislation* (Ottawa: Department of Finance, October 2012), clause 170 (http://www.fin.gc.ca/drleg-apl/nwmm-amvm-1012n-05-eng.asp).

27 NWMM October 2012, supra note 7.

New subparagraph 6(1)(a)(vi) creates a new exception to paragraph 6(1)(a) of the Act for benefits received or enjoyed under an employer provided educational assistance program by any person who does not deal at arm's length with the employee. Accordingly, post secondary education benefits received or enjoyed by an employee under an employer provided educational assistance program will no longer be considered a taxable benefit for the employee. The exception in subparagraph 6(1)(a)(iv) is not applicable to non-arm's length employees of the employer or in cases where the discount may reasonably be viewed as a substitute for an employee's salary, wages, or other remuneration.

Prior to 2007 it was the CRA's position that employer-provided scholarships and other education assistance for family members of employees constituted a taxable benefit to the employee. New subparagraph 6(1)(a)(vi) is a response to the Tax Court of Canada decisions in *Bartley* and *DiMaria* which dealt with the taxation of employer-provided post-secondary scholarships for family members of employees.[28] In both cases the Tax Court of Canada held, and the Federal Court of Appeal affirmed, that scholarships paid by employers to an employee's child do not constitute employment benefits in the hands of the employees under paragraph 6(1)(a).[29] In response, the CRA adopted a new administrative position with respect to scholarships and bursaries paid to the family members of employees.[30] However, this change in administrative position did not extend to scholarships, bursaries, or tuition provided to employees' family members who attend elementary or secondary schools. In such cases, the CRA continued to treat the fair market value ("**FMV**") of the scholarship, bursary, or tuition to be a taxable benefit to the employee.[31]

It should be noted that the proposed subparagraph 6(1)(a)(vi) exception is broadly worded in that it is not restricted to post-secondary education benefits. As such, tuition discounts that an elementary or secondary school gives to its employees' family members will generally no longer be considered a taxable benefit for the employee.[32]

The proposed amendment to paragraph 6(1)(a) clarifies that all employment benefits received by a person who does not deal at arm's length with the employee are included in the employee's income, other than those benefits specifically excluded. New subparagraph 6(1)(a)(vi) is added to exclude any benefit received or enjoyed by a person who is not the employee, under a program provided by the employer that is designed to assist individuals to further their education, thereby preserving the above *Bartley* and *DiMaria* exception for scholarships to arm's length employees' family members.

---

28 *Bartley v. R*, 2008 TCC 141, 2008 CarswellNat 594, and *DiMaria v. R,* 2008 TCC 114, 2008 CarswellNat 595, both affirmed by *Bartley v. R,* 2008 FCA 390, 305 DLR (4th) 566; Maureen DeLisser and Bob Neale, "Ernst & Young Commentary: 2012 – 015 Proposed benefit exception extends to elementary and secondary school tuition", April19, 2012 (http://www.cais.ca/uploaded/ENotify_Docs/Proposed_taxable_benefit_exception_elementary_secondary_school_tuition.docx) [Proposed Benefit].

29 In *Bartley v. R,* 2008 FCA 390, 305 DLR (4th) 566, at para 1, J.E. Sexton J.A. states that the reasons apply to the appeal of *DiMaria* and *Bartley* and a copy of the reasons will be placed on each of the files.

30 CRA document no. 2010-0364111E5, September 29, 2010.

31 Proposed Benefit, supra note 28; Administrative position of CRA document nos. 2008-0296041E5 and 2009-0320591E5 (Taxnet Pro).

32 CRA document no. 2012-0435091M4, October 31, 2011; David Sherman's Notes, "Income Tax Act, [proposed] 6(1)(a)" (Taxnet Pro).

Status of Proposed Amendment

The first and second reading of Bill C-48-(Part 5) *Technical Tax Amendments Act*, 2012 was heard before the House of Commons of Canada on November 21, 2012 and March 8, 2013, respectively.[33]

The proposed amendment is applicable in respect of benefits received or enjoyed after October 30, 2011.

7. <u>Deduction of Legal Expenses of an Employee</u>

Paragraph 8(1)(b)

Section 8 of the Act provides for limited deductions in computing income from an office or employment. Paragraph 8(1)(b) of the Act allows for the deduction of legal expenses incurred by an individual to collect or establish a right to salary or wages owed by an employer or former employer in computing the individual's income from an office or employment for the year in which they are paid.[34]

Proposed Amendment to Paragraph 8(1)b)

The proposed amendment will amend paragraph 8(1)(b), effective for amounts paid after 2000, to instead allow for a deduction for legal expenses incurred by a taxpayer to collect (or establish a right to collect) an amount that would be included in computing the taxpayer's employment income if received. The proposed amendment is intended to address concerns that where an amount is not owed to the employee directly by the employer, any legal expenses incurred by the taxpayer would not be deductible under current paragraph 8(1)(b) even though the amount, when received, would be taxable as employment income.[35]

The proposed amendment reads as follows:[36]

> (b) Legal expenses of employee – amounts paid by the taxpayer in the year as or an account of legal expenses incurred by the taxpayer to collect, or to establish a right to<u>, an amount owed to the taxpayer that, if received by the taxpayer, would be required by this subdivision to be included in computing the taxpayer's income</u>;

Implications of the Proposed Amendment to Subparagraph 8(1)(b)

The current wording of paragraph 8(1)(b) of the Act allows the deduction of amounts paid by the taxpayer to collect or establish a right to salary or wages owed to the taxpayer by the taxpayer's employer or former employer. Although this provision seems to be fairly straightforward, it has generated a significant amount of litigation.

In *Fenwick*[37], the Federal Court of Appeal found that paragraph 8(1)(b) did not apply to legal expenses incurred by a taxpayer where the central issue of the case was the reasonableness of remuneration that the taxpayer caused to be paid to himself. At paragraphs 7 and 8 of the decision, the Court stated that:

---

33 Bill C-48, supra note 13.

34 *Act*, supra note 3 at paragraph 8(1)(b).

35 Canada Tax Service, "Legal Expenses of Employees", March 2010 (Taxnet Pro).

36 NWMM October 2012, supra note 7.

37 *Fenwick v. Canada*, 2008 FCA 370, [2009] 2 CTC 184.

> Paragraph 8(1)(b) has a relatively narrow scope. It is intended to apply where an employee incurs legal expenses in attempting to collect unpaid salary or wages, or in attempting to resolve a dispute with an employer or former employer as to the amount of salary to which the employee is entitled (see Loo v. R., 2004 FCA 249 (FCA)). In the latter case, it is usually the employee alleging an underpayment … Paragraph 8(1)(b) is not intended to permit legal expenses to be deducted when they are incurred in litigation involving a claim for damages involving disputes other than those arising from the terms of employment, merely because the defendant's entitlement to particular remuneration is an element of the claim.

In *Loo*[38], the Federal Court of Appeal found that paragraph 8(1)(b) applied to a taxpayer attempting to establish entitlement to more than the taxpayer had been paid. The CRA commented on the decision stating that:[39]

> Essentially, the FCA found that the legal expenses fell squarely within the words of paragraph 8(1)(b) of the Act because Mr. Loo was trying to establish, by litigation, that in respect of the services he already rendered to his employer, the law may require that he be paid more than he was already paid.
>
> The FCA also noted that paragraph 8(1)(b) of the Act has two branches. The first branch permits a deduction for legal expenses incurred in an action to collect salary or wages owed (i.e. it contemplates litigation resulting from the failure of an employer to pay the salary or wages due to an employee). In these circumstances, there may be no dispute as to the amount of salary or wages that the employee is entitled to be paid for the services the employee has performed, but there may be a factual dispute as to how much of the salary or wages remains unpaid … .
>
> The second branch contemplates a situation in which the matter in controversy is the legal entitlement to the salary claimed and applies if, for example, an individual incurs legal expenses in litigating a factual dispute as to whether he or she has actually performed the services required by the contract of employment, or a dispute as to the rate of salary payable for services performed (ie this would include, for example, a dispute as to the terms and conditions of employment).

Concern has been expressed that where an amount is not owed to the employee directly by the employer, any legal expenses incurred by the taxpayer would not be deductible under paragraph 8(1)(b), even though the amount, when received, would be taxable as employment income.[40] This would be the case, for example, with respect to legal fees incurred by a taxpayer to collect insurance benefits under a sickness or accident insurance policy provided through an employer. The scope of amended paragraph 8(1)(b) is broadened (effective for amounts paid after 2000) to permit a deduction for legal expenses incurred by a taxpayer to collect, or establish a right to collect, an amount that, if received, would be included in computing the taxpayer's employment income. In other words, a deduction will be available whether or not it is "salary or wages" and whether it is paid by an "employer or former employer", as long as it is included in employment income under Part I, Division B, subdivision a.[41]

---

[38] *Loo v. Canada*, 2004 FCA 249, [2004] FCJ No 132.

[39] CRA document no. 2009-0310391I7, April 6, 2009.

[40] Canada, Department of Finance, *Explanatory Notes Relating to the Income Tax Act, The Excise Tax Act and Related Legislation* (Ottawa: Department of Finance, October 2012), clause 172 (http://www.fin.gc.ca/drleg-apl/nwmm-amvm-1012n-05-eng.asp).

[41] Ernst & Young, "Deductibility of Legal Fees Paid by an Employee: *Chagnon v. The Queen*, 2011 TCC 268" (2011) (http://www.ey.com/CT/en/Insights/Insights_Case_Comment_2011-013).

Status of Proposed Amendment

The first and second reading of Bill C-48- *Technical Tax Amendments Act*, 2012 was heard before the House of Commons of Canada on November 21, 2012 and March 8, 2012, respectively.[42]

The amendment of paragraph 8(1)(b) applies to amounts paid by the taxpayer after 2000 to collect, or to establish a right to, an amount owed to the taxpayer.[43]

8. <u>Changes to Employee Stock Options</u>

Section 7 - Agreement to Issue Securities to Employees and Section 110 - Deductions Permitted

The employee stock option provisions are contained in Section 7 of the Act and apply to any agreement to sell or issue securities to an employee. Paragraph 7(1)(a)[44] of the Act provides that where a particular qualifying person[45] has agreed to sell or issue its securities or the securities of a non-arm's length qualifying person to an employee of the particular qualifying person or another non-arm's length qualifying person, the employee is taxed in the year in which the employee exercises the option and acquires the securities. In the year of acquisition, the employee is deemed to receive a benefit from employment equal to the value of the security, at the time the security is exercised, less the amount paid by the employee to acquire the security plus the amount, if any, paid by the employee to acquire the option. The amount of the deemed employment benefit is added to the adjusted cost base of the security at the time of acquisition, included in the employee's income in the year the option is exercised and taxed as ordinary employment income. Paragraph 7(1)(b) of the Act provides similar treatment for when an employee transfers or otherwise disposes of a right under an agreement in respect of some or all of the securities.[46] In this situation, the employee is deemed to have received a benefit equal to the amount by which the value of the consideration for the disposition exceeds the amount, if any, paid by the employee to acquire those rights. Unless certain conditions are satisfied, the deemed employment benefit is taxed as ordinary employment income.

In certain circumstances, employees who are deemed to receive a taxable employment benefit arising under Section 7 of the Act are entitled to receive a one-half deduction of the deemed benefit. The effect of this deduction is to tax the stock option benefits under Section 7 at the same rate as capital gains. Section 110 of the Act describes certain deductions which may be permissible for the purpose of computing an individual's taxable income for the year. Paragraph 110(1)(d) sets out certain conditions that must be satisfied in order to qualify for the stock option deduction. Generally speaking, the deduction is allowed if the security is a prescribed share[47] or a unit of a mutual trust fund, the option exercise price (plus the amount

---

[42] Bill C-48, supra note 13.

[43] Canada, Department of Finance, *Explanatory Notes Relating to the Income Tax Act, The Excise Tax Act and Related Legislation* (Ottawa: Department of Finance, October 2012), clause 237 (http://www.fin.gc.ca/drleg-apl/nwmm-amvm-1012n-05-eng.asp) [Explanatory Note Clause 237].

[44] *Act,* supra note 3 at paragraph 7(1)(a).

[45] Subsection 7(7) of the Act defines a qualifying person as a corporation or a mutual fund trust.

[46] *Act,* supra note 3 at paragraph 7(1)(b).

[47] Regulation 6204 of the Act defines a prescribed security. In general terms, to be a prescribed security, there can be no limit of the security's right to participate in dividends or on the winding-up or liquidation of the corporation. There can be no right or obligation of the corporation to purchase the security except at fair market value and there could be no reasonable expectation that within two years of its issue the paid-up capital will be reduced or the security will be redeemed or purchased for cancellation. Generally, such securities will have the attributes of

paid to acquire the option, if any) was not less than the FMV of the security at the time the option was granted, and the employee was dealing at arm's length with the employer (and the corporation or mutual fund that granted the option, if it was not the employer).[48]

Proposed Amendment to Subsection 7(7) Definitions

Subsection 7(7) of the Act defines the expressions "qualifying person" and "security" for the purposes of section 7 and certain other provisions of the Act relating to those agreements. Subsection 7(7) is amended to have these definitions also apply for the purposes of new subsections 110(1.7) and (1.8) of the Act.[49] Subsection 110(1.7) of the Act provides that the definitions in subsection 7(7) of the Act relating to employee stock options also apply for the purposes of subsections 110(1.5) and 110(1.6) of the Act. Since subsection 7(7) also provides for the definitions to so apply, existing subsection 110(1.7) is unnecessary and is repealed.[50] New subsection 110(1.7) ensures that a reduction in the exercise price under an employee stock option will not disqualify the employee from claiming the paragraph 110(1)(d) deduction, provided certain conditions are met. New subsection 110(1.8) sets out the conditions that must be met in order for new subsection 110(1.7) to apply.[51]

The current wording of subsection 7(7) is as follows:[52]

> (7) The following definitions apply in this section and in subsection 47(3), paragraphs 53(1)(j) and 110(1)(d) and (d.01) and subsections 110(1.1), (1.2), (1.5), (1.6) and (2.1).

The proposed amendment to subsection 7(7) reads as follows:[53]

> (7) The following definitions apply in this section and in subsection 47(3), paragraphs 53(1)(j) and 110(1)(d) and (d.01) and subsections 110(1.1), (1.2), (1.5) to (1.8) and (2.1).

Implications of the Proposed Amendment to Subsection 7(7) and Addition of New Subsections 110(1.7) and (1.8)

The draft legislation proposes to add subsections 110(1.7) and (1.8).[54] New subsection 110(1.7) applies in circumstances where there is a reduction in the exercise price payable by

---

common shares although they do not have to carry voting rights. Additionally, the securities do not have to be those of a Canadian corporation to qualify for a deduction under paragraph 110(1)(d), so the deduction may apply to stock options in respect of public corporations and non-Canadian controlled corporations.

48 *Act,* supra note 3 at paragraph 110(1)(d).

49 Canada, Department of Finance, *Explanatory Notes Relating to the Income Tax Act, The Excise Tax Act and Related Legislation* (Ottawa, Department of Finance, October 2012), clause 171 (http://www.fin.gc.ca/drleg-apl/nwmm-amvm-1012n-05-eng.asp).

50 Explanatory Notes Clause 237, supra note 43.

51 Ibid.

52 *Act,* supra note 3 at subsection 7(7).

53 NWMM October 2012, supra note 7.

54 Reduction in exercise price

(1.7) If the amount payable by a taxpayer to acquire securities under an agreement referred to in subsection 7(1) is reduced at any particular time and the conditions in subsection (1.8) are satisfied in respect of the reduction,

(a) the rights (referred to in this subsection and subsection (1.8) as the "old rights") that the taxpayer had under the agreement immediately before the particular time are deemed to have been disposed of by the taxpayer immediately before the particular time;

(b) the rights (referred to in this subsection and subsection (1.8) as the "new rights") that the taxpayer has under the agreement at the particular time are deemed to be acquired by the taxpayer at the particular time; and the employee to acquire securities under an employee stock option and the conditions in new subsection 110(1.8) are satisfied. The purpose of subsection 110(1.7) is to ensure that a reduction in the exercise price under an employee stock option will not disqualify the employee from claiming the deduction under paragraph 110(1)(d), if the same reduction could have been effected by way of an exchange of options without jeopardizing the employee's eligibility for the deduction.[55]

As discussed earlier in this section, paragraph 110(1)(d) provides a deduction in computing taxable income in circumstances where subsection 7(1) of the Act deems an employee to have received a benefit from employment in connection with the exercise, transfer or disposition of rights under an employee option agreement. Paragraph 110(1)(d) sets out certain conditions that must be satisfied in order to qualify for the stock option deduction.

The conditions in paragraph 110(1)(d) include a minimum exercise price requirement under the option giving rise to the benefit under subsection 7(1) and, if that option was acquired as a consequence of one or more qualifying exchanges of options, under each of the previous options. Thus, if a reduction in the exercise price under an employee stock option causes the exercise price to fall below the minimum threshold established under paragraph 110(1)(d) for that option, the employee will not be entitled to claim the stock option deduction. However, there are situations in which an otherwise disqualifying reduction in an option exercise price could be effected by way of an exchange of options without jeopardizing the employee's eligibility for the deduction. This would be the case, for example, if the exercise price had originally been set at the FMV of the underlying securities at the time of grant, there is a subsequent decline in the FMV of the securities and the exercise price is adjusted to that lower FMV.[56] The combined effect of subsections 110(1.7) and (1.8) is to deem such a reduction to have been effected by way of an exchange, thus ensuring that the employee remains eligible for the paragraph 110(1)(d) deduction. According to the CRA, proposed subsections 110(1.7) and (1.8) do not restrict the number of times the exercise price under an option can be reduced.[57] In addition, the Department of Finance has indicated that there is no intent to preclude the application of proposed subsection 110(1.7) and (1.8) where an amendment that reduces the exercise price under a stock option also increases the number of shares covered by the option provided the combined changes to the option do not result in an increase in the net benefit associated with the option.[58]

In particular, new subsection 110(1.7) provides that, where there is a reduction in the exercise price under an employee stock option and the conditions in subsection 110(1.8) are

---

(c) the taxpayer is deemed to receive the new rights as consideration for the disposition of the old rights.

Conditions for subsection (1.7) to apply

(1.8) The following are the conditions in respect of the reduction:

(a) that the taxpayer would not be entitled to a deduction under paragraph (1)(d) if the taxpayer acquired securities under the agreement immediately after the particular time and this section were read without reference to subsection (1.7); and

(b) that the taxpayer would be entitled to a deduction under paragraph (1)(d) if the taxpayer

(i) disposed of the old rights immediately before the particular time,

(ii) acquired the new rights at the particular time as consideration for the disposition, and

(iii) acquired securities under the agreement immediately after the particular time.

55 Explanatory Notes Clause 237, supra note 43.

56 Ibid.

57 CRA document no. 2004-0093241E5, October 29, 2004.

58 Canada, Department of Finance, “Department of Finance Comfort Letters – 2002-05-29” (Taxnet Pro).

satisfied, the employee is deemed to have disposed of the rights under the option immediately before the reduction and to have acquired the amended rights immediately thereafter as consideration for the disposition.[59]

An example provided in the Explanatory Notes to the draft legislation is paraphrased below and may be instructive to the reader in that it illustrates the application of new subsections 110(1.7) and (1.8).

Example:

Pierre is granted an option to acquire ten shares of Company A at an exercise price of $100 per share, which is equal to the FMV at that time. The business has a few poor years and the value of Company A declines. Company A amends the option to reduce the exercise price to $30 a share, which is the new FMV.

Results:

Without the benefit of subsection 110(1.7), paragraph 110(1)(d) would require that the exercise price under the option at the time of exercise be no less than the FMV of the underlying share at the time the option was granted. Since the exercise price of $30 per share would be less than the FMV of $100 at the time the option was issued, this condition would not be met and Pierre would not be eligible for the paragraph 110(1)(d) deduction.

If the reduction had been effected by way of an exchange of options, there would have been no increase in the net benefit associated with the option (i.e., the difference between the FMV of the shares under the "new option" and the "new exercise price" ($300 – $300 = $0) would have been no greater than the difference between the FMV of the shares under the "old option" and the "old exercise price" ($300 – $1,000 = $0)). Thus, the exchange could have been an exchange to which subsection 7(1.4) applied.

If Pierre had exercised the new option immediately after the exchange, subparagraph 110(1)(d)(iii) would have required that the following exercise price tests be met:

- The exercise price under the old option at the time it was disposed of would have to be not less than the FMV of the underlying shares when the option was granted. Since the exercise price of $100 was equal to the FMV at the date of grant, this condition would have been met.

- The exercise price under the new option at the time of exercise would have to be not less than the exercise price set when the new option was acquired. Since Pierre would have paid $30 a share on exercise, which was the exercise price established when the new option was acquired, this condition would have been met.

Thus, if the reduction had been effected by way of an exchange and Pierre had exercised the option immediately after the exchange, he would have been eligible for the security option deduction.

---

[59] Explanatory Notes Clause 237, supra note 43.

Since the requirements of subsection 110(1.8) are satisfied, subsection 110(1.7) applies to deem the reduction to have been effected by way of an exchange. Consequently, the reduction will not disqualify Pierre from claiming the paragraph 110(1)(d) deduction.

Status of Proposed Amendment and New Subsections

The first and second reading of Bill C-48- *Technical Tax Amendments Act*, 2012 was heard before the House of Commons of Canada on November 21, 2012 and March 8, 2013, respectively.[60]

The amendment of subsection 7(7), which applies after 1998, is consequential to the enactment of new subsections 110(1.7) and (1.8) which apply to exercise price reductions occurring after 1998.[61]

9. <u>Benefits Conferred on a Shareholder</u>

Subsection 15(1) of the Act requires a shareholder of a corporation to include in computing income for a taxation year the amount or value of a benefit conferred in the year by the corporation on the shareholder.[62] The provision also applies to benefits conferred on a person in contemplation of the person becoming a shareholder of the corporation.

Proposed Amendment to Subsection 15(1)

Subsection 15(1) is amended in conjunction with the introduction of new subsection 15(1.4) of the Act, which provides several new rules for applying subsection 15(1). Subsection 15(1) is amended in a number of respects.[63] Subsection 15(1) is clarified to apply to a benefit conferred by a corporation on a member of a partnership that is a shareholder. The reference to "contemplated shareholder" in subsection 15(1) is clarified and expanded by new paragraph 15(1.4)(a).

Proposed New Subsection 15(1.4)

New subsection 15(1.4) of the Act provides rules of interpretation that apply for the purposes of applying the shareholder benefit income inclusion rule in subsection 15(1) and extend those rules to partnerships that are a shareholder of the corporation or contemplate becoming a shareholder of the corporation.

---

[60] Bill C-48, supra note 13.

[61] Explanatory Notes Clause 237, supra note 43.

[62] *Act,* supra note 3 at subsection 15(1).

[63] Canada, Department of Finance, *Explanatory Notes Relating to the Income Tax Act, The Excise Tax Act and Related Legislation* (Ottawa, Department of Finance, October 2012), clause 177 (http://www.fin.gc.ca/drleg-apl/nwmm-amvm-1012n-05-eng.asp) [Explanatory Notes Clause 177]. The wording of subsection 15(1) is revised to remove the postambles currently found at the end of subparagraph(c)(i) and at the end of the subsection. Paragraph 15(1)(c) is re-worded and, in the case of the postamble at the end of subsection 15(1), its substance is moved to the preamble of the revised subsection: (1) the requirement that the benefit be included in computing income of the shareholder for the year; and (2) the exception that applies to the extent a benefit is deemed by section 84 to be a dividend. No substantive change is made to the wording of paragraphs 15(1)(b) to (d).

Implications of the Proposed Amendment to Subsection 15(1) and Addition of Subsection 15(1.4)

The current paragraph 15(1)(a) provides an exception to the general rule that a benefit conferred on a shareholder or contemplated shareholder of the corporation must be included in computing the shareholder's taxable income for the year. This exception is applicable to reductions of a corporation's paid-up capital, the redemption, cancellation or acquisition of its shares or on the winding up, discontinuance or reorganization of its business, or otherwise by way of a transaction to which section 88 of the Act applies. The proposed amendments narrow the exception so that it applies only if the corporation is a resident of Canada.[64] In other words, this exception is no longer available to non-resident corporations. The proposed amendments to subsection 15(1) impacting the non-resident rules are a response to the Tax Court of Canada decision in *Morasse*[65] impacting the non-resident rules. A detailed discussion of the changes impacting non-resident corporations is outside the scope of this paper.[66]

New subsection 15(1.4) of the Act provides rules of interpretation that apply for the purposes of applying the shareholder benefit income inclusion rule in subsection 15(1). Subsection 15(1) applies where the benefit is conferred on a member of a partnership in contemplation of the partnership becoming a shareholder of the corporation. New paragraph 15(1.4)(a) clarifies that subsection 15(1) applies not only where a benefit is conferred by a corporation on a person in contemplation of the person becoming a shareholder, but also where the benefit is conferred on a partnership in contemplation of the partnership becoming a shareholder of the corporation.[67]

New paragraph 15(1.4)(c) provides a rule that applies, in general, if a benefit is conferred on an individual (other than an excluded trust) who does not deal at arm's length with, or is affiliated with, a shareholder of the corporation, a member of a partnership that is a shareholder of the corporation or a contemplated shareholder of the corporation.[68] In such cases, new paragraph 15(1.4)(c) provides that for the purposes of subsection 15(1) the benefit is conferred on the shareholder, the member of the partnership or the contemplated shareholder, as the case may be. This rule does not apply to the extent that the benefit is conferred on an individual who is required to include the value of the benefit in computing the income of the individual or any other person.

The application of subsection 15(1) in the context of multi-tiered partnerships is clarified by the rule in new paragraph 15(1.4)(b). New paragraph 15(1.4)(b) provides that a person or partnership that is (or is treated by the paragraph as being) a member of a particular partnership that is a member of another partnership, is deemed to be a member of the other partnership. In general, this provides a partnership look-through rule when considering if a person or partnership is a member of a partnership that is a shareholder of a corporation or that is a contemplated shareholder of the corporation.

---

[64] Explanatory Notes Clause 177, supra note 63.

[65] *Morasse v. The Queen*, 2004 TCC 239, 58 DTC 2435 - held that the current paragraph 15(1)(a) may apply where a non resident corporation confers a benefit in the course of a reorganization.

[66] See Explanatory Notes Clause 177, supra note 63 for a discussion of the changes to the non-resident rules.

[67] Explanatory Notes Clause 177, supra note 63.

[68] NWMM October 2012, supra note 7.

Status of Proposed Amendment

The first and second reading of Bill C-48- (Part 5) *Technical Tax Amendments Act*, 2012 was heard before the House of Commons of Canada on November 21, 2012 and March 8, 2013, respectively.[69]

These amendments apply in respect of benefits conferred on or after October 31, 2011.[70]

Shareholder Debt - Section 15(2)

Subsection 15(2.1)

Subsection 15(2) of the Act generally requires that certain indebtedness be included in the income of the debtor in the year in which the indebtedness arose.[71] This subsection is intended to prevent a person, that is directly or indirectly a shareholder of a particular corporation or that is connected with a shareholder of the particular corporation, from avoiding tax by receiving property from the corporation through an otherwise non-taxable loan, rather than as a dividend or other taxable amount.[72] Paragraphs 15(2)(a) to (c) describe the debtors to which section 15(2) applies in terms of their relationships with the particular corporation. In this regard, paragraph 15(2)(b) provides that subsection 15(2) may apply to a debtor if the debtor is connected with a shareholder of the particular corporation.

Proposed Amendment to Subsection 15(2.1)[73]

Subsection 15(2.1) of the Act generally provides, for the purposes of subsection 15(2), that a person is connected with a shareholder of a particular corporation if the person does not deal at arm's length with the shareholder. Subsection 15(2.1) is amended to clarify that a partnership can be connected with a shareholder of a particular corporation if that partnership does not deal at arm's length with, or is affiliated with, the shareholder.

Status of Proposed Amendment

The first and second reading of Bill C-48- *Technical Tax Amendments Act*, 2012 was heard before the House of Commons of Canada on November 21, 2012 and March 8, 2013, respectively.[74]

This amendment applies in respect of loans made and indebtedness arising after October 31, 2011.

10. <u>Subsection 88(1) and the Bump Rules in Respect of a Partnership Interest</u>

Proposed Amendments to Subsection 88(1)

Subsection 88(1) of the Act applies to a winding-up of a taxable Canadian corporation where not less than 90% of the issued shares of each class in the share capital of a subsidiary

---

[69] Bill C-48, supra note 13.

[70] Explanatory Notes Clause 177, supra note 63.

[71] *Act,* supra note 3 at subsection 15(2).

[72] Explanatory Notes Clause 177, supra note 63.

[73] NWMM October 2012, supra note 7.

[74] Bill C-48, supra note 13.

were immediately before the winding-up held by a parent corporation that is also a taxable Canadian corporation and all of the shares of the subsidiary that were not held by the parent immediately before the winding-up were owned at that time by persons with whom the parent was dealing with at arm's length. If the foregoing requirements are applicable to a winding-up, the remainder of subsection 88(1) provides particular rules that govern the winding-up.

One important set of provisions are the so-called bump rules found in paragraph 88(1)(d) of the Act (the "**Bump Rules**"). A comprehensive review of the Bump Rules is beyond the scope of this paper.[75] The Bump Rules permit a parent corporation to add certain amounts to the cost of the subsidiary's former capital property distributed to the parent on the winding-up. Subparagraph 88(1)(d)(ii) provides that the bump amount, or the increase in the adjusted cost base cannot exceed the amount, if any, by which the FMV of the capital property at the time the parent last acquired control of the subsidiary exceeds the cost amount to the subsidiary of the property immediately before the winding-up.[76] The Bump Rules are extremely complicated and contain a number of anti-avoidance provisions.

Generally, the Bump Rules provide that only capital assets, such as land, shares of a corporation or an interest in a partnership are eligible for the bump. Assets that are not eligible for the bump include eligible capital property, depreciable property, inventory and resource property. [77]

Certain bump transactions were designed to hold a subsidiary's income assets (ie. assets that do not qualify for the bump) in a corporate partnership structure. In these structures, the income generating assets are held indirectly through a partnership rather than directly by the subsidiary. After the acquisition of control of a subsidiary, the parent amalgamates with or winds up the subsidiary and then bumps up the cost of the partnership interest in circumstances where all of the FMV of the partnership interest is derived from income-producing assets.

As initially introduced in the 2012 Federal Budget, the Notice of Ways and Means Motion to Implement Certain Provisions of the Budget tabled in Parliament on March 29, 2012 and released on October 15, 2012 ("**NWMM – October 15**") proposes certain rules and measures to prevent structures that have been used in an attempt to increase the cost base of ineligible properties on the winding-up of a subsidiary.

More specifically, NWMM – October 15, proposes to introduce measures that will generally deny the bump in respect of a partnership interest to the extent that the accrued gain in that partnership interest is reasonably attributable to the amount by which the FMV of income-producing assets exceed their cost amount. This has the effect of looking through the partnership for the purpose of this new provision. This new measure will apply where the income assets are held directly by the partnership or indirectly through another partnership. The new rules will not apply to income assets that are held by a corporation whose shares are held by a partnership.

---

75 For a more detailed summary of subsection 88(1)(d) and the associated bump rules, See Timothy Kirby and Christopher Montes, "Practical Issues Encountered When Winding-Up a Corporation", 2011 Prairie Provinces Tax Conference (Edmonton: Canadian Tax Foundation, 2011).

76 Canada, Department of Finance, *Explanatory Notes Relating to the Income Tax, the Excise Tax Act and Related Acts and Regulations* (Ottawa, Department of Finance, October 15, 2012), clause 18 (http://www.fin.gc.ca/drleg-apl/bia-leb-1012-eng.asp).

77 See section 54 and subsections 13(21), 248(1) and 66(15) of the Act for the definitions of capital property, depreciable property, inventory and Canadian resource property.

NWMM – October 15 contemplates revising paragraph 88(1)(d) by adding new subparagraph 88(1)(d)(ii.1). The new subparagraph 88(1)(d)(ii.1) which was added to the Act by S.C. 2012, c. 31 s. 18(1) reduces the FMV of an interest in a partnership held by a subsidiary at the time the parent last acquired control of the subsidiary to the amount determined by the formula A – B, where:

A is defined as the FMV of the partnership interest at the time the parent last acquired control of the subsidiary (determined without reference to the subparagraph); and

B is defined as the portion of the amount by which the FMV (determined without reference to the subparagraph) of the interest at the time exceeds its cost amount at that time as may reasonably be regarded as being attributable at that time to the total of all amounts each of which is:

(A) in the case of depreciable property held directly or indirectly by the partnership, the amount by which the FMV (determined without reference to liabilities) of the property exceeds its cost amount;

(B) in the case of Canadian resource property or a foreign resource property held directly or indirectly by the partnership, the FMV (determined without reference to liabilities) of the property; or

(C) in the case of property that is not a capital property, a Canadian resource property or a foreign resource property and that is held directly by the partnership or held indirectly through one or more other partnerships, the amount by which the FMV (determined without reference to liabilities) of the property exceeds its cost amount.

Implications of Proposed Amendments to Subsection 88(1)

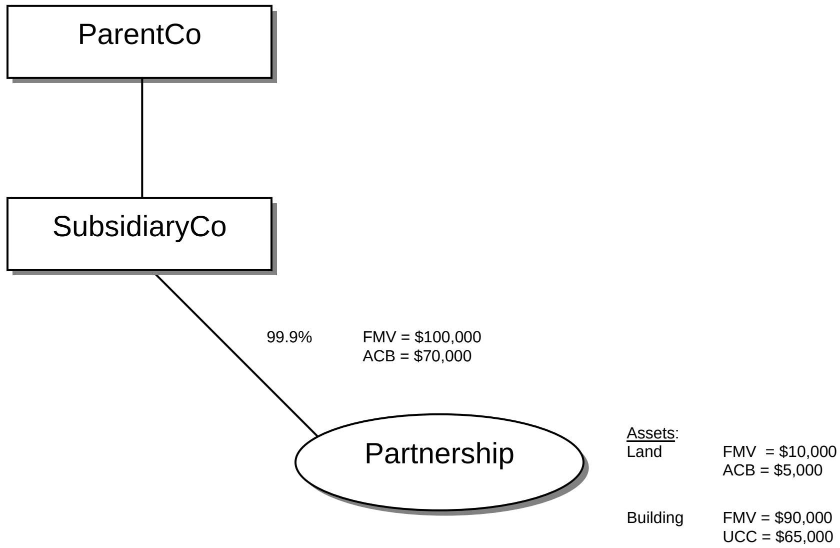
In the explanatory notes that accompanied the draft legislation with respect to this matter, the Department of Finance noted that this measure is designed to ensure that the bump available in respect of a subsidiary's interest in a partnership does not reflect unrealized gains and recapture income in respect of property that would not be eligible for a bump if it were held directly by the subsidiary (for example, ineligible property).[78] The effects of this new subparagraph are best illustrated by way of examples that are outlined in the Explanatory Notes regarding NWMM – October 1.[79]

---

78 NWMM - October 2012, supra note 7 at 22.

79 Ibid., at 23-25.

Example 1



In the example illustrated above, assume that the FMV and adjusted cost base of SubsidiaryCo's interest in the Partnership is at the time control of SubsidiaryCo was acquired by ParentCo. Under the old rules, if ParentCo effected steps to cause the winding-up of SubsidiaryCo pursuant to subsection 88(1) of the Act, and the winding-up took place immediately after acquiring control of SubsidiaryCo, the bump in respect of the SubsidiaryCo's partnership interest would be $30,000. In accordance with the former version of subparagraph 88(1)(d)(ii), the bump amount (the increase in adjusted cost base) cannot exceed the amount, if any, by which the FMV of the capital property at the time the parent last acquired control of the subsidiary exceeds the cost amount to the subsidiary of the property immediately before the winding-up. In applying subparagraph 88(1)(d)(ii) to the above example, the bump amount is $30,000 which is the increase in adjusted cost base which is calculated by taking the FMV of SubsidiaryCo's interest in the Partnership ($100,000) and subtracting SubsidiaryCo's adjusted cost base in respect of the interest in the Partnership ($70,000).

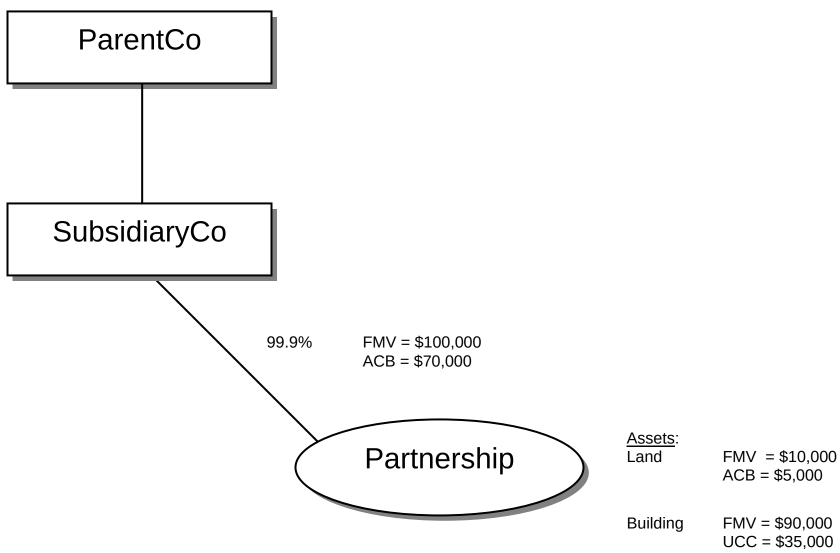
However, by applying new subparagraph 88(1)(d)(ii.1) to this example, the FMV of SubsidiaryCo's partnership interest is deemed to be $75,000, not $100,000. This FMV is calculated by applying the formula discussed above of A – B, where:

> A is equal to $100,000, being the FMV of SubsidiaryCo's partnership interest without reference to subparagraph 88(1)(d)(ii.1); and
>
> B is $25,000, being $30,000 x $25,000/$30,000. $25,000 is the portion of the $30,000 outside gain in respect of the partnership interest ($100,000 less its cost amount of $70,000) that may reasonably be regarded as being attributable to A in the case of the building, being depreciable property, $25,000 ($90,000 FMV, less the $65,000 UCC). As there is no resource property or non-capital property, in the above example, there are no further amounts to take into account in calculating variable B.

In this first example, as the relationship between the outside gain of $30,000 in respect of SubsidiaryCo's Partnership interest and the inside gain in respect of the ineligible property held by Partnership ($25,000) is easy to appreciate as the outside gain and the total inside gains are equal. The portion of the $30,000 outside gain that is reasonably attributable to the gain on the ineligible property is the $25,000 gain for the ineligible property held by the Partnership. Therefore, the FMV of SubsidiaryCo's interest in the Partnership is reduced from $100,000 to $75,000 by reducing the $25,000 inside gain in respect of partnership's ineligible property (the building).

The explanatory notes to the proposed legislation provides a second example which involves a situation in which the outside gain in respect of the partnership interest is less than the total inside gain in respect of the property held by the partnership and the facts of this example are illustrated below.

Example 2



Note that the only difference in the facts in Examples 1 and 2 is in Example 2, the UCC of the building has been reduced to $35,000 from $65,000. Applying subparagraph 88(1)(d)(ii), if ParentCo were to cause a winding-up or a vertical amalgamation of SubsidiaryCo into ParentCo (immediately after acquiring control of SubsidiaryCo), the bump in respect of SubsidiaryCo's interest in the Partnership would be $30,000 (which is equal to the $100,000 FMV of SubsidiaryCo's interest in the partnership less its adjusted cost base of $70,000).

However, under new subparagraph 88(1)(d)(ii.1), the FMV of SubsidiaryCo's interest in the Partnership is reduced to $72,500 (down from $100,000). The lower FMV is calculated by applying the formula A – B, where:

> A represents $100,000, which is equal to the FMV of SubsidiaryCo's interest in the Partnership before the application of the subparagraph); and
>
> B is $27,500, which is equal to $30,000 x $55,000/$60,000, which is the portion of the amount of $30,000 less the FMV of SubsidiaryCo's interest in the Partnership ($100,000) less SubsidiaryCo's adjusted cost base of the interest in the Partnership ($70,000) that may reasonably be regarded as being attributable to A with respect to the building, which is depreciable property, $55,000, which is the FMV of $90,000 less its UCC of $35,000 and as there are no resource properties or non-capital properties, there is no further calculation in respect of variable B.

In this second example, variable B is equal to $27,500 due to the unrealized outside gain of $30,000 being attributable to both the unrealized gain and recapture in respect of the building ($55,000) and the unrealized gain in respect of the land ($5,000). Therefore, the portion of the outside gain that may reasonably be regarded as being attributable to the building is based on an apportionment of the outside gain to the inside gains in respect of the two properties held by partnership ($27,500 = $30,000 x $55,000/$60,000).

Related Amendments (88(1)(e) and 97(3))

To ensure the effectiveness of the new Bump Rules in respect of an interest in a partnership, two related amendments were passed under S.C. 2012, c.31. The first of which is new paragraph 88(1)(e) of the Act which is an anti-avoidance rule that reduces the FMV of a subsidiary's partnership interest for the purposes of determining variable A in the new formula introduced in subparagraph 88(1)(d)(ii.1). Essentially, new paragraph 88(1)(e) provides that the FMV of an interest in a partnership help by a subsidiary at the time the parent of the subsidiary last acquired control of the subsidiary is deemed not to include the amount that is the total of each amount that is the FMV of a property that would otherwise be included in the FMV of the interest, if:

- as part of a series of transactions where a events in which control of the subsidiary (that holds the partnership interest) is last acquired by the parent and on or before the acquisition of control,
    - o the subsidiary disposes of the property to the particular partnership or any other partnership to which subsection 97(2) applies to the disposition; or
    - o the subsidiary acquires an interest in a partnership from a person or partnership with whom it does not deal at arm's length and section 85 applies to the acquisition; and
- at the time of the acquisition of control of the subsidiary, the particular partnership holds, directly or indirectly through one or more other partnerships, ineligible property described in clauses A to C of the description of B in new subparagraph 88(1)(d)(ii.1).

As mentioned, new paragraph 88(1)(e) is an anti-avoidance provision intended to address transfers of property pursuant to subsection 97(2) or section 85 in circumstances where the transfers are made to alter the factors that are relevant when applying the formula A – B set forth in new subparagraph 88(1)(d)(ii.1).[80]

The second ancillary change made to the Act in respect of the new Bump Rules is new subsection 97(3). New subsection 97(3) prevents the application of subsection 97(2) in certain circumstances. Briefly, subsection 97(2) of the Act provides for a rollover where property is transferred by an existing or new member of a partnership to a partnership. Essentially, subsection 97(2) incorporates the rollover provisions of subsection 85(1) where the transferee is a partnership.

New subsection 97(3) will prevent the application of subsection 97(2), where a disposition of property is made by a taxpayer to a Canadian partnership in which a subsidiary (as referred to in subsection 88(1)), holds an interest if the disposition occurs after control of the

---

[80] Ibid., at 27.

subsidiary is acquired by its parent (as referenced in subsection 88(1)). The intent of subsection 97(3) is to ensure that property that is not eligible for a bump under paragraph 88(1)(c) (ineligible property) is not transferred on a tax-deferred basis pursuant to subsection 97(2) to a partnership of the subsidiary after the control of the subsidiary is acquired by the parent in circumstances that would attempt to frustrate the spirit of new paragraph 88(1)(d)(ii.1).

More specifically, new subsection 97(3) will apply to prevent the application of a rollover under subsection 97(2) to a particular partnership if:

(a) a part of a transaction or event or series of transactions or events that includes the disposition

   (i) control of a taxable Canadian corporation (the subsidiary) is acquired by another taxable Canadian corporation (the parent);

   (ii) the subsidiary is wound-up pursuant to subsection 88(1) or pursuant to an amalgamation with one or more corporations pursuant to subsection 87(11); and

   (iii) the parent makes a designation under paragraph 88(1)(d) in respect of an interest in the partnership;

(b) the disposition occurs after the acquisition of control of the subsidiary;

(c) the particular partnership acquires property that is

   (i) ineligible for the bump (for example, depreciable property, inventory and resource property) or

   (ii) is an interest in a partnership that holds such property; and

(d) the subsidiary is the taxpayer or has, before the disposition of the property, directly or indirectly in any manner whatever, an interest in the taxpayer.[81]

Status of Proposed Amendment

New subparagraphs 88(1)(d)(ii.1), 88(1)(e) and new subsection 97(3) were all passed into law and are applicable in respect of dispositions made after March 28, 2012.

11. <u>The Prohibited Investment Rules in respect of Registered Retirement Savings Plans and Tax-Free Savings Accounts</u>

The March 2011 Federal Budget introduced special taxes on non-qualified investments, prohibited investments and advantages for TFSAs, RRSPs and RRIFs. After discussions with the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants, the Department of Finance agreed to introduce some relieving provisions and to clarify certain changes. These relieving provisions and clarifying rules were introduced in December 2012.

---

81 Ibid.

Summary of March 2011 Special Taxes

Strict penalties were introduced in the March 2011 Budget that imposed high tax rates on specific investments. Highlights of these special taxes are outlined below:

Tax is payable on investments that are non-qualified investments, advantages and prohibited investments that were acquired after March 22, 2011 and on pre-March 23, 2011 investments that first became non-qualified investments, advantages or prohibited investments after March 22, 2011. The penalty is equal to 50% of the FMV of the property at the time it was acquired or it became non-qualified, prohibited or an advantage. If income earned on specified non-qualified investments is not withdrawn promptly from the TFSA, RRSP or RRIF, the annuitant is liable for the 100% advantage tax on the income.[82]

In relation to TFSAs, RRSPs or RRIFs, on an advantage that is a benefit, tax will be payable based on the FMV of the benefit; in relation to an advantage that is a loan or a debt, the amount of the loan or debt will be considered, and in the case of an RRSP strip, the amount of the RRSP strip will be considered when assessing the tax payable.[83] If an investment qualifies as both a non-qualified investment and a prohibited investment, it is treated as a prohibited investment only, and the trust is not subject to tax on the investment earnings.[84] If a prohibited investment ceases to be a prohibited investment while it is held by the trust, the trust is considered to have disposed of and immediately re-acquired the property at its FMV.[85]

Feedback was provided on the strict application of these anti-avoidance rules and in response, relieving and clarifying rules were provided. These rules provide for some leniency where the strict rules would have otherwise captured transactions of which the primary intention was not to avoid tax consequences. The below discussion highlights the main relieving provisions and clarifying rules introduced in December 2012.

Proposed Amendments - Relieving Provisions and Clarifying Rules

The definition of "advantage" in subsection 207.01(1) of the *Act* is amended in three ways. First, to create a new exception to the definition to accommodate reasonable incentive programs frequently offered by plan issuers, such as rebate programs or favourable rates of return, as long as the main purpose of these programs is not to benefit from tax exemptions.[86] Second, to address concerns that the phrase "open market" in the definition of "advantage" would be interpreted too narrowly, clause *(b)*(i)(A) of the definition is amended to replace the reference to "open market" with "a normal commercial or investment context".[87] Third, the description of income and capital gains is amended to be more consistent with similar usage elsewhere in the *Act*, and to clarify that the dividend gross-up is not included in the amount of an

---

82 Canada Revenue Agency, "Tax payable on non-qualified investments" (http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ntvdnc/nnqlfdnvst-eng.html) [CRA Non-Qualified Investments].

83 Canada Revenue Agency, "Tax payable on an advantage" (http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ntvdnc/vntg-eng.html).

84 CRA Non-Qualified Investments, supra note 82.

85 Canada Revenue Agency, "Tax payable on prohibited investments" (http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/ntvdnc/prhbtnvst-eng.html).

86 Canada, Department of Finance, *Legislative Proposals Relating to Income Tax* (Ottawa: Department of Finance) (http://www.fin.gc.ca/drleg-apl/ita-lrir-dec12-l-eng.pdf).

87 Canada, Department of Finance*, Explanatory Notes to Legislative Proposals Relating to the Income Tax Act and Regulations* (Ottawa: Department of Finance, December 2012) (http://www.fin.gc.ca/drleg-apl/ita-lrir-dec12-n-eng.asp).

advantage that is a dividend.[88] Several other definitions were amended to relax the strict interpretation.

"Excluded property" replaces the previous definition for "prescribed excluded property" found in section 5000 of the *Income Tax Regulations*. "Excluded property" is the new definition describing registered plan investments that are excluded from being prohibited investments for the TFSA, RRSP or RRIF that holds it. The three categories of excluded property are: certain insured mortgages, investment fund start-up and wind-up and equity that meets the alternative widely-held test. There are seven conditions to be met in the alternative widely-held test that ultimately determines whether an investment represents a low risk of self-dealing even though the investment would or might otherwise be a prohibited investment.[89]

Another relieving provision is found in the definition of "prohibited investment" in subsection 207.01*(b)*(ii); the phrase "or with a person or partnership described in subparagraph (i)" is eliminated, which effectively reduces the likelihood that an individual would have a prohibited investment in circumstances where the connection between the investment and the individual is less direct. This amendment applies to investments made after March 22, 2011.[90]

The definition of "RRSP strip" in subsection 207.01(1) of the *Act* is also amended as underlined below:

> "RRSP strip", in respect of a RRIF or RRSP, means <u>the amount of a reduction in the fair market value of property held in connection with the RRIF or RRSP, if the value is reduced</u> as part of a transaction or event or a series of transactions or events one of the main purposes of which is to enable the controlling individual of the RRIF or RRSP, or a person who does not deal at arm's length with the controlling individual, to obtain <u>a</u> benefit <u>in respect</u> of property held in connection with the RRIF or RRSP <u>or to obtain a benefit as a result of the reduction</u>, but does not include an amount that is…

This amendment was made to better target transactions in which there is an actual reduction in the value of property held in connection with an RRSP or RRIF.[91]

The exclusion regarding consideration provided to the registered plan in paragraph (c) of the definition for "swap transaction" is amended to clarify that consideration, and not just the removal of the investment is considered part of the excluded transaction and that as a consequence neither side of the transaction is a swap transaction.[92] This amendment comes into force on July 1, 2011. A swap transaction undertaken to remove property from an RRSP or RRIF comes into force though on January 1, 2022 if it is reasonable to conclude that the retention of the property in the RRSP or RRIF would result in a tax being payable under Part XI.01 of the *Act*.[93]

Subsection 207.04(5) which provides for a deemed disposition and reacquisition where property ceases to be a non-qualified investment or a prohibited investment is being repealed. Instead, two new subsections to the *Act*, 207.01(6) and (7), have been added.

---

88 Ibid.

89 Ibid.

90 Ibid.

91 Ibid.

92 Ibid.

93 Ibid.

Subsection 207.01(6) provides a deemed disposition rule for property immediately before it becomes, or ceases to be, a non-qualified investment or prohibited investment for proceeds of disposition equal to the property's FMV. The registered plan is also deemed to have reacquired the property for the same amount at the time of its change in status.[94]

Subsection 207.01(7) deems that the cost of property held by an RRSP or RRIF on March 22, 2011 that was a prohibited investment on March 23, 2011 is to be equal to its FMV on March 22, 2011. This is relevant for determining the capital gain (loss) for the purposes of the definition "transitional prohibited investment benefit". [95]

In effect for the 2013 fiscal year, the federal government has also increased the annual contribution to TFSAs up $500.00 to $5,500.00. When the TFSA was first introduced, it was announced that the annual contribution limit would be indexed to inflation in $500 increments; this is the first increase since the introduction of the TFSA in 2009.

Implications of Proposed Amendments

The strict anti-avoidance rules for non-qualified transactions, prohibited investments and advantages introduced in March 2011 caught the attention of many tax professionals. Relieving provisions and clarifying rules were subsequently introduced in December 2012. These new rules provide for some leniency and limit the scope of transactions that will be penalized by the special taxes introduced in March 2011. It is still important to be aware of the definitions and rules surrounding non-qualified investments, prohibited investments and advantages for TFSAs, RRSPs and RRIFs so as not to be penalized by the high tax rates.

Status of Proposed Amendment

These changes are in effect as of March 22, 2011, but some of the relieving provisions, for example swap transactions as outlined above, will not come into force until 2022.

12. Conclusion

It is hard to believe that the *Income War Tax Act* that received royal assent on September 30, 1917 comprised of 11 pages. Almost 100 years later, the Act is comprised of thousands of pages, not to mention the addition of the *The Income Tax Regulations*, *The Income Tax Application Rules* and other tax legislation, such as *The Excise Tax Act*.

New tax legislation is introduced or enacted regularly and tax practitioners are faced with a somewhat overwhelming task of trying to stay on top of the latest changes. Hopefully this paper proves useful in assisting tax practitioners with an owner-manager focus in understanding some of the recent technical bill issues announced in the last eight months.

---

[94] Ibid.

[95] Ibid.