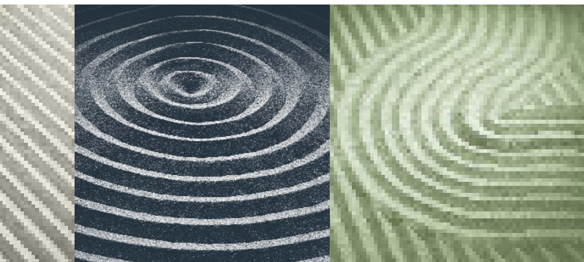

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TAX NOTES

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Inside

Department of Finance overrides *Manrell:* non-competition payments are no longer tax free

Winning your lawsuit: how much is taxable?

An overview of oil & gas flow-through share financing

Tax and estate planning for individuals with disabilities

Announcements

Achievements, Publications and Seminars

DEPARTMENT OF FINANCE OVERRIDES *MANRELL*: NON-COMPETITION PAYMENTS ARE NO LONGER TAX FREE

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In the Spring 2003 issue of *Tax Notes*, we reported on the good news for taxpayers arising out of the Federal Court of Appeal's recent decision in *Manrell* (2003 DTC 5225). Previously, in *Fortino* (2000 DTC 6060), the Federal Court of Appeal had held that a payment received by a taxpayer for signing a non-competition agreement in a non-arm's length share sale transaction was not taxable as ordinary income. In *Manrell*, the Court followed its decision in *Fortino*, and further held that such payments were not taxable as a capital gain. Taken together, these cases stand for the proposition that a payment received by a taxpayer for signing a non-competition agreement, even with a concurrent sale of shares, would generally be tax-free.

The Federal Court of Appeal concluded the discussion of the taxability of the non-competition agreement at the end of their reasons for judgment in Manrell by stating:

> "This litigation history demonstrates that the potential solution to the problem of whether and how to tax non-competition payments ranges from full taxation as income, to partial taxation as capital gains, to no taxation at all . . . The debate is a matter of tax policy, for which the only proper forum is Parliament."

Unfortunately for the Canadian taxpayer, Parliament has answered the Court's call. On October 7, 2003, the federal Department of Finance issued a News Release announcing the Department's intention to amend the *Income Tax Act* in order to address the "tax free" receipt of non-competition payments resulting from the Federal Court of Appeal's decisions in *Fortino* and *Manrell* (the "Proposed Amendments").

Although draft legislation is still being drafted by the Department of Finance and an expected release date has not been provided, the Backgrounder to the News

Release provides some general insight into the Department of Finance's position. The general rule will be that amounts received for granting a “restrictive covenant” will be taxed as ordinary income. While this amendment is primarily aimed at the Court’s treatment of non-competition payments in the context of a sale of a business, the News Release uses the broader term “restrictive covenant”. The scope of this amendment will not be known until draft legislation is available.

The Department of Finance has stated that exceptions to the ordinary income rule will apply to amounts receivable in respect of a non-competition agreement granted in the context of an arm's length sale of a business, either directly or indirectly, though the sale of shares of a corporation or an interest in a partnership. A portion of non-competition payments may be taxed as a capital gain under a formula based on the increase in the value of the shares or partnership interest as a consequence of granting the covenant (such increase being measured by comparing a sale where the taxpayer grants a restrictive covenant for no consideration to a sale where such a covenant is not granted) and the ratio of shareholdings of recipients of such payments. The balance will be taxed as ordinary income.

On an asset sale, an amount receivable for goodwill is treated as an eligible capital receipt, one-half of which is included in the vendor’s income. This result will not be altered where a restrictive covenant is provided for no additional consideration to support the transfer of goodwill.

For example, assume that Terence and Isabel each own 50 of the 100 common shares of X Ltd. which carries on a business. The adjusted cost base of their shares is nil. An arm's length purchaser offers to purchase all of the shares of X Ltd. for $2 million provided that Terence agrees not to compete with the business of the purchaser after the sale. If Terence does not provide the restrictive covenant, the purchaser would only be prepared to pay $1.8 million for the shares. Therefore, $200,000 can reasonably be attributed to the restrictive covenant granted by Terence as this is the amount by which the restrictive covenant would increase the value of the shares. Under the Proposed Amendments, the tax consequences to Terence and Isabel on the sale of their shares would be as follows: Isabel would receive $900,000 for her 50 common shares of X Ltd. and would have a capital gain of $900,000; Terence would receive $900,000 for his 50 common shares of X Ltd and $200,000 for the restrictive covenant. Due to the fact that the restrictive covenant increased the value of the 100 common shares by $200,000, Terence can add 50% (due to the fact that he owns 50 of the 100 common shares of X Ltd.) of the $200,000 to his share proceeds and would therefore have a capital gain of $1 million. The remaining $100,000 would be considered ordinary income to Terence.

Conversely, where an amount is paid for a restrictive covenant in conjunction with the acquisition of a business (i.e. an asset purchase), or of a share or partnership interest, the amount will be considered an eligible capital expenditure of the payer of which a certain amount will be eligible for a declining balance writedown or will be added to the cost of the share or partnership interest.

The Proposed Amendments will apply to amounts that are received or receivable after October 7, 2003. However, there is a grandfathering provision in that the Proposed Amendments will not apply to amounts that are received prior to January 1, 2005 pursuant to a written agreement entered into on or before October 7, 2003 between parties that are dealing at arm's length.

Taxpayers will await with interest the release of draft legislation implementing these proposals. If you would like any further information relating to the Proposed Amendments and the status of non-competition payments for tax purposes, please contact your local member of the Miller Thomson LLP Tax Group for further information and assistance.

WINNING YOUR LAWSUIT: HOW MUCH IS TAXABLE?

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Finally, it is pay day. After lengthy preparation, negotiations and court time, the judge has awarded you a significant sum for damages caused by the defendant. You receive the cheque. As you deposit it, you ask yourself, "Is any of this taxable?" Great question, but bad timing. Income tax considerations in relation to your lawsuit should be addressed at the outset.

Any payment to you in settlement or as court-awarded damages gives rise to income tax considerations. Depending on circumstances relating to you, the defendant and the subject matter of the lawsuit, the payment can constitute ordinary income or a capital gain in your hands or, in rare instances, an income tax-free "windfall". If the payment can be characterized as a capital gain, only one-half of the payment must be included in computing your income for tax purposes.

The appropriate characterization of a payment as income, capital gain or "windfall" is governed mainly by case law, not specific provisions of the *Income Tax Act*. (However, see the previous article on a proposed statutory amendment regarding restrictive covenants). Often, that characterization is not black or white, but a shade of gray. It is sometimes possible to frame the lawsuit in pleadings, and otherwise in the conduct of the lawsuit or in a settlement agreement, in a manner that can support more favourable income tax treatment for a plaintiff if and when a claim is settled or court-awarded damages are paid.

The basic question tax lawyers ask about a lawsuit is: "Will the payment on judgment or settlement be an income or a capital receipt to the plaintiff, or a "windfall"?" To answer, they look at the *purpose* of the payment; in other words, what is the payment designed to replace? They also look at the *effect* of the payment. That is, if the plaintiff gets the payment, will the plaintiff have had its income, or some capital asset, replaced? Particularly in complex commercial lawsuits, the answers to these questions are not often readily apparent. Claims that are founded in both breach of contract and tort (e.g., negligence) add another layer of complexity to this analysis.

While tax-free "windfalls" are a rarity, case law and the resulting administrative position of the Canada Customs & Revenue Agency support the proposition that sums paid to a plaintiff for personal injury are generally income tax-free. Case law also supports also the proposition that payments for human rights abuses or for punitive damages are generally tax-free. Where the payment is a "mixed bag", the allocation of what is tax-free and what is taxable must be "reasonable". For example, allocation issues arise in a successful lawsuit for wrongful dismissal where part of the payment is a "retiring allowance" (i.e., compensation for lost employment and taxable as income to the recipient) and another part is for damages to reputation, loss of career opportunities or for sexual harassment (which can be received tax-free).

The case law is clear that the measure of damages cannot be confused with its purpose or effect. Consider a wrongful dismissal case where a judge decides that 80% of the award is to be paid for damages relating to the plaintiff's reputation. Even if the computation of the sum awarded is based exclusively on experts' reports on projection as to how much the plaintiff would have earned but for the damages caused by the defendant, this loss-of-income approach to measuring damages should not be confused with the purpose or effect of the plaintiffs' receipt of the payment.

There are other important tax considerations that need to be considered, long before pay day:

- Will the payment be deductible in computing the defendant's income tax liability?
- Is the defendant aware of this deductibility issue and, if so, will the plaintiff's tax-sensitive pleadings, negotiations or draft settlement agreement be enhanced or inhibited by that awareness? In this regard, note that there is no requirement for symmetry between plaintiff and

defendant: for example, a settlement payment may be a tax-free windfall to a plaintiff and fully deductible by the defendant.

- Will pre- and post-judgment interest be taxable to the plaintiff?
- Will such interest be deductible by the defendant?
- Will the payment be subject to goods and services tax?

A truly successful lawsuit is one where the plaintiff not only wins, but understands and plans for the income tax consequences of winning.

AN OVERVIEW OF OIL & GAS FLOW-THROUGH SHARE FINANCING

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This paper summarizes some of the main points covered in a comprehensive article entitled *Flow-Through Share Financing: Basics and Some Quirks in Practice*, which I prepared for and presented to the Institute of Chartered Accountants for British Columbia in November 2002. Corporate finance and tax lawyers at Miller Thomson LLP are familiar with all features of flow-through share financing for mining and oil and gas companies, and for companies engaged in certain "green" renewable resource and conservation projects and industries. The summary below focuses on flow-though share financing used by Canadian oil and gas companies. (The rules for mining companies are similar.)

What is the main tax benefit for a subscriber for flow-through shares? A subscriber for "flow-though shares" in a private placement or public offering generally can deduct, from all sources of the subscriber's income, 100% of the price paid to buy those shares. Complex rules in the *Income Tax Act* (ITA) governing flow-through shares are designed to encourage investment in Canadian oil & gas companies that are engaged in exploration and development.

Can anyone subscribe and get the tax benefits? Canadian resident and non-resident individuals and corporations are entitled to the tax deduction derived from buying "flow-through" shares. A non-resident of Canada will find the deduction useful to offset any Canadian-source income that is taxable in Canada. Special rules apply to deductions claimed by subscribers that are trusts and partnerships.

What is a flow-through share? A flow-through share is a share of a Canadian oil and gas company that is issued to a subscriber under an agreement in writing (an FTS Agreement) containing certain conditions required by the ITA. A flow-through share must not be a "prescribed share". A holder of a prescribed share is denied income tax benefits accorded to flow-through shares. Generally, a share will not be a prescribed share if it is a common share with no conditions attaching to it, whether by the constitution of the issuer or by agreements relating to the share.

What does an FTS Agreement require? Under an FTS agreement, the issuer must agree to:

- Incur, in the period from the day the agreement was made to the end of 24 months after the end of the month that includes that day, "Canadian exploration expense" (CEE) in an amount not less than the consideration for which the share is to be issued, and
- "Rrenounce" to the subscriber, before March of the first calendar year that begins after that period, an amount in respect of the CEE so incurred not exceeding that consideration. ("Renunciation" is the process in the ITA by which a subscriber obtains an income tax deduction for CEE that the issuer incurs.)

What is the "claw-back" or "look-back" rule? This rule is popular because it allows flow-through share financing to occur near a calendar year-end, when the demand for tax deductions is high, but allows the issuer to spend the proceeds as late as December 31 of the next year. Basically, the "claw-back rule"

provides that where an FTS Agreement is entered into before the end of a calendar year ("Year 1"), the issuer may make a renunciation by March 31 of the next calendar year ("Year 2") in respect of certain kinds of CEE which it plans to incur or has incurred in Year 2, and such renunciation will be effective retroactive to December 31 of Year 1. There are some strict conditions to be met for the "claw-back" benefits, including a somewhat odd requirement that the subscriber must deal with the issuer at arm's length throughout Year 2 (not year 1). It is often a delicate question of fact as to if and when a director or officer of an issuer starts or ceases to deal with it on an arm's length or a non-arm's-length basis.

What is CEE? CEE includes, among other expenses:

- Any expense including a geological, geophysical or geochemical expense incurred by the taxpayer for the purpose of determining the existence, location, extent or quality of an accumulation of petroleum or natural gas (other than a mineral resource) in Canada, and

- Certain expenses incurred, prior to production in reasonable commercial quantities, to bring an oil and gas resource into production including drilling or completing an oil or gas well in Canada, or building a temporary access road to, or preparing a site in respect of, any such well if various conditions are met.

What if an issuer spends money on CDE instead of CEE? Certain types of "Canadian development expense" (CDE) are deemed to be CEE under the ITA. Normally, a renunciation of CDE gives rise to a 30% income tax deduction only. The main effect of this deeming rule is to convert certain CDE from expenses that give rise to a 30% deduction to ones that give rise to a 100% deduction. In many FTS Agreements, the issuer covenants to incur CDE only if the expenses will qualify as deemed CEE under these rules. Intuitively, it seems that if the issuer incurred expenses that qualify as CDE but not as "deemed" CEE, the issuer would nonetheless be permitted to renounce the CDE so that a subscriber would be eligible for the 30% income tax deduction. However, it is the tax authorities' long-standing position that this will be permissible only if the FTS Agreement contemplated such a possible CDE renunciation. Accordingly, an FTS Agreement should deal with the possibility that CDE will be renounced even if it fails to qualify as "deemed" CEE. The language used in the agreement must reconcile properly the issuer's obligation to incur CDE only if it qualifies as "deemed" CEE with the notion that, in spite of that obligation, the issuer will renounce CDE if and to the extent that it incurs CDE which fails to qualify as "deemed" CEE.

Getting "agreements in writing" in prospectus type offerings. It is seldom a problem obtaining signatures of subscribers on an FTS Agreement under a private placement. However, in prospectus or short form offerings, it can be cumbersome or impossible to get subscribers' signatures. Since the definition of "flow-through share" in the ITA requires "an agreement in writing entered into between the [subscriber] and the [issuer]", this exigency cannot be taken lightly. In prospectus or short form offerings, a broker can enter into the agreement on his or her client's (i.e., the subscriber's) behalf. The broker should take steps to provide to the client a copy of the FTS Agreement (a form of which is usually attached as an appendix to the offering document, such as a prospectus) as soon as possible after the broker takes the order and, in any event, before the offering closes. The agency by which the broker signs the FTS Agreement on behalf of the subscriber can be oral or written. If it is oral, there is an evidentiary problem. Practically, though, written authority may be as impractical as getting the FT Agreement itself signed. The next best thing is for the broker to adopt a practice of getting the authorization orally when taking the order for flow-through securities, and making notes or journal entries as evidence of the client's consent for the broker to sign as agent.

TAX AND ESTATE PLANNING FOR INDIVIDUALS WITH DISABILITIES

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The December 20, 2002 proposed amendments to the *Income Tax Act* (the "*Act*") and the February, 2003 Federal Budget (the "Budget") provide individuals with disabilities and their families enhanced tax relief and estate planning opportunities. The legislation implementing the Budget proposals received Royal Assent on June 19, 2003.

Child Disability Benefit

The new Child Disability Benefit, introduced in the Budget, provides an additional tax-free benefit of up to $1,600 to families already receiving the income-tested National Child Benefit supplement to the Child Tax Credit with a minor child who qualifies for the Disability Tax Credit ("DTC"). The first payment is to be made in March 2004 (retroactive to July 2003).

Disability Tax Credit

In light of the Federal Court of Appeal decision in *Hamilton*, certain aspects of eligibility for the DTC were clarified in the Budget legislation:

- Individuals who are restricted in either feeding or dressing themselves will continue to qualify for the DTC. However:
- The activity of feeding oneself does not include "identifying, finding, shopping for or otherwise procuring" food or preparing food where the activity of preparing is associated with a dietary restriction or regime; and
- "Dressing oneself" does not include the activities of finding, shopping for or otherwise procuring clothing.

Medical Expense Tax Credit

The Budget legislation also includes an expansion of the list of eligible medical expenses for the Medical Expense Tax Credit to include, for example, the cost of voice recognition software for individuals with a physical impairment, costs incurred by individuals with celiac disease who require a gluten-free diet, and the costs of note-taking services used by individuals with disabilities.

RRSP and RRIF rollovers

The December 2002 proposed amendments (which had not yet passed into law as of November 6, 2003) and the Budget legislation facilitate the access to the RRSP and RRIF rollovers for certain disabled beneficiaries.

Generally, on death, the full value of property remaining in an RRSP or RRIF at the time of death is included in the income of the deceased for the year of death and taxed in the deceased's terminal tax return. The *Act* provides for a number of rollovers of RRSPs and RRIFs, such that the funds are ultimately taxable in the hands of the beneficiary. This rollover is available where the RRSP or RRIF is left to a surviving spouse or financially-dependent child or grandchild of the deceased annuitant.

Where the surviving spouse is the beneficiary, the funds may be transferred to his or her RRSP or RRIF, thereby deferring the tax until the surviving spouse withdraws the funds from a RRIF. Where the financially-dependent child or grandchild was dependent because of a disability, a similar tax deferral is available. There is also a deferral available for financially-dependent minor children and grandchildren: the RRSP or RRIF funds may be transferred to an annuity for the child to age 18. Tax is payable on the annuity payments as they are received. The annuity payments may be made to a trust for the child.

Whether a child or grandchild was "financially-dependent" on the deceased annuitant is a question of fact. However, prior to the Budget, if the child's income in the year preceding the annuitant's death exceeded the basic personal amount for that year, the child was presumed to be not financially-dependent. The Budget raised the income threshold used for determining financial dependency of disabled children and grand-children to $13,814 for deaths occurring after 2002 (subject to indexation). (The threshold for other children and grandchildren remains the basic personal amount.)

Where the disabled child's income exceeds this threshold, financial dependence may still be established, depending on the factual evidence, including:

- The income of the child;
- The cost of living;
- The ability of the child to support himself or herself;
- Support provided by others.

Currently, in order to take advantage of the rollover of an RRSP or RRIF to a financially-dependent disabled child or grandchild, the child or grandchild must be the direct beneficiary of the RRSP/RRIF. The rollover is not available if the RRSP/RRIF are to be deposited to a trust. Depending upon the nature of the child's disability, and whether or not he or she is a recipient of government benefits (in Ontario, benefits under the Ontario Disability Support Program, "ODSP"), it may be however be necessary for the benefits to flow into a trust, rather than directly to the child.

The December 20, 2002, proposed amendments to the *Income Tax Act* rectify this issue, to a point. The draft amendments to sub-para. 60(l)(ii)(A) of the *Act* provide that a trust may be named as the annuitant of an annuity purchased with the RRSP/RRIF proceeds, rather than the child or grandchild, provided that the individual (i.e., the financially-dependent child or grandchild) is:

- Physically or mentally infirm; and
- The sole person beneficially interested in the amounts payable under the annuity.

This is certainly a welcome development for families with disabled children as the amendment recognizes that funds for disabled beneficiaries must often be held for them in trust. However, in Ontario, for the beneficiary of such a trust to maintain his or her eligibility for ODSP benefits, the value of the capital of such a trust must be limited. The *Ontario Disability Support Program Act* and related Regulations limit the value of assets that an ODSP recipient may own and the income ho or she may receive from sources other than from the ODSP. An ODSP recipient is permitted to have a beneficial interest in a trust where the capital of the trust was derived from and inheritance (or proceeds of life insurance) provided that the capital of the trust does not exceed $100,000 (under the current Regulations). If RRSP/RRIF proceeds are to flow into such a trust, the value of the trust must not exceed the $100,000 threshold.

Families with disabled children will often establish what has become known as a "Henson," or discretionary trust, for such children. The courts have confirmed that the value of a properly-established Henson trust will not be included in the calculation of the ODSP recipient's assets for purposes of the ODSP asset test. However, the trust contemplated by amended sub-para. 60(l)(ii)(A) of the Act does not qualify as a Henson trust. For ODSP recipients to be able to take advantage of the RRSP/RRIF rollover, then, the value of the benefits received must remain under the $100,000.

ANNOUNCEMENTS

We are pleased to announce that **Robert MacRae** has joined Miller Thomson's Tax Department in our Vancouver Office to continue his tax practice. He comes to Miller Thomson from another Vancouver law firm with 30 years experience in income tax. His practice includes disputing tax assessments and corporate and personal tax planning.

We are also pleased to announce that **Katherine Xilinas** has joined Miller Thomson's Tax Department in our Vancouver office. Her practice focuses on resolution of disputes and appeals for corporations and individuals in respect of matters related to income tax and customs duties.

We are also pleased to announce that **James A. Hutchinson** has joined Miller Thomson's Tax Department in our Toronto office. Prior to joining the firm, James practised tax law for a large financial services company and had practised tax and tax litigation with a corporate boutique firm in Toronto. James has also clerked at the Tax Court of Canada.

ACHIEVEMENTS, PUBLICATIONS AND SEMINARS

Robert B. Hayhoe of our Toronto Office published an article: *Canada Customs and Revenue Agency Audits* in *The Philanthropist* at p. 17:4.

Gregory P. Shannon of our Calgary spoke on *Recent Developments in Canada -- U.S. Cross Border Estate Planning* in Kelowna, BC to the Kelowna Estate Planning Council on September 9, 2003.

Gerald D. Courage will be speaking on *Utilization of Tax Losses* at the Fifth Annual Conference on Taxation of Corporate Reorganizations presented by Federated Press in Toronto on January 19, 20 and 21, 2004.
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Note:

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