Tax Notes

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SELL NOW! (HOW THE 2014 BUDGET MAY IMPACT ON SMALL BUSINESS OWNERS' EXIT STRATEGIES)

- –Michael Goldberg, tax partner, Minden Gross LLP, MERITAS law firms worldwide

Although to most of the world the federal Budget tabled on February 11, 2014 (the “Budget”) may have seemed to be of limited consequence, there are many tax practitioners and clients who will be significantly impacted by its content. From painful changes to the taxation of estates, to the elimination of immigrant trust planning, severe restrictions on both the offshore regulated “bank” exception and captive insurance programs, as well as a host of pending tightening measures that will impact multinational enterprises and the use of treaties, tax planners will definitely have their hands full.

However, for my clients, I see the biggest impact coming from the proposed consultation process to make changes to the taxation of eligible capital property (“ECP”). While at first glance, a move to coordinate the current ECP regime (the “Current Regime”) with the existing capital cost allowance regime seems completely logical and relatively innocuous,[1]it is the change to how ECP is taxed upon its disposition that may cause owner-managers who are considering selling their businesses to start thinking about selling more seriously.

In this regard, for most owner-managers whose ECP has been internally generated and has been the subject of little, if any, eligible capital expenditure claims, the recapture element associated with the sale of ECP is usually not a big deal. However, for many clients, ECP and, in particular, goodwill, will be the single biggest asset that they will have to sell, and a shift from the Current Regime of taxing such income at 50% of the active business rate to the traditional capital gains regime applicable to other depreciable property (the “New Regime”) may result in a significant loss of tax deferral in situations where the owner-manager has no personal need for the full amount of the proceeds of sale.

For example, assume that your client Ely is the sole shareholder of a Canadian-controlled private corporation, Ely’s Caps Limited (“Ely Cap”), carrying on a hat business, and the goodwill of Ely Cap has recently been valued at $20 million. What would be the impact to Ely and Ely Cap under the Current Regime and under the New Regime, assuming that it is implemented as described in the Budget papers?

Under the Current Regime, if Ely Cap sold all its business assets (assuming that the remainder of its assets, inventory, etc. would be sold at cost), the $20 million of proceeds receivable for the goodwill would give rise to an addition to Ely Cap’s “cumulative eligible capital” account of $15 million under paragraph (*e*) of the definition in subsection 14(5). Two-thirds of this amount, an amount of $10 million, would be included in Ely Cap’s income and would be taxable at ordinary corporate rates pursuant to paragraph 14(1)(b). As a result, assuming that Ely Cap has otherwise used its $500,000 small business deduction in the year, in Ontario the $10 million of taxable income would be subject to corporate taxes at a rate of 26.5% for a total of $2.65 million of tax.

In addition, the sale would give rise to a $10 million addition to Ely Cap’s capital dividend account (“CDA”) (after the end of Ely Cap’s current taxation year), which would allow Ely to remove $10 million of cash from Ely Cap for his personal use with no additional taxation.

If Ely wanted to remove the remaining $7.35 million of goodwill proceeds ($10 million net of the $2.65 million of corporate tax) for his personal use, Ely would likely do so by way of Ely Cap declaring eligible dividends on his shares of Ely Cap, which would result in him paying additional tax of 33.82%,[2]being approximately $2.485 million. If Ely were to do this, the total tax payable on a $20 million sale of goodwill would be approximately $5.135 million.

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Under the New Regime, the full $20 million of proceeds would be subject to corporate capital gains tax rates, which in Ontario are currently about 23.08%; this would give rise to tax of slightly more than $4.615 million in the corporation. As was the case under the Current Regime, this sale would generate a CDA in Ely Cap of $10 million, which could be distributed to Ely tax-free. However, due to recent tax rate changes that have increased the tax rate for ineligible dividends to 40.13%, the integrated tax rate to remove the remaining goodwill proceeds of $5.385 million ($10 million less $4.615 million of corporate tax) from Ely Cap would increase the total tax payable on the sale of its goodwill (net of refundable taxes receivable by Ely Cap) to approximately $5.18 million.[3]

As the Ely Cap example makes clear, there will be a small absolute tax cost of making a personal distribution of the corporate after-tax ECP proceeds under the New Regime of about $45,000 ($5.18 million # $5.135 million).[4]On the other hand, by leaving the ECP proceeds in excess of CDA amounts in a vendor corporation such as Ely Cap, it will be possible to enjoy some personal deferral of tax in both these cases. In particular, under the Current Regime, this deferral would be about $2.485 million ($5.135 million # $2.65 million)[5]and under the New Regime it will be reduced to about $565,000 ($5.18 million # $4.615 million).[6]

The "cost" of the loss of this deferral should not be understated since as a practical matter, most clients in Ely's situation and in situations involving far more modest sales than Ely's would likely not draw more than the CDA balance out of Ely Cap for a very long time, *if ever*. As a result, in many cases the corporate deferrals under both regimes will really amount to effective personal tax "savings" and the change from the Current Regime to the New Regime on a $20 million sale of Ely Cap's goodwill will "cost" Ely Cap nearly $2 million ($4.615 million # $2.65 million)[7]by forcing it to pay those additional corporate taxes in the year of the sale.

Some practitioners might take comfort that the proposal to create the New Regime in the Budget has been put forward as a "consultation" process. However, based on prior experience with the current government's consultation process (for example, in respect of the taxation of estates), the cynical side of me believes that practitioners should view the Budget announcement as fair notice that the New Regime will likely be enacted in the manner proposed—without grandfathering. As a result, given the potential cost to clients, I think this may be the time to ask them about their exit-planning decisions and to consider whether now may be the time to sell.[8]

Michael Goldberg is a tax partner at Minden Gross LLP, a member of MERITAS law firms worldwide, and is the founder of "Tax Talk with Michael Goldberg", a quarterly conference call about current, relevant, and real life tax situations for professional advisers who serve high net worth clients. Any errors or omissions are the author's sole responsibility.

2014 FEDERAL BUDGET

The 2014 federal Budget was tabled on February 11, 2014. Subscribers to the *Canada Income Tax Guide* (print, DVD, and online) will have received Wolters Kluwer CCH's *Special Report* No. 076H containing the Budget Plan and the Notice of Ways and Means Motion as well as commentary on the proposals by Dentons LLP, Joseph Frankovic, and Wolters Kluwer CCH. Additional copies of the *Budget Special Report* may be ordered by calling (416) 224-2248 (toll-free 1-800-268-4522), by faxing (416) 224-2243 (toll-free 1-800-461-4131), or by emailing cservice@cch.ca. The commentary, table of effective dates, and tax-related portions of the government's Budget Plan (e.g., Annex 2) will be available in the *Canada Income Tax Guide* online and on DVD under the heading Federal Budget. The Budget documents are also posted on Wolters Kluwer CCH's federal income tax News Tracker.

The 2014 Budget contained a Notice of Ways and Means Motion to amend the *Income Tax Act* and other tax legislation with 38 resolutions, as well as some revisions to capital cost allowance ("CCA") for Classes 43.1 and 43.2 that were not part of the Notice of Ways and Means Motion. Personal tax measures include modifications to the adoption and medical expense tax credits, adjustments to pension transfer limits and the tax on split income, and changes to the various exemptions and taxation rates on *inter vivos*, testamentary, and non-resident ("immigrant") trusts. The Budget announced several measures affecting businesses and charities including the proposed creation of a new CCA class to replace the eligible capital property regime, increased thresholds pertaining to remittance of employer-source deductions, changes to the tax treatment of estate donations, and an increased carryforward for donations of ecologically sensitive land. As

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well, enforcement initiatives included restrictions on donations of certified cultural property gifted through tax shelter arrangements, Ministerial discretion to refuse or revoke registration of charities or associations that accept donations from terrorist states or their agencies, and the government's announced intention to assesses sufficiency of current reporting standards for non-profit organizations.

On the international tax front, the Budget introduced measures regarding application of the foreign accrual property income ("FAPI") anti-avoidance rules to insurance swaps, additional FAPI regime conditions for regulated foreign financial institutions, and treatment of back-to-back loan arrangements in the context of avoidance of the thin capitalization and Part XIII withholding tax rules. As well, the Budget provided updates regarding base erosion and profit shifting strategies in the context of multinational enterprises, the government's consultation on treaty shopping, and updates to the Canada-US tax information exchange agreement.

COMMENTARY

Excerpts of some of the commentary written for Wolters Kluwer CCH by Dentons LLP and Joseph Frankovic on Budget Day are reproduced below.

GST/HST Credit Administration

The Goods and Services Tax/Harmonized Sales Tax Credit is a refundable tax credit that is available to low-income eligible individuals, based on their adjusted family net income. For 2014, the credit is phased out when the adjusted family income reaches $34,872.

Under current rules, an eligible individual is required to apply for the credit by checking a box on his or her income tax return. Resolution 11 proposes to eliminate that requirement, and instead the CRA will automatically determine if the individual qualifies. In the case of eligible couples, the resolution proposes that the Minister will designate the eligible individual; the Budget papers indicate that this will be the eligible individual whose tax return is assessed first. The measures will apply to tax returns filed for the 2014 year and subsequent years.

A notice of determination will not be sent to ineligible individuals (those who do not qualify for the credit). However, an ineligible individual can request a notice of determination from the CRA. Once the determination is made, the individual will have the opportunity to object to the determination.

Tax on Split Income

The Canadian income tax system applies a progressive marginal rate structure to the taxation of personal income. The *Income Tax Act* contains a number of rules intended to reduce the ability of a high-income taxpayer to split taxable income with lower-income individuals. One of these rules, which imposes a tax on "split income", limits income-splitting techniques that seek to shift certain types of income from a high-income individual to a lower-income minor. The highest marginal tax rate (currently 29%) applies to split income paid or payable to a minor, which generally comprises:

- taxable dividends (and shareholder benefits) received directly, or indirectly through a partnership or trust, in respect of unlisted shares of Canadian and foreign corporations (other than shares of a mutual fund corporation);
- capital gains from dispositions of those types of shares to persons who do not deal at arm's length with the minor; and
- income from a partnership or trust that is derived from providing property or services to, or in support of, a business carried on by a person related to the minor or in which the related person participates.

The tax on split income does not currently apply to situations where a minor is allocated income from a partnership or trust that is derived from business or rental activities conducted with third parties. As a result, certain taxpayers who engage in those activities are using trust and partnership structures to split business and rental income with minors. For example, an adult might provide services to clients of a partnership of which the adult's minor child is a member (either directly or through a trust of which the child is a beneficiary). The child is then allocated a share of the partnership's income—in essence, income that was earned as a result of the services provided by the adult.

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Resolution 13 proposes to amend the definition of “split income” in subsection 120.4(1) of the *Income Tax Act* so as to preclude the use of a partnership or a trust to split income in the above manner. In particular, it is proposed that the definition “split income” be amended to include income that is, directly or indirectly, paid or allocated to a minor from a trust or partnership if:

- the income is derived from a source that is a business or a rental property; and
- a person related to the minor
  - is actively engaged on a regular basis in the activities of the trust or partnership to earn income from any business or rental property, or
  - has, in the case of a partnership, an interest in the partnership (whether held directly or through another partnership).

The proposed amendment will apply to the 2014 and subsequent taxation years.

2014 NEW BRUNSWICK BUDGET

The 2014 New Brunswick Budget was tabled on February 4, 2014. All New Brunswick provincial tax rates will remain at existing levels. The 2014 Budget enhanced the scope of the non-refundable small business investor tax credit by providing investors with an equivalent non-refundable credit for investing in “community economic development investment funds”. As well, beginning in the 2014 taxation year, the credit will be expanded to allow for corporations and trusts to access it; the credit will be 15% for investments by corporations/trusts and continues to be 30% for investments by individuals, each to a maximum non-refundable tax credit of $75,000. The Budget documents are posted on the provincial tax News Tracker on CCH Online and are also available in the *Atlantic Tax Reporter* online and on DVD.

2014 NORTHWEST TERRITORIES BUDGET

The 2014 Northwest Territories Budget was tabled on February 6, 2014. The Budget contains no new taxes; however, the tax rate on loose tobacco increased from 20 cents per gram to 26.6 cents per gram effective February 1, 2014. In addition, property taxes and fees will continue to be indexed for inflation. The Budget documents are posted on the provincial tax News Tracker on CCH Online and are also available in the *Alberta and Territories Tax Reporter* online and on DVD.

INCOME TAX FOLIO S1-F2-C2: TUITION TAX CREDIT

On January 23, 2014, the Canada Revenue Agency announced updates to Income Tax Folio S1-F2-C2: Tuition Tax Credit. The updates to the Folio (which replaces and cancels Interpretation Bulletin IT-516R2, Tuition Tax Credit) include changes to reflect legislative amendments made by S.C. 2013, c. 34 (formerly Bill C-48), S.C. 2013, c. 40 (formerly Bill C-4), and several clarifications. The Folio is revised at ¶2.2, ¶2.7, ¶2.10, ¶2.25, ¶2.37, ¶2.50, ¶2.55, and ¶2.57.

INCOME TAX FOLIO S5-F2-C1: FOREIGN TAX CREDIT

On February 6, 2014, the Canada Revenue Agency (“CRA”) announced updates to Income Tax Folio S5-F2-C1: Foreign Tax Credit. The updates to the Folio (which replaces and cancels Interpretation Bulletin IT-270R3, Foreign Tax Credit; Interpretation Bulletin IT-395R2, Foreign Tax Credit—Foreign-Source Capital Gains and Losses; and Interpretation Bulletin IT-520 (consolidated), Unused Foreign Tax Credits—Carryforward and Carryback) include general revisions to update readability (e.g., at ¶1.31 and ¶1.101), clarifications as to CRA and US policy (e.g., at ¶1.12.1 and ¶1.27), and changes to reflect legislative amendments made by S.C. 2013, c. 34 (formerly Bill C-48; e.g., at ¶1.39.1, ¶1.44, and ¶1.48.1). The Folio is variously also revised at paragraphs ¶1.3, ¶1.4, ¶1.23, ¶1.29, ¶1.30, ¶1.39, ¶1.41, ¶1.53, ¶1.60, ¶1.71, and ¶1.74.

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PARTNERSHIPS—CARRYING CHARGES— PROVINCIAL ALLOCATION OF MANAGEMENT FEES

The first situation examined by the Canada Revenue Agency ("CRA") involved a limited partnership having incurred financing fees or other carrying charges in the course of carrying on its business. The CRA was asked if those charges would have to be reported in Box 22, "Limited partnership business income (loss)", or Box 59, "Carrying charges", of Form T5013. The CRA confirmed that the carrying charges had to be included in Box 22 of Form T5013 because they were incurred by the partnership to carry on its business and should be included in the calculation of its business income or loss. Box 59 should instead be used to report carrying charges incurred by a partnership to earn investment income. For more details, see CRA Guide T4068, Guide for the Partnership Information Return.

The second situation considered by the CRA involved a partnership ("P-1") having a permanent establishment ("PE") in Province A ("P-A") and being associated with two other partnerships ("P-2" and "P-3"), each having a PE in a different province ("P-B" and "P-C"). P-2 and P-3 earned business income from their respective PEs and paid management fees to third parties in their respective provinces for services normally rendered by their employees. Since the rules to allocate taxable income between provinces are different for corporations and individuals, the CRA assumed that the partners in P-2 and P-3 were corporations. The CRA was asked if those management fees could be treated as salaries and wages paid by P-2 and P-3 for the purpose of allocating taxable income by province. The CRA confirmed that management fees paid by P-2 and P-3 could qualify as salaries and wages paid to the employees of a PE located in provinces P-B and P-C for the purpose of allocating their taxable income by province if the following conditions were met:

- P-2 and P-3 had their own employees;
- the services rendered or duties performed under the management contracts are generally executed by employees of P-2 and P-3; and
- the management contracts satisfied only short-term needs of the two partnerships.

No profit margin or commissions may be included in the management fees (salaries and wages) for the purpose of calculating the provincial taxable income allocation. Assuming that there is no breakdown of the composition of the management fees paid by P-2 and P-3, they would have to determine the reasonable portion of the fees considered to be "salaries and wages" (e.g., the cost of phone calls or other out-of-pocket expenses would not qualify as salaries and wages).

—External Technical Interpretation, International Operations Division, September 25, 2013, Document No. 2013-0477571E5

CROWDFUNDING

The Canada Revenue Agency ("CRA") was asked about the tax treatment of funds received through crowdfunding. This method of raising funds allows individuals or businesses to receive contributions for a specific project such as producing a musical recording or bringing a product to market. In return for the money, the individual or business may give the contributor a gift such as a copy of the recording or some other promotional item. The contributors do not receive any equity in the project. The CRA cited paragraph 4 of IT-334R2, Miscellaneous Receipts, which states that "voluntary payments (or other transfers or benefits) received by virtue of a profession or by virtue of carrying on a business are taxable receipts" and concluded that crowdfunding receipts would be included in income under subsection 9(1) as income from a business. The expenses related to the crowdfunding activities may be deductible under paragraph 18(1)(a) if they are incurred for the purpose of gaining or producing income from a business.

—External Technical Interpretation, International Division, August 16, 2013, Document No. 2013-0484941E5

REPAYMENT OF DIVIDEND

The Canada Revenue Agency ("CRA") confirmed that a taxpayer having received a *bona fide* dividend legally declared by the board of directors of a corporation could not reduce or eliminate the income tax arising from the taxation of that

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dividend by simply repaying the dividend to the corporation. Based on the current jurisprudence, a taxpayer cannot retroactively modify a legal situation to which he or she was a party. Unless a court order is issued to that effect, the CRA cannot accept retroactive changes to the terms of a corporate act or agreement for the sole purpose of reducing the tax base on which an assessment is prepared.

—External Technical Interpretation, Reorganizations Division, September 25, 2013, Document No. 2013-0488571E5

RECENT CASES

LOAN TO PURCHASE DWELLING A TAXABLE SHAREHOLDER BENEFIT, NOT EMPLOYEE LOAN

The Minister reassessed the taxpayer for the years 2006 to 2008 and included income of $786,828, $97,551, and $53,260 for each of those years, respectively, under subsection 15(2) of the *Income Tax Act* ("ITA"). The taxpayer was an employee, sole officer, director, and shareholder of Michael Mast Investments Ltd. ("MastCo"). MastCo had one other employee, the taxpayer's wife. The taxpayer entered into a loan agreement with MastCo to purchase a personal dwelling. The loan was payable over a 10-year term and the documentation indicated that the loan was a "shareholder loan". The issue was whether the loan was made to the taxpayer as an employee under subsection 15(2.4) of the ITA and not subject to tax. The Minister argued that the loan was a non-interest-bearing and unsecured advance consistent with a shareholder advance.

The taxpayer's appeal was dismissed. The loan was consistent with one being made to a shareholder. It would be unreasonable to conclude that it was an employee loan under subsection 15(2.4).

Mast, 2014 DTC 1001

LEGAL AND PROFESSIONAL FEES PAID TO DEFEND AGAINST SECURITIES REGULATORS NOT DEDUCTIBLE

The taxpayer incurred legal and professional fees to defend himself against allegations of improper disclosure after being charged by the Alberta Securities Commission in 2001. In computing income for 2003 and 2004, the taxpayer deducted $22,883 and $463,181, respectively, in fees from his professional income under paragraph 18(1)(a) of the *Income Tax Act.* He carried forward the losses from one year to another with the appeals before the Court being 2001, 2003, 2004, and 2006. The Minister disallowed the deductions as the fees were not incurred to gain or produce income, but to protect the taxpayer's reputation and marketability (which are enduring assets), and were therefore capital outlays.

The taxpayer's appeal was dismissed. The taxpayer failed to establish, and the facts failed to support, the requisite connection or nexus between the legal and professional expenses and his ability to keep his designation as an accountant and to produce future income from that designation.

Ironside, 2014 DTC 1002

TAXPAYER COULD NOT OBJECT TO NIL ASSESSMENT, EVEN IF INTEREST AMOUNTS IN DISPUTE

The taxpayer appealed an assessment of arrears interest of $6,027 for 2007 because the Minister erred by denying the taxpayer the full amount of capital cost allowance ("CCA") claimed due to the Minister's reclassification of part of its capital costs in 2007 from class 13 to classes 1 and 8. This change reduced the taxpayer's CCA by an amount resulting in taxable income of $144,166 on which such interest was calculated. This appeal was for a subsequent reassessment having resulted in nil taxes due to the application of a non-capital loss carryover to 2007.

The parties agreed that the Court should first consider the jurisdictional question as to whether the taxpayer can challenge arrears interest by attacking the calculation of underlying tax in a nil tax assessment situation. The Minister argued that the taxpayer could not indirectly challenge the tax amount reassessed on a nil assessment; the taxpayer argued that the result of the assessment was to uphold arrears interest and it could challenge taxes, interest, or penalties.

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The taxpayer's appeal was dismissed. A nil assessment refers to either the notice, issued by the Minister, that no taxes are payable or, in case law, to an assessment that cannot be appealed because no taxes are claimed. The Court has limited jurisdiction in dealing with appeals to interest assessments, which are generally restricted to the issue of calculation. The nil assessment, in this case, stemmed from the taxpayer's decision to carry back losses to 2007 rather than challenge the original assessment. The Court did not have jurisdiction to hear a challenge to an assessment of interest based on the underlying tax assessment where there was a nil assessment.

Nottawasaga Inn Ltd., 2014 DTC 1021

TAXPAYER DEMONSTRATED DUE DILIGENCE, NOT LIABLE FOR UNREMITTED CORPORATE SOURCE DEDUCTIONS

The Minister assessed the taxpayer, as a director of Goldstaff Personnel Inc. (“Goldstaff") for Goldstaff’s unremitted source deductions for 2008 and 2009. On appeal to the Tax Court of Canada, the taxpayer argued, in part, that (a) she was an immigrant with cultural and language difficulties, and had difficulties finding a job; (b) as a condition of her employment as an accountant at Goldstaff, she was required to purchase some of the company’s shares; (c) she was asked by Goldstaff’s manager, S, to become a director, and did so, but her duties remained limited to those of an accountant; and (d) she was never told of Goldstaff’s directors’ meetings, never attended them, and did not have the power to manage Goldstaff’s affairs.

The taxpayer’s appeal was allowed. The standard of care required of a corporate director under subsection 227.1(3) of the *Income Tax Act* is an objective one and does not take into account the director’s personal skills, knowledge, abilities, and capacities. The taxpayer's particular circumstances, however, are relevant and are to be measured against a "reasonably prudent person standard". In this case, the taxpayer took all the necessary measures within her power to prevent Goldstaff’s failure to remit its source deductions and even attempted to convince S to make those remissions. She also resigned as a director of Goldstaff when she realized that S would not comply with her suggestions. She did the best she could reasonably have done in the circumstances, but did not have the power to manage Goldstaff’s business affairs. She demonstrated the required degree of due diligence to exonerate herself from personal liability for Goldstaff’s unremitted source deductions.

Qian, 2014 DTC 1024

Footnotes

[1] In some cases, it may even be positive. For example, vendors with capital will now be able to offset capital gains on a sale of ECP against their capital losses, which would not have been the case under the Current Regime.
[2] For simplicity, I have assumed that Ely pays tax at the top marginal tax rates in Ontario.
[3] It is assumed that Ely Cap does not have a general rate income pool balance.
[4] Determined by calculating the difference between the total integrated tax under the New Regime and under the Current Regime.
[5] Determined by calculating the difference between the total integrated tax under the Current Regime and the corporate tax under the Current Regime.
[6] Determined by calculating the difference between the total integrated tax under the New Regime and the corporate tax under the New Regime.
[7] Determined by calculating the difference between the corporate tax under the New Regime and the corporate tax under the Current Regime.
[8] Assuming the New Regime is legislated, expect a return to the old status quo of vendors having a very strong preference to sell shares (it appears that the capital cost allowance rate for new ECP acquisitions will be set to emulate the existing eligible capital expenditure rates with some slightly less favourable variations for existing ECP, so that the New Regime should be relatively tax neutral for purchasers). Due to the low tax rates applicable to ECP sales, this may not have always been the case in the more recent past, even for vendors whose shares would otherwise have qualified for capital gains exemption treatment.

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