TAX FOR THE Owner-Manager

Editor: Thomas E. McDonnell, QC

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Employee Stock Option Rules and Legally Binding Agreements

In a recent technical interpretation (TI 2016-0641841I7, September 19, 2016), the CRA concluded that for the stock option rules in section 7 and paragraph 110(1)(d) to apply, there must be a "legally binding agreement" to issue shares. In the TI, the CRA considered several share-based compensation plans and discussed its views on whether the stock option rules apply or, alternatively, whether a corporation may deduct bonus expenses under these plans because the stock option rules do not apply.

CRA Rulings noted that this internal TI is intended to address inquiries from CRA auditors on the meaning of the word "agreement" for the purposes of the employee stock option rules following the decision in *Transalta Corporation v. The Queen* (2012 TCC 86).

Background

Generally, if a share-based compensation plan does not create a legally binding agreement, employees cannot claim a stock option deduction but the employer can deduct the expense incurred. Conversely, if there is a legally binding agreement, employees can claim a deduction but the employer cannot deduct the expense incurred.

Section 7 governs the taxation of employee stock options. In general, an employee is deemed to receive an employment benefit equal to the excess of the FMV of the share at the time the option is exercised over the total of the amount paid by the employee to acquire the option at grant, plus the amount paid to acquire the shares upon exercise of the option. The employment benefit is included in income either under paragraph 7(1)(a) in the year in which the option is exercised or under subsection 7(1.1), in the case of a qualifying CCPC, at the time that the shares are disposed of or exchanged.

An employee who meets certain conditions can claim a deduction under paragraph 110(1)(d) of one-half of the taxable benefit following the exercise of the employee stock option, effectively paying tax on the employment benefit at the same rate as a capital gain. These conditions depend on when the option "agreement" is considered to have been made. Paragraph 110(1)(d.1) provides a one-half deduction when a CCPC's stock option shares are sold if the taxable benefit was deferred under subsection 7(1.1) and the employee holds the share for at least two years after the date of acquisition.

Under subsection 7(3), an employer cannot claim a deduction incurred in connection with the sale or issue of its shares to an employee. In considering whether an agreement to sell or issue shares is a legally binding agreement under the employee stock option rules, the CRA cited jurisprudence and concluded that although an arrangement to issue or sell shares does not have to be a detailed written contract, it must create legally binding rights and enforceable obligations. The CRA also provided its views on whether certain types of employer plans create a legally binding agreement such that the employee stock option rules apply and an employer deduction is not available.

No Legally Binding Agreement

Discretionary Share Bonus Plan

The CRA noted that a discretionary share bonus plan, as described in the TI, is not considered a legally binding agreement for the purposes of the employee stock option rules because the corporation's commitment is fully discretionary. Therefore, a corporation that offers this type of plan generally is eligible to deduct the expense of a bonus settled by issuing shares, since the corporate employer expense deduction denial rule in paragraph 7(3)(b) would not apply.

The CRA described a discretionary share bonus plan similar to the plan considered in *Transalta*. Under this plan, at the beginning of a three-year period, an employee is advised of the maximum number of shares that can be earned as a bonus for the period. The employee does not have to meet any performance conditions to be entitled to the bonus. At the end of the period, the employer has discretion regarding the payment amount of the bonus and the form of payment (shares issued from treasury or cash).

The CRA said that a corporation can deduct the expense, even if the discretionary stock option bonus plan does not have a cash option, when the award is granted and the shares

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are issued concurrently. The CRA noted, however, that the employee stock option rules would apply if the share issuance was subject to time or other vesting conditions.

Further, the CRA cautioned that the salary deferral arrangement rules may apply to share bonus plans that include a discretionary cash settlement option designed to avoid the bonus expense deduction denial rule in paragraph 7(3)(b). Under these rules, a taxpayer who has a right to a bonus from a salary deferral arrangement is deemed to have received it in the year in which it was earned, and under subsection 6(11) he or she must include the amount in income in that year rather than in the year that it is received.

Share Appreciation Rights Plan or Deferred Share Unit Plan

The CRA said that a public corporation that offers a share appreciation rights plan or a deferred share unit plan, as described in the TI, generally can deduct the expense of a bonus. Because these plans do not include an agreement to issue shares, the corporation is free to choose the form of payment (which includes cash) to fulfill its obligations under the plan.

Generally, under a share appreciation rights plan, employees are entitled to a payment at the end of a vesting period corresponding to the increase in the value of a common share of the corporation during that period. Under a deferred share unit plan, an employee is entitled to a payment that is equal to the value of one common share of the corporation, determined at the time of the employee's retirement, termination of employment, or death, whichever is earliest. Under these plans, the corporation has complete discretion to make these payments in cash, in shares issued from treasury, or in a combination of both.

Legally Binding Agreement

Employee Share Purchase Plan

The CRA stated that an employee share purchase plan, as described in the TI, constitutes a legally binding agreement to issue shares, and therefore paragraph 7(3)(b) will apply to the share discount such that the corporation (that is, the employer) cannot deduct the compensation expense. Under the employee share purchase plan described by the CRA, employees of a public corporation subscribe for the employer's shares at a 10 percent discount. Once the employee pays for the shares, the corporation issues them from treasury.

"Depending on the Facts"

Employee Stock Options with Discretionary Vesting Condition

The CRA said that when a corporation grants its employees options to acquire shares that can be exercised only when the employees receive notice from the corporation, a legally binding agreement arises only after the corporation sends the employees notice specifying the number of shares that they may exercise. In the case described in the TI, there is no agreement for the purposes of section 7 and paragraph 110(1)(d) at the time that the options are initially granted.

The CRA said that before receiving this notice, an employee has no enforceable right to acquire the shares and the corporation has no obligation to issue the shares. As a result, the employee is not entitled to a deduction if the share price increases between the date of the grant and the date of the notice.

Discretionary Employee Stock Trust

The CRA also considered a discretionary employee stock trust arrangement whereby a CCPC establishes a trust to acquire and hold some of its shares for the benefit of its employees (the beneficiaries of the trust). The trustees have discretion to allocate and distribute the shares.

The CRA noted that subsection 7(2) generally provides that if a security is held by a trustee for an employee, the employee is deemed to have acquired the security at the time that the trust began to hold it for the purposes of section 7, paragraph 110(1)(d), and paragraph 110(1)(d.1). However, subsection 7(2) cannot apply before a specific number of shares have been allocated to an identifiable employee under a legally binding agreement to issue or sell shares.

In this case, the CRA said that because a discretionary employee stock trust arrangement does not include a legally binding agreement to issue or sell shares to any specific beneficiary and no particular beneficiary is entitled to a distribution from the trust, the employee benefit plan rules (paragraph 6(1)(g)) rather than the employee stock option rules (section 7) will apply. Under the employee benefit plan rules, the full value of the shares will be included in the employee's income as employment income, and the capital gains deduction will not be available on the disposition of the shares.

Dino Infanti
KPMG Enterprise Tax, Vancouver

Capital Gains Taxed Twice

101139810 Saskatchewan Ltd. v. The Queen (2017 TCC 3) is a timely reminder of the potentially harsh consequences of subsection 55(2) and the need to exercise caution in any planning involving actual or deemed intercorporate dividends. The events in *101139810* occurred in 2009, before the recent amendments to subsection 55(2), but the reasoning in the case remains relevant today.

A Canadian corporation (8231) held 34 shares worth $2.6 million in another Canadian corporation, CSM. In 2009, 8231 and its sole owner (Mr. C) entered into a reorganization to enable Mr. C to personally claim a capital gains deduction under section 110.6 on an indirect sale of the 34 CSM shares

to two CSM shareholders unrelated to 8231. To facilitate this transaction, the 34 CSM shares were spun out to two new Holdcos (9810 and 9807) solely owned by Mr. C before the sale, and the following steps were taken:

- 8231 transferred 17 CSM shares to 9810 and 17 CSM shares to 9807 on a fully tax-deferred basis under subsection 85(1). As consideration, 8231 took back shares worth $1.3 million from each of 9810 and 9807.
- Mr. C transferred shares in 8231 worth $1.3 million to each of 9810 and 9807 on a fully tax-deferred basis. As consideration, Mr. C took back shares from each of 9810 and 9807.
- The shares transferred between 9810 and 8231 were cross-redeemed by causing each corporation to issue to the other a $1.3 million promissory note, which were subsequently offset. The same occurred for the shares transferred between 9807 and 8231.

Mr. C then sold 9810 and 9807 to the two purchasers for $2.6 million in aggregate, giving rise to a $2.6 million capital gain on which Mr. C claimed his available section 110.6 deduction of $0.2 million.

As a result of the share redemptions, 9810, 9807, and 8231 each reported a subsection 84(3) deemed dividend and an offsetting dividend deduction under subsection 112(1). However, because the reorganization and the subsequent sale were part of the same series, there was no dispute that the exception in paragraph 55(3)(a) was inapplicable. The primary issue to be decided was whether subsection 55(2) recharacterized the $1.3 million deemed dividend received by each of 9810 and 9807 as capital gains. The minister initially reassessed 8231 on the same basis but vacated that reassessment prior to reassessing 9810 and 9807.

The taxpayers argued that subsection 55(2) should not apply because no significant reduction in capital gains resulted from the deemed dividends (for subsection 84(3) deemed dividends, the relevant test is the "result" test). Although the deemed dividends fully eliminated 9810's and 9807's proceeds of disposition, no capital gain was avoided when the transactions were considered in the aggregate, because Mr. C actually incurred $2.6 million of capital gains afterwards. If subsection 55(2) were to apply, the taxpayer argued, it would exceed its scope as an anti-avoidance provision and would lead to double and potentially triple taxation.

The court examined the wording of subsection 55(2) and found it clear that the phrase "a significant reduction in the portion of the capital gain" refers to the dividend recipient corporation's capital gain because of references to that corporation before and after that phrase. The court also pointed out that the phrase clearly refers to a notional capital gain occurring immediately before the dividend as opposed to an actual gain occurring afterward. Therefore, the court found that a plain reading of subsection 55(2) does not permit the consideration of an actual capital gain realized subsequently by another entity in place of the dividend recipient corporation, especially when the other entity is an individual. The court also undertook a purposive analysis and concluded that 9810 and 9807 "walked right into" a situation to which Parliament intended the subsection to apply, since it was "incumbent" on the taxpayers to ensure that they met the exceptions to subsection 55(2).

The court also discussed whether the application of subsection 55(2) offended the general policy of preventing double taxation. The recharacterization caused the value of the CSM shares to be taxed in 9810's and 9807's hands and again in the hands of Mr. C. After reviewing relevant jurisprudence on the subject, the court concluded that there was no double taxation because the same taxpayer was not subject to tax twice on the same amount.

This case was probably decided correctly. The fact that the relevant test is the "result" test leaves little room for interpretation when a redemption has indeed significantly reduced a notional capital gain. Although it is debatable whether the court's narrow interpretation of the double taxation policy is fair, it is not likely that even a finding of double taxation could have prevented the application of subsection 55(2) when a transaction fell squarely under the provision.

Although subsection 248(28) was not mentioned in the judgment, that provision would not have been helpful because it also applies only in the case of double taxation of the same taxpayer. It is interesting that the minister vacated the subsection 55(2) reassessment against 8231, because that would have resulted in the same value being taxed three times; it is anyone's guess whether *101139810* would have been decided differently if that were the case.

The taxpayers brought up *729658 Alberta Ltd. v. The Queen* (2004 TCC 474) in their argument, but in my view that decision has little bearing on *101139810*: the issue in *729658* was the determination of how much accrued gain should "reasonably" be apportioned to safe income, which is a different issue from the issue in *101139810*.

Apart from its value as a cautionary tale, the decision in *101139810* could call into question some of the CRA's recent views on the application of GAAR to transactions that rely on share redemptions and paragraph 55(3)(a) to avoid the broad reach of the new subsection 55(2)—for example, TI 2015-0604521E5 (January 13, 2016): if failing to meet paragraph 55(3)(a) could result in the same amount being taxed twice as capital gains, then why would complying with paragraph 55(3)(a) to prevent the acceleration of gain recognition be a misuse or abuse of the Act?

Kenneth Keung
Moodys Gartner Tax Law LLP
Calgary

Loss Trading and Subsection 69(11)

The Act contains a number of provisions that are intended to restrict the use of tax losses. Some examples follow.

Subsection 111(5) imposes strict conditions on the use of losses incurred by a corporation (Lossco) after a "loss restriction event" (which, according to section 251.2, in the case of a corporation is an acquisition of control of Lossco).

Even if the acquiror of Lossco can use its losses because the conditions in subsection 111(5) are met, the debt-parking rules of section 80.01 may erode those losses.

Section 80.01 will apply if debt owed by Lossco to, say, its shareholders or to a financial institution is not forgiven by the creditor (forgiveness would erode Lossco's losses by virtue of the provisions of section 80) but is instead acquired from the creditor at a discount of more than 20 percent. In such circumstances, the debt would be deemed by subsection 80.01(8) to have been settled for a payment equal to the cost to the holder, thus bringing section 80 into play.

Various provisions deny the immediate deduction of losses incurred on transactions between "affiliated persons" (defined in section 251.1).

When creative taxpayers have devised plans to circumvent the loss transfer restrictions in the Act, the courts have often applied GAAR to deny the use of the acquired losses. *Mathew* (2005 SCC 55), for example, denied the use of losses acquired from an arm's-length entity.

Virtually, but not entirely, absent from the Act are provisions that prevent a taxpayer (say, a Lossco) that has incurred losses from monetizing such losses by acquiring a business or property that would enable the taxpayer to utilize the losses itself rather than sell them to an arm's-length party. An exception is subsection 69(11) (in conjunction with subsection 69(13) when an amalgamation is involved): this provision is discussed in the context of the following example.

1) Assume that X Co, a CCPC, has three shareholders, none of whom has used his or her capital gains exemption. Therefore, the total of the exemptions available is approximately $2.472 million.
2) The ACB and the PUC of the shares to all of the shareholders are nominal.
3) X Co is in the equipment-leasing business, an active business for tax purposes. X Co's only asset is heavy equipment that it leases to arm's-length lessees. X Co has no liabilities.
4) The equipment has been depreciated down to a value well below cost.
5) X Co has received a $5 million offer from Buyco for the equipment.
6) The shareholders, who want to take advantage of their capital gains exemptions, would rather sell their shares to Buyco and are prepared to accept $4 million to account for the fact that Buyco would be inheriting X Co's low UCC base.
7) Buyco refuses to consider a share purchase.
8) The shareholders' advisers introduce the shareholders to an arm's-length party, Lossco, that is prepared to enter into the following series of transactions:
   a) Lossco would acquire all of the shares of X Co for a negotiated amount of, say, $4.5 million. As will be seen, this transaction would give Lossco a $500,000 profit to compensate it for the erosion of its losses.
   b) The shareholders of X Co would each receive a $1.5 million promissory note from Lossco.
   c) Lossco would acquire X Co's equipment by winding up X Co under subsection 88(1). Lossco would thus inherit X Co's tax attributes of the equipment.
   d) Lossco would sell the equipment to Buyco for $5 million and would offset the resulting recapture and capital gains with its losses.
   e) Lossco would pay off the $4.5 million promissory notes held by the former shareholders of X Co.

In a short article such as this one, it is not possible to fully analyze the potential impediments to these arrangements. However, my (brief) take on these issues is as follows.

Subsection 69(11)

Subsection 69(11) penalizes a taxpayer (the transferor) that transfers property to another taxpayer (the transferee) that is not "affiliated" (in this example, Lossco) if the proceeds are less than FMV and the intention is to take advantage of the transferee's losses or other deductions.

Subsection 69(11) will apply if the property (the shares of X Co) or substituted property (the equipment) is resold (or if arrangements are made for its resale) within three years. In the example, the equipment will be sold shortly after Lossco acquires the shares of X Co. If subsection 69(11) were to apply, the transferor would be deemed to have received FMV proceeds.

In my view, subsection 69(11) will not generally be applicable in this type of example. As the example illustrates, the shareholders of X Co will have received proceeds that would be more, not less, than the proceeds they were prepared to accept from Buyco.

If Buyco was a real estate developer and the property owned by X Co was real estate that was capital property to it but inventory to Buyco, subsection 69(11) could be an issue. The shares of X Co would be worth the full $5 million to Buyco, because Buyco could step up the cost of X Co's underlying land to the $5 million purchase price of the shares of X Co. (See "The Windup Bump," *Tax for the Owner-Manager*, April 2006.) This being the case, the shareholders of X Co, in order

to effect the share sale to Lossco, will have accepted less from Lossco ($4.5 million) than they could expect Buyco to pay ($5 million).

It is not absolutely clear that the shares of X Co were disposed of for less than FMV proceeds. In the example, a willing seller negotiated a price with a willing arm's-length buyer. Should this negotiated price not be regarded as the FMV of the shares? Keep in mind that subsection 69(11) generally applies when the transferor elects proceeds that are less than FMV on the rollover of an asset into a transferee under, say, subsection 85(1), following which the transferee sells the asset and absorbs the gain with its losses.

Section 84.1

If section 84.1 were to apply to the sale of shares to Lossco, the shareholders of X Co would be deemed to have received dividends rather than to have realized capital gains.

Section 84.1 would apply only if the shareholders of X Co could be said not to be at arm's length with Lossco, as a question of fact, for the purposes of these arrangements. This is not likely to be the case.

A similar sale to an accommodating party was the subject of *McNichol* (97 DTC 111 (TCC)). In holding that the parties were at arm's length, the TCC stated that

> [t]he fact that the tax savings potentially accruing to the appellants as a consequence of sale formed not only the reason for the sale but also the boundaries within which [the] sale price might be negotiated does not suggest that the appellants and Forestell acted in concert. Buyer and seller do not act in concert simply because the agreement which they seek to achieve can be expected to benefit both. Section 84.1 is therefore not applicable.

GAAR

A similar but considerably more complicated case, *594710 British Columbia Ltd. v. The Queen* (2016 TCC 288), involved the acquisition by Lossco of shares of a profitable corporation (Profitco) that was wound up into Lossco. Lossco then offset its losses against partnership income that would otherwise have been allocated to Profitco. The TCC held that GAAR did not apply. I do not know whether the CRA has appealed the decision.

Agency

In my opinion, I do not think that, in the example given above, a credible argument could be made that Lossco was the agent of X Co.

Perry Truster
Truster Zweig LLP
Richmond Hill, ON

Evoy Estate: The Meaning of Subsection 104(2) Clarified

In *Evoy Estate v. The Queen* (2016 TCC 263), the issue in dispute was whether the minister had properly treated the appellant (which was one of three testamentary trusts created in the will of the late George Kenneth Evoy [George]) along with two other trusts created pursuant to the will as one individual pursuant to subsection 104(2). That subsection allows the minister to treat multiple trusts as a single trust for the purposes of the Act if

1) substantially all of the property of the various trusts has been received from one person, and
2) the various trusts are conditioned so that the income thereof accrues or will ultimately accrue to the same beneficiary or group or class of beneficiaries.

The facts are relatively straightforward. George died on November 17, 2007 and was survived by his spouse (Pauline) and by his three children (David, Wendy, and Karie) and their respective children. Pursuant to George's will (as amended), George created three separate trusts: one for the appellant (David's trust) and two other trusts ultimately benefiting the two other children (Wendy's trust and Karie's trust). Each of David's trust, Wendy's trust, and Karie's trust was entitled to a block equal to approximately one-third of the testator's shares in a certain corporation. Each of David's trust, Wendy's trust, and Karie's trust was one to which subsection 70(6) applied (that is, each trust was a trust colloquially referred to as a spousal rollover trust).

The terms governing David's trust provided that Pauline was to receive the net income of David's trust during her lifetime. The terms of David's trust further provided that after Pauline's death and until the termination of the trust, David and his children were entitled to all of the net income of the trust. Upon the termination of David's trust, the trust capital would go to David; if David was not alive, it would go to his children in equal shares *per stirpes*. If David left no children, the trust capital would be divided among George's other children in equal shares *per stirpes*, provided that any capital accruing to either Wendy or Karie would be added to Wendy's trust or Karie's trust, as applicable. The terms of Wendy's trust and Karie's trust were identical to the terms of David's trust, but they substituted Wendy and her children and Karie and her children for David and his children, as applicable.

Pauline, being alive, was entitled to and received all of the income of David's trust, Wendy's trust, and Karie's trust for the trusts' 2008, 2009, and 2010 taxation years. Pursuant to subsection 104(2), the minister included all of the income of all three testamentary trusts in the income of the appellant in respect of the appellant's 2008, 2009, and 2010 taxation years.

The issue before the TCC was the meaning to be given to the words "conditioned so that the income thereof accrues or will ultimately accrue to the same beneficiary or group or class of beneficiaries" in paragraph 104(2)(b) and, in particular, whether the determination required by that wording is to be made on an annual basis (the position advanced by the minister) or for the entire life of the trusts in question (the position advanced by the appellant).

Paris J cited *Canada Trustco Mortgage Co. v. Canada* (2005 SCC 54), which sets out the approach to interpreting tax statutes and states that "an instrument dominated by explicit provisions dictating specific consequences" invites a largely textual interpretation. He also cited *Canada v. Quinco Financial Inc.* (2014 FCA 108), in which the FCA reiterated the dominance of "the plain meaning of the text of the Act in the process of interpreting provisions of the Act."

The TCC held that that the inclusion of the wording "or will ultimately accrue" supported the conclusion that the paragraph contemplated the consideration of the right to receive the income of the trust over the trust's entire lifetime. The court also held that there was nothing in the text of paragraph 104(2)(b) that would require the reading in of an annual test.

Furthermore, the court found that no power was given to the minister to re-designate a consolidated trust as multiple trusts in the event that the conditions in paragraph 104(2)(b) were not met in a subsequent taxation year. The court noted that if the test in subsection 104(2) were an annual one, it would be impossible for trustees of such trusts to know whether to file on a consolidated or an unconsolidated basis, thereby creating unpredictable results contrary to the admonition of the SCC in *Canada Trustco*.

Paris J then considered the purpose of subsection 104(2), noting that the parties were in agreement that the provision was intended to prevent income splitting among a number of trusts, each with the same beneficiary or group or class of beneficiaries, in order to take advantage of lower marginal rates in respect of the income of each of the trusts. However, the court, agreeing with the appellant, found that the purpose of subsection 104(2) is to prevent income splitting between trusts that are identical over the entire period of the trusts' existence.

The minister also argued, in the alternative, that the three trusts were still conditioned so that the income accrued or would ultimately accrue to the same beneficiary or group of beneficiaries—namely, George's children and grandchildren. In the minister's view, they were part of the same class of beneficiaries because they were all members of the same family.

The TCC rejected this argument and stated that even if the children and grandchildren of George formed a class, (1) each of the applicable trusts had different children and grandchildren of George as residual income beneficiaries, (2) a different part of the class was named in each trust, and (3) there was no crossover of beneficiaries among the children and grandchildren of George in any of the three trusts. Thus, the court held that the trusts were not conditioned so that the income would ultimately accrue to the same group or class of beneficiaries.

The TCC rejected the minister's argument that the condition in paragraph 104(2)(b) was met if the beneficiaries of each trust were members of the same group or class. Paris J said that this rejection was supported by reference to the language of paragraph 104(2)(b), which refers to "the same group or class" and not to "members of the same group or class"—that is, it refers to beneficiaries within each trust, not to a class of beneficiaries distributed among the different trusts forming part of a common group or class.

On the basis of the foregoing, the appeal was allowed. It is now reasonably clear that for the purposes of subsection 104(2) the beneficiaries of each trust must be considered separately and compared when one is considering whether the test in paragraph 104(2)(b) is met. It is also clear that subsection 104(2) is not a test to be applied on an annual basis.

As a result of the 2016 amendments to the Act, which severely curtail the availability of graduated rates to testamentary trusts, the salience of this provision may well be diminished. Nonetheless, the TCC's decision is a welcome clarification of the law.

Philip Friedlan and Adam Friedlan
Friedlan Law
Richmond Hill, ON

Coming to Grips with Quebec's Lack of GRIP

Previously, the 2015-16 Quebec budget announced additional criteria necessary for Quebec-resident CCPCs to qualify for the Quebec small business deduction (QSBD) for taxation years ending after December 31, 2016. That budget stated that a CCPC must employ more than three full-time employees to qualify for the QSBD. This criterion was subsequently changed in the 2016-17 Quebec budget to a number-of-hours test. Subject to certain conditions, this test does not apply to Quebec-resident corporations that are in the primary and manufacturing sectors.

A Quebec-resident corporation will meet the number-of-hours test and be eligible for the full QSBD for a taxation year if, as applicable,

- during the taxation year, its employees worked at least 5,500 hours, and
- during the previous taxation year, its employees and the employees of the corporations with which it is associated worked a total of at least 5,500 hours.

However, the Quebec legislation has not made any corresponding change to reflect the above requirements in respect

of dividends that are paid out to shareholders. Under Quebec legislation, all dividends are ineligible dividends by default unless they are designated as eligible dividends for federal tax purposes pursuant to section 1 of the Quebec Taxation Act.

A problem arises when a CCPC that pays dividends qualifies for the federal SBD but does not qualify for the QSBD. Consider, for example, a Quebec-resident CCPC that has taxable income of $500,000. The CCPC is not in the primary or manufacturing sector, and it does not have employees with 5,500 hours; therefore, it cannot claim the QSBD. However, it is eligible to claim the federal SBD. Any dividends paid by the corporation will be considered ineligible dividends for federal and Quebec purposes because they are not paid out of the general rate income pool (GRIP), which is only federally defined. Thus, an SBD is available for federal purposes but not for Quebec purposes.

The table illustrates the tax consequences for a Quebec-resident CCPC earning active business income on a fully distributed basis in three situations: (1) a Quebec-resident corporation qualifies for the full SBD; (2) a Quebec-resident corporation qualifies for the federal SBD but not for the QSBD; and (3) a Quebec-resident corporation does not claim any SBD.

	Full SBD	No QSBD	No SBD or QSBD
Taxable income in Quebec CCPC	$500,000	$500,000	$500,000
Corporate taxes			
Federal tax rate	10.50%	10.50%	15.00%
Quebec tax rate	8.00%	11.90%	11.90%
Federal taxes	52,500	52,500	75,000
Quebec taxes	40,000	59,500	59,500
Total corporate taxes	$92,500	$112,000	$134,500
Distributed personally			
Personal income	$407,500	$388,000	$365,500
Combined personal tax rates (highest)	43.84%	43.84%	39.83%
Personal taxes	$178,648	$170,099	$145,579
Total taxes (corporate and personal)	$271,148	$282,099	$280,079
Effective tax rate	54.23%	56.42%	56.02%

Note: The calculations shown assume that the taxpayer has personal income in excess of $202,800 and has made the maximum contributions to CPP.

It appears as though Quebec is reducing the effectiveness of the federal SBD: the difference between qualifying and not qualifying for the QSBD is a little over 2 percent (the first column versus the second column). A similar tax rate on a fully distributed basis is in effect when no QSBD is claimed versus no SBD at either taxation level (the second column versus the third column). The simple solution would be for Quebec to legislate its own definition of GRIP that is not linked to the federal definition.

However, on the basis of the numerical example above, it seems unlikely that Quebec will do so. Quebec is restricting the use of the QSBD and at the same time is making the taxpayer indifferent to claiming the federal SBD when the QSBD is not available. Query whether the overly restrictive and complex federal SBD rules are a further signal that the SBD may soon become extinct in the CCPC tax-planning landscape.

Hiren Shah
Manu Kakkar CPA Inc., Toronto

Manu Kakkar
Manu Kakkar CPA Inc., Montreal

ETA: Changes to the "Closely Related" Test

Amendments to the ETA's "closely related" test were announced in the 2016 budget; they received royal assent on December 15, 2016, and came into force as of March 22, 2017. The amendments add a new eligibility condition in respect of elections under ETA sections 150 and 156. Specifically, the amendments introduce a "qualifying voting control" criterion to elections made since March 23, 2016, such that elections that are currently in force among the entities of a group could become invalid.

The amendments also restrict eligibility for the subsection 228(7) offset provision—a provision of significance for any corporation that has been reducing its tax payable or remittable by absorbing the tax refunds or rebates of a closely related corporation.

Excise Tax Act Shortcuts

ETA section 150, section 156, and subsection 228(7) establish tax shortcuts for members of a "closely related" group. ("Closely related" is defined in ETA section 128.) These shortcuts operate as follows:

- Section 150 allows closely related groups that contain a listed financial institution to make a joint election whereby intragroup supplies of property by way of lease, licence, or similar arrangement that would otherwise be taxable are deemed to be supplies of a financial service and therefore GST/HST-exempt. Section 150 applies only to corporations.
- Section 156 allows closely related groups to jointly file an election, pursuant to which taxable supplies between the filing parties are deemed to have been made for no consideration. As a result, no GST/HST is payable. Section 156 applies to corporations and partnerships.

- Subsection 228(7) allows a corporation to offset its taxes payable or remittable by absorbing the tax refund or rebate of a closely related corporation. Subsection 228(7) applies to corporations and partnerships.

Previously, entities were considered "closely related" when a parent corporation (or partnership) held at least 90 percent of the value and number of the issued and outstanding shares with full voting rights ("the 90 percent criterion") of a subsidiary corporation. According to the 90 percent criterion, the shortcuts provided for in section 150, section 156, and subsection 228(7) were available to a parent corporation (or partnership) and its subsidiary, even if the parent corporation (or partnership) did not hold at least 90 percent of the voting rights attached to the subsidiary's shares.

Changes to the "Closely Related" Test

The recent amendments to ETA subsection 128(1) replace the 90 percent criterion with a stricter test ("the qualifying voting control criterion"). Now, in order to make an election under section 150, an election under section 156, or an offset under subsection 228(7), the parent corporation (or partnership) must own shares of the subsidiary that include not less than 90 percent of the votes, with two exceptions (discussed below).

To illustrate this change, consider two corporations, X Co and Y Co. Y Co has a multiple voting share (MVS) structure: class A shares have 100 votes per share, and class B shares have 1 vote per share. There is 1 issued class A share, 9 issued class B shares, and no other outstanding shares.

On the basis of the previous 90 percent criterion, in order for X Co and Y Co to be closely related, X Co would have to own at least 9 of the 10 Y Co issued shares. It could own 1 class A share and 8 class B shares, or it could own all 9 class B shares. Under the previous test, the respective voting power of the shares would have been inconsequential in assessing whether the corporations were closely related. However, on the basis of the new qualifying voting criterion, in order for X Co and Y Co to be closely related, X Co must own the class A share, because even if X Co owned all 9 class B shares it would only own 8.26 percent of the votes ($^{9}/_{109}$).

Note that close relatedness operates transitively, so that if A Co is closely related to B Co, and B Co is closely related to C Co, then A Co is closely related to C Co. This transitivity remains unaffected by the amendments.

Exceptions

There are two exceptions to the new qualifying voting criterion that would allow an election or offset in cases where a parent corporation owns less than 90 percent of the votes of a subsidiary. The first applies when a statute (1) requires an adjustment to the nature or scope of the voting rights of any shareholder of the subsidiary, or (2) provides that holders of a class or series of shares are entitled to vote separately as a class or series. The second exception applies as prescribed (though currently nothing has been prescribed).

For example, the second version of the first exception would apply in the context of CBCA section 176(1), which provides that holders of shares of a class or series are entitled to vote separately as a class or series on a proposal to amend the corporation's articles relating to specific matters. According to the exception, the specific matters covered by CBCA section 176(1) would not be considered for the purposes of determining whether a person holds qualifying voting control of a corporation.

Policy Considerations

As described in the CRA's *Excise and GST/HST News*, no. 100 (November 2016), the amendments implement measures proposed or confirmed in the 2016 budget by "strengthening" the test for determining whether two corporations, or a partnership and a corporation, can be considered closely related.

Note that the new test appears to affect only corporate relationships in which the owned corporation has an MVS structure. The changes appear to have no new impact on corporations in which there is one vote per voting share.

In this light, one can speculate that the policy driver behind the amendments was to limit MVS corporations' access to the benefits of the sections 150 and 156 elections and the subsection 228(7) offset.

In Canada, an estimated 20 to 25 percent of companies listed on the TSX have some form of dual-class structure of special voting rights, including Canadian Tire, Magna, and Shopify. MVS structures have been viewed favourably because they allow corporations to maintain family or founder control.

As this type of corporate structure has become more popular, however, it has been criticized for undermining corporate governance standards and the rights of minority shareholders, who end up carrying the financial risk of the corporation without having corresponding power (see, for example, Anita Anand, "Offloading the Burden of Being Public: An Analysis of Multiple Voting Share Structures" (2016) 10:3 *Virginia Law and Business Review* 395-412).

What You Need To Know

The new "closely related" test applies to all new elections made under section 150 or 156. In addition, although the amendments did not come into force until March 22, 2017, they apply retroactively to all elections made on or since March 23, 2016. Thus, an election made on March 23, 2016 must meet the new "closely related" test. All elections made on or before March 22, 2016 are unaffected by the amendments.

Because the new "closely related" test also restricts a corporation's ability to offset tax payable or remittable by absorbing the tax refund or rebate of a closely related corporation, it is no longer enough that one corporation own 90 percent of the

other corporation; it is now necessary that the offsetting corporation own 90 percent of the votes of the other corporation, as described above.

An owner or manager of a corporation or partnership that has filed an election under section 150 or 156 in the past year (or has been offsetting taxes owed under subsection 228(7)) should assess whether his or her business group meets the new "closely related" test. Owners and managers should be especially careful if the business group includes corporations with an MVS structure.

Finally, note that all new section 156 elections have been subject to mandatory filing since January 1, 2015, and all pre-2015 elections have been subject to mandatory filing since January 1, 2016; these changes came into effect in 2015.

Kathryn Walker and Robert Kreklewetz
Millar Kreklewetz LLP
Toronto

ETA: Winding Down a Business—Input Tax Credit Issues

Input tax credits (ITCs) may be claimed against the GST paid or payable when a taxpayer is a recipient of a supply and that supply was acquired in the course of a commercial activity. The extent to which a supply was acquired in the course of a commercial activity has been an issue before the courts on numerous occasions, most recently in *ONEnergy Inc. v. The Queen* (2016 TCC 230).

C. Miller J heard a rule 58 motion asking the court whether ONEnergy Inc. (the taxpayer) was deemed to have incurred litigation costs in the course of a commercial activity. ETA paragraph 141.1(3)(a) deems an activity (other than the making of a supply) that is done "in connection with" the acquisition, establishment, disposition, or termination of a commercial activity of the person to have been done in the course of a commercial activity of that person.

The taxpayer operated a telecommunications business and held two principal assets—a radio licence spectrum covering 18 million people and a CRTC broadcast licence. The taxpayer experienced financial difficulties and announced that it would seek to wind up its business and dispose of its assets. The taxpayer sold its two principal assets to the Inukshuk Wireless Partnership, which was a partnership between Rogers Communications and Bell Media, for net proceeds of $64 million ("the spectrum sale"). The parties agreed that the spectrum sale terminated or disposed of the taxpayer's business and was therefore a commercial activity.

The board of directors received payments from the sale totalling $14.7 million in excess of "restructuring awards" lawfully due to them. The shareholders opposed the excess payments and caused the taxpayer to commence a legal action against the board of directors. The taxpayer then paid GST/HST on the legal fees that it incurred and claimed related ITCs on the basis that the litigation costs were incurred in the course of its commercial activities. The minister denied the ITC claim.

To claim the ITCs, the taxpayer had to incur the legal fees "in connection with" the spectrum sale. The taxpayer argued that the expense was incurred in connection with the windup of its commercial activities because the restructuring awards were planned and incurred in connection with the spectrum sale, and had the sale not occurred there would not have been any litigation related to the misappropriation of the sale proceeds. The Crown claimed that the taxpayer's argument amounted to a broad "but for" test—specifically, "but for the Spectrum Sale there would not have been the restructuring awards and, therefore, there would not have been any litigation." This argument raised the question whether the "but for" test was appropriate when one was analyzing whether an expense was incurred in the course of a taxpayer's commercial activities. That is, if an expense would not have been incurred "but for" a taxpayer's commercial activities, did it follow that the expense was incurred in the course of the activities? The TCC embarked on a textual, contextual, and purposive analysis to interpret the phrase "in connection with" in ETA paragraph 141.1(3)(a).

Beginning with a textual analysis, the TCC cited dictionary definitions and prior case law that interpreted similar phrases. The court found that while the phrase "in connection with" is textually broad, it does not allow for "the remotest of links, such as a link only arising by way of the 'but-for' test." The "but for" test was too tenuous, notwithstanding ample authority for the proposition that words such as "in connection with" are among the broadest possible phrases that can be used to express connection.

The TCC then conducted a contextual and purposive analysis. C. Miller J found that the relevant technical notes to the predecessor of ETA paragraph 141.1(3)(a) permitted ITCs to be claimed during the winding-down phase of operations; he then drew a distinction between the winding down of a business and the winding down of a corporation. Furthermore, he clarified that the activities for which the taxpayer was permitted to claim ITCs must have been in connection with the spectrum sale itself, not with the consequences of the spectrum sale. The distinction between the windup of the commercial activities and the windup of the corporation itself was integral to the decision. The activity of pursuing the board of directors was "one step removed" from the commercial activity and "nothing in the [spectrum sale] itself triggered litigation." This finding is curious, given that the spectrum sale gave rise to the proceeds that were absconded with. It is difficult to see why every situation of employee theft is not "one step removed" from the transaction that gave rise to the proceeds that were stolen, and yet few would doubt that litigation in such a context generally is in connection with commercial activities.

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Canadian Tax Foundation
595 Bay Street, Suite 1200
Toronto, Ontario M5G 2N5
Telephone: 416-599-0283
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The TCC held that the legal expense incurred by the taxpayer was not incurred in the course of a commercial activity because there was "no commercial expectation that directors on winding up a corporation will abscond with funds and that the cost of such [a] contingency is somehow worked into the cost of the supply." It is not clear why the court seemed to read in a requirement that a cost must be expected to be incurred in connection with an earlier commercial activity.

The effect of this decision is that the link between the supply and the commercial activity has been constricted. Perhaps an activity that originates and is conducted exclusively in the winding-down phase of a corporation may be "one step removed" from a commercial activity; however, should an activity that arose as a result of a commercial activity (such as the spectrum sale) be afforded the same treatment? It seems unreasonable to expect a taxpayer to somehow extend the winding-down phase of its operations, and thereby potentially incur great losses, so that it can claim ITCs before entering the winding-down phase of the corporation itself. It is possible that the narrow interpretation adopted by C. Miller J will not be followed in other decisions, and that when taxpayers claim ITCs of this nature they should rely on earlier analogous case law as authority.

The taxpayer filed an appeal to the FCA on October 24, 2016.

Ahmed Elsaghir
Felesky Flynn LLP, Calgary