RECENT ISSUES IN OWNER-MANAGER REMUNERATION PLANNING

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Introduction

The purpose of this paper is to comment on recent developments including judicial decisions and government policy that affect owner-manager remuneration planning. The following topics will be discussed:

1. Owner-manager remuneration update;
2. Employee profit-sharing plan trusts;
3. Retirement compensation arrangements; and
4. Structural considerations to enhance owner-manager remuneration planning in light of recent developments.

Emphasis will be placed on recent developments as opposed to examining the particular topic area in its entirety. In addition, this paper will not discuss two common tools in owner-manager remuneration – health and welfare trusts/private health services plans and individual pension plans because another speaker at this conference will be discussing each topic.

In order to illustrate certain issues, a typical scenario has been developed. Mr. Apple is a Canadian resident, non-US citizen. Mr. Apple owns 100% of the issued shares of "Opco." Opco is a Canadian controlled private corporation ("CCPC") that was incorporated pursuant to the laws of a province in Canada. Mr. Apple is married to Mrs. Apple who is also a Canadian resident, non-US citizen. Mr. and Mrs. Apple have three minor children whose ages are eight, five and two. It is assumed that Mr. and Mrs. Apple's objective in receiving remuneration or funds from Opco is to receive the highest after-tax amounts from Opco in all cases. However, such an objective, in real life, may not always be a primary objective given that other intentions may be desirable such as the need for Opco to receive financing that may conflict with the intent of receiving high after-tax amounts.

In addition, this paper does not consider any cross-border issues involving the United States or other international issues that may add complexity in dealing with owner-manager remuneration planning. However, such issues are becoming more and more prevalent and the reader is encouraged to explore them independently.

Owner-Manager Remuneration Update

General Comments

There have been many excellent papers written about owner-manager remuneration.[2] Accordingly, the purpose of this section is not to duplicate much of the material that is contained in those papers. Instead, the focus of this section will be to comment on issues that have arisen during the recent past that will cause practitioners to rethink many habits or common planning practices.

Some issues in owner-manager remuneration do not change. For example, the issues generally require consideration of the following:

1. The amount of the remuneration;
2. The form of the remuneration; and
3. The timing of the payment of the remuneration.

When dealing with the amount of the remuneration, one must deal with three main issues. These are:

1. Covering an amount of money that has already been withdrawn from the company (i.e. a debit balance in the shareholder loan account);
2. Making funds available for personal cash needs; and
3. Maximizing tax deferral opportunities. This usually involves leaving money in the corporation.

When dealing with the form of the remuneration, the most common forms are salary and dividend payments. However, remuneration may also take the form of interest on shareholder loans, repayment of shareholder loans,[3] recouping adjusted cost base or paid up capital of shares, and capital gains. Of course, the form of the remuneration will also affect the ultimate taxation of such. One must also consider other factors such as alternative minimum tax,[4] the impact on the individual's cumulative net investment loss account,[5] "kiddie tax" exposure,[6] and the individual's desire to contribute to an RRSP.[7]

The timing of the payment of the remuneration may be influenced by personal cash needs or perhaps by the need to correct a debit balance in a shareholder loan account.[8] In some cases, tax deferral may be a significant objective. Given the fact that the federal and provincial governments have been reducing individual taxation rates for the last number of years, the deferral of income may result in tax savings to the extent that income is deferred to a taxation year where there has been a decrease in taxation rates.

When dealing with bonuses from an owner-manager corporation, as most practitioners know, the implications of subsection 78(4) of the Act must be observed.[9] Accordingly, it is usually very important that such bonuses be paid on a timely basis. Failure to do so will result in tax integration not being adhered to.[10]

Income Tax Integration

Integration is a cornerstone of the Canadian tax system. As practitioners know, a corporation is a separate legal entity from its shareholders. Accordingly, one of the prime objectives of integration is to ensure that the total tax paid by a corporation and it shareholders should approximate the tax that an individual would have paid directly by carrying out the activity without the corporate vehicle. In theory, integration is designed to work in respect of the following income sources:

1. Active business income[11] eligible for the small business deduction;[12]
2. Canadian taxable dividends received by a "private corporation"[13] that is resident in Canada; and
3. Canadian source property income (including capital gains) and income from a specified investment business[14] of a Canadian-controlled private corporation ("CCPC.")[15]

Integration works in a limited way for foreign investment income of a CCPC, but is eroded if foreign tax credits are claimed. It also works for foreign accrual property income[16] where the shareholder is a CCPC, and the income is investment income other than capital gains. The integration is eroded if the foreign corporation pays tax on the foreign investment income.

Integration does not work for income earned by a corporation which is not a CCPC (other than Canadian dividend income) or for active business income that does not qualify for the small business deduction (because it exceeds the small business limit, is foreign sourced, rather than Canadian sourced, or the corporation itself is not eligible).

Integration does not work for public companies in almost all circumstances.

One will also note from a review of Appendix Tables 1 and 2 that there is a significant deferral for taxing active business income up to the business limit[17] inside a CCPC as compared to being taxed individually (22.88% - Alberta, 27.79% - Ontario, 26.20% - Quebec).

In practice, where the corporate tax rate is approximately below 22 percent, there is under-integration meaning that there is an advantage to distributing dividends as opposed to salary. Using British Columbia, Alberta, Manitoba and Ontario as examples, Appendix Tables 3 and 4 provide a comparison using a distribution of $10,000 of active business income ("ABI"). The tables display that there is a distinct advantage to dividends as opposed to salary in this situation.

In addition, there is now a small disadvantage in retaining investment income inside a corporation. This is an anti-deferral as opposed to an overall tax cost. See Appendix Tables 5 to 7, which compare the taxation of portfolio dividends, capital gains and interest/rental income inside a corporation with the tax which would be incurred personally.

Because capital gains are now taxed substantially more favorably than dividends, any instance where a capital gain can be realized will be desirable, compared to a dividend, unless the corporation would otherwise realize a dividend refund[18] from the payment of the dividend. Some of the strategies outlined later in the paper will discuss planning opportunities to realize capital gains.

In addition, given the wide discrepancy in provincial tax rates (with Alberta being the lowest taxed province), many tax plans have been entered into by entrepreneurs to try to move their income to a lower taxing province. Some of the planning involves the use of trusts (i.e. "Alberta Trusts.") Another speaker at this conference will be discussing the use of such vehicles and therefore provincial rate shopping will not be discussed in this paper.

Income Tax Rate Reductions

Appendix Table 1 attached to this paper reflects the fact that virtually all provinces have been subject to individual tax rate reductions if one were to compare such rates to that of say five years ago. One of the most significant income tax rate reductions resulted from the October 18, 2000 Federal Mini-Budget.[19] As mentioned above, the capital gains inclusion rate was reduced to 50 percent effective as of that date. This fact alone has now encouraged shareholders of private corporations to seek to receive capital gains rather than dividends. In addition, the 2003 Federal Budget introduced a phased-in increase of the small business limit.[20] The 2004 Federal Budget accelerated such increase in the small business limit.[21]

The 2000 Federal Budget also introduced section 123.4 of the Act which provided for an overall general rate reduction for corporations. Subsection 123.4(3) was also introduced to generally provide for an additional rate reduction for CCPCs for taxable income between $200,000 and $300,000. However, due to the introduction of the increase in the small business limit introduced in the 2003 and 2004 Federal Budgets, subsection 123.4(3) will be repealed effective 2005. Accordingly, the "rule of thumb" whereby CCPCs declare a bonus to reduce the active business income to the $200,000 level will now have to be modified to bonus down to $300,000 effective for the calendar year ended 2005. Many provinces have also increased their small business limits from $200,000 to $300,000 or more.[22]

Reasonableness of Remuneration

In order to preserve integration and ensure that remuneration to owner-managers is deductible it is important to ensure that the CRA agrees that such remuneration is reasonable. The CRA has been asked many times about its administrative position with respect to reasonable remuneration for owner-managers. As mentioned above, in order to ensure that integration is maintained, it will often make sense for owner-managers to realize remuneration in the form of bonuses paid out of active business income so as to reduce the CCPC's income to the small business limit. Since 1981, the CRA's position has been that it would not challenge the reasonableness[23] of salaries and bonuses paid to the principal shareholders-managers of a corporation when:

a) The general practice of the corporation is to distribute the profits of the company to its shareholders-managers in the form of bonuses or additional salaries; or
b) The company has adopted a policy of declaring bonuses to the shareholders to remunerate them for the profits the company has earned that are, in fact, attributable to the special know-how, connections or entrepreneurial skills of the shareholders.[24]

The CRA further outlined that bonuses paid to shareholders other than principal shareholder-managers will be subject to the normal test of reasonableness. Over the years, the CRA has been asked many times to clarify its position on bonuses paid to shareholders.[25] In addition, there have been many cases with respect to the reasonableness of remuneration paid from a corporation to owner-managers and their family members.[26] However, in 2000 and 2001, three technical interpretations were released by the CRA with respect to reasonableness of owner-manager remuneration.[27] In addition, the decision of *Safety Boss*[28] was released. This case dealt with the reasonableness of a "bonus" paid to the corporation's non-resident president and fees paid to a non-resident corporation. The court found the payments to be reasonable. Accordingly, the release of the three technical interpretations and the *Safety Boss* case created great uncertainty with respect to whether or not the 1981 Round Table administrative position would still be respected in certain cases.

In response to such uncertainty, direct questions were posed to the CRA at the Annual Conference of the Canadian Tax Foundation held in 2001 at Vancouver, BC. At the conference, the CRA outlined its criteria that must be met where the Agency will not challenge the reasonableness of remuneration. Such criteria were subsequently documented by the CRA in Technical News No. 22 released January 11, 2002 as follows:

1. The salaries and/or bonuses are paid to managers who are shareholders (either directly or indirectly) of a CCPC;
2. The shareholders/managers are Canadian residents; and
3. The shareholders/managers are actively involved in the day-to-day operations of the business and contribute to the income-producing activities from which the remuneration is paid.

The CRA also clarified that the ownership structure of a corporation does not matter with respect to their administrative policy so long as the criteria referred to above are met. In addition, the CRA also clarified that they would continue to challenge the reasonableness of inter-corporate management fees.[29] This topic will be discussed more in-depth later.

However, in a somewhat surprising commentary in Technical News No. 22, the CRA stated that it would not challenge the reasonableness of salaries and bonuses paid out of "non-active business income" as long as the criteria above are met.[30] However, what does "non-active business income" mean? Such a phrase is not defined in the Act. This question was posed to the CRA in a recently released Technical Interpretation.[31] The Agency explained that the term "non-active business income" is meant to encompass all business income, active or otherwise. In general terms, this could include income incidental to an active business and income of a "specified investment business."[32] The Agency stated in the technical interpretation that, if a corporation's only source of income is from stocks and interest-bearing investments, the income would be considered "non-active business income." A further question was posed to the CRA in the subject technical interpretation as to how much activity is required of a shareholder-manager in order for the shareholder to be considered active in the day-to-day operations of the company where the company generates non-active business income. The CRA responded by stating that whether or not managing a portfolio is sufficient to qualify as being active in the day-to-day operations of the business will be a question of fact. However, the CRA is of the view that where a corporation's only business activity is investments, which are managed through a third party, the shareholder is <u>not</u> considered active in the day-to-day operations of the business.

In another subsequent technical interpretation,[33] the CRA clarified its position in Technical News No. 22 with respect to "non-active business income." A question was posed as to whether or not a corporation can pay a bonus to an active shareholder to offset the taxable portion of a capital gain and have the reasonableness assertion not challenged by the CRA. The CRA concluded that salaries and bonuses are <u>not</u> deductible in computing a capital gain and, accordingly, the policy in Technical News No. 22 would not apply. The CRA arrived at such a conclusion on the basis that outlays or expenses may only be deducted in computing a taxable capital gain pursuant to subparagraph 40(1)(a)(i) of the Act to the extent that "they were made or incurred by the taxpayer for the purpose of making the disposition." The CRA stated that the words "for the purpose of" mean "for the immediate or initial purpose of"[34] and not the eventual or final goal which the taxpayer may have in mind. They stated that to give the words the latter meaning would permit the most indirect or most distantly related outlay or expense to reduce the amount of a gain. The CRA believes that this could not have been Parliament's intent. However, one can question whether or not such an interpretation is consistent with the Act. For example, presumably it is the work effort of the owner-manager that has contributed to the capital gain. Perhaps it was previous years' foregone bonuses that yielded a greater capital gain. If the bonus was negotiated between the corporation and the owner-manager prior to the business assets being sold, and such a negotiation was documented by a binding contract, would such a bonus be deductible against the capital gain? It is conceivable for such a bonus to meet the conditions of subparagraph 40(1)(a)(i). Accordingly, CRA's administrative policy should not be to categorically deny the deduction of bonuses in the computation of taxable capital gains.

At the 2003 Canadian Tax Foundation National Conference in Montreal, the CRA once again commented on the reasonableness of owner-manager remuneration. The CRA subsequently documented its comments in Technical News No. 30 dated May 21, 2004. Some of the comments provided are of interest to practitioners. The CRA noted that the intent of the policy documented in Technical News No. 22 is to provide flexibility to CCPCs and its active shareholder/managers and allow tax planning in order for taxpayers to take full advantage of marginal corporate and personal income tax rates and any integration provided for under the law. In addition, the CRA stated that it would consider ruling on the reasonableness of shareholder/manager remuneration in order to provide certainty to taxpayers as to the taxable status of transactions that are within the intent of the policy outlined in Technical News No. 22.[35] The CRA also clarified that the following situations would be beyond the intent of the policy outlined in Income Tax Technical News No. 22:

1. Remuneration paid out of the proceeds generated from a major sale of business assets including the sale of the entire business assets or those of a large division;
2. Further to the above, all sources of income triggered by the proceeds including capital gains, recapture of capital cost allowance, and income arising from the disposition of eligible capital properties (unless such sale of assets is incidental to the normal business operations);
3. Remuneration paid from the income of a CCPC where such income is derived from management fees; and
4. Remuneration paid from a CCPC where the income of the CCPC is derived from dividends that have flowed through a complex corporate structure.[36]

In Technical News No. 30 the CRA suggests that its administrative policy will not apply when recapture of capital cost allowance and/or eligible capital properties is the source of income from which the bonus is paid. In a recently released technical interpretation[37] the CRA commented that, in light of its response documented in Technical News No. 30, in its view recapture of capital cost allowance and the income arising from the disposition of an eligible capital property generated from a major sale of business assets is not earned during the normal course of business operations but rather as an indication of the cessation of business operations notwithstanding that such income may be active business income. In such technical interpretation, the CRA noted that remuneration paid from the proceeds of a major sale of business assets will not necessarily be considered unreasonable for the purpose of section 67 of the Act. However, they stated that they reserve the right to review the reasonableness of the amount.

As per the CRA's recent comments that it will now issue advance tax rulings on the reasonableness of owner-manager remuneration, one should note that there have been a number of recently released rulings. Interestingly, two such rulings deal with situations where remuneration is paid out of income triggered from the proceeds of a sale of business assets. In one of the first of such rulings,[38] the assets of a CCPC including land, buildings, other fixed assets, working capital, franchise rights and goodwill were sold generating taxable amounts including amounts taxable under subsection 14(1) of the Act.[39] The CCPC had six shareholders, three of whom were active in the day-to-day management of the operations of the business prior to its sale. Subsequent to the sale, the corporation declared a bonus payable to the three active shareholders. The bonus was unanimously authorized by the corporation's board of directors and approved by its shareholders in a meeting. Subsequent to that meeting, the corporation and the owner-managers became aware that the CRA had clarified its policy on when such remuneration would be considered reasonable for the purpose of section 67 of the Act and, as a result, decided that the bonus would not be paid until such time as a favorable advance income tax ruling could be obtained on the income tax status of the bonus. Accordingly, the purpose of the subject ruling was to ensure, prior to payment, that the CRA would not invoke section 67 to deny the deductibility of the bonus by the payer corporation. In the ruling, it was stated that the purpose of the payment of the bonus was to remunerate the owner-managers for their contribution towards the successful management of the corporation. Based upon the facts at hand, the CRA ruled that section 67 and paragraphs 18(1)(a) and 18(1)(e) of the Act would not apply to prohibit the corporation from deducting the amount of the bonus in computing its business income for the applicable taxation year. Although this ruling is not thoroughly enlightening, it is interesting given that it is one of the first advance tax rulings on reasonableness of remuneration and also does provide a taxpayer certainty[40] in a situation where such income is generated from the disposition of business assets. Another such ruling also concluded that paragraph 18(1)(a) and section 67 would not apply in a situation where the disposition of business assets resulted in recaptured depreciation under subsection 13(1) of the Act.[41]

An additional ruling recently released by the CRA dealt with the situation where the payment of a bonus would create a non-capital loss for the corporation, and whether or not such payment would be reasonable in light of CRA's policy.[42] In the subject ruling, the bonus was paid from cash reserves arising from the corporation's profitable activities in prior years and was to be payable to its active owner-manager. However, the proposed payment would create a non-capital loss for the corporation and therefore the corporation would request a carry back of the non-capital loss to reduce its taxable income for prior taxation years. The carry back of the losses would result in the reduction of the corporation's prior years' taxable income to approximate the small business deduction limit in those years. Again, after a review of the facts, the CRA ruled positively that section 67 and paragraph 18(1)(a) would not apply to deny the deductibility of the bonus. In addition, it also ruled that the non-capital loss could be carried back to its prior taxation years subject to the limits of paragraph 111(1)(a).

Given the above general principles as outlined by the CRA in Technical News No. 22 and 30 and subsequently released technical interpretations, there are many variations that practitioners could advise on to try to creatively remunerate owner-managers. For example, would a bonus from a corporation to a trust shareholder of a CCPC resident in Canada be subject to the reasonableness provisions under section 67? A careful read of the criteria outlined in Technical News No. 22 would seem to indicate that such a payment to a trust from a CCPC would be subject to section 67 in the CRA's opinion. This was confirmed by a recently released technical interpretation.[43] Ignoring CRA's comments, one would also need to ensure that any payments to a trust shareholder be properly characterized since a salary or bonus payment to a trust could be problematic given that a trust cannot likely be an employee. What about payments to an employees profit sharing plan trust? This subject will be reviewed in more detail later in the paper but a strict read of the CRA's administrative policy would suggest that such a payment would not be captured.

Appendix Tables 8 and 9 attempt to briefly summarize the CRA's views on the reasonableness of remuneration.

There have been many cases on reasonableness of shareholder remuneration. Recently, the courts have had a chance to look at the continuing saga of reasonableness of shareholder remuneration. *Mépalex*,[44] is one such example. The taxpayer was the majority shareholder of one corporation - Agridanax - and his wife was the majority shareholder of another corporation - Mépalex Inc. From 1995 to 1997, Agridanax and Mépalex paid various amounts ranging from a low of $19,185 to a high of $50,835 to each of their two children. One child was aged 17 and the other aged 13 in 1995. Those amounts were deducted by the various corporations as "bonus" amounts and therefore treated as salary amounts to the children. The parents explained that their children assisted in the business activities of the two corporations including catalogue preparation, website maintenance, secretarial assistance and sales assistance. The CRA argued that the salaries paid to the children were not reasonable given the ages of the children, the fact that the children attended school on a full-time basis and that one of the children also had a part-time job at Wal-Mart. Interestingly, the taxpayers agreed that the salary payments to the children were not reasonable but argued that such salary payments would have been reasonable had they been directed to themselves, and therefore they argued that such amounts should be taxed in their own hands pursuant to the provisions of subsection 56(2) or subsection 74.1(2) of the Act. Obviously, such arguments were made in order to prevent the double taxing effect that section 67 would create to the extent that the deduction for the unreasonable salary payments would be denied. The court found that subsection 56(2) did not apply (in addition to subsection 74.1(2)). Instead, the court found that the bonuses or salaries paid to the children were unreasonable, stating:

> The appellants were reassessed because the bonuses or salaries paid to the managers' children were unreasonable, and it is those assessments that are in appeal here. The Minister was entitled to find those bonuses unreasonable. Even the appellants agreed with him, but they are asking that the salaries paid to the parents and children be amended by increasing the salaries of the parents and reducing those of the children. The court cannot restructure what has been done.[45]

However, the Court found that some of the services rendered by the children might deserve remuneration. It appears that the CRA auditor had already performed an analysis of what might be reasonable in the circumstances and the Court agreed with such analysis. Accordingly, section 67 applied to deny the unreasonable portion of the payments by the corporation. *Mépalex* is an ongoing example of taxpayers needing to be cautious and reasonable with payments made to children who might perform nominal type services in the business activities of the CCPC.

In *Petrovic*,[46] the reasonableness of a "management fee" paid to a spouse was called into question. Although *Petrovic* is not a case that relied on section 67 to determine its outcome (rather such a case relied on the reasonable expectation of profit doctrine[47]), *Petrovic* is an interesting review. The case involved a husband and wife whereby the husband financed a home-based jewelry manufacturing business that was operated by the wife. The business struggled throughout its formative years and was not profitable. "Management fees" were paid by the proprietor husband to the wife to compensate her for her efforts. However, the management fees drove the business into a further loss. Such losses were then deducted by the taxpayer husband and taxes which were paid on his normal employment income were recovered. Such refunds were further utilized by the taxpayer to continue to finance the business. Given that the deduction of the management fees either eliminated all of the marginal profits or increased the already existing losses**,** the CRA utilized such fact to further argue that there was no business and that the "business" was really personal in nature. The court agreed. Accordingly, practitioners should be aware of such issues when recommending income splitting opportunities between family members notwithstanding that such a case was decided outside of the provisions of section 67 and decided pre-*Stewart* and pre-*Walls*.

The Tax Court of Canada has also recently heard a number of Informal Procedure cases[48] that deal with the reasonableness of shareholder/owner-manager remuneration. *Prefontaine*[49] is an example of such a case. *Prefontaine* addressed the issue of whether certain expenses claimed by Mrs. Prefontaine in her rental business were deductible. Mrs. Prefontaine had full-time employment outside of her rental property business. The rental property business generated profits. Approximately $3,000 in "salaries" was paid by Mrs. Prefontaine to her two daughters, one of whom was 17 and the other who was 12. The Minister was not satisfied that such payments were reasonable and therefore denied such deduction against the rental profits. The Judge found that the wages of $1,925 paid to the 17 year old daughter were unreasonable given that one of the rental units was vacant for several months during the applicable taxation year, the daughter was in full-time attendance at school and also taught music lessons earning $20 an hour. However, the Judge found that the daughter did do some clean up and yard work and therefore estimated that a reasonable amount would be $500. The Judge also found that the salary amounts paid to the 12 year old were not justifiable given insufficient evidence presented at trial.

Aessie[50] is another example of an Informal Procedure case of the Tax Court of Canada that dealt with reasonableness of owner-manager remuneration. *Aessie* involved the case of a self-employed chartered accountant providing public accounting services from his own personal residence. The appellant's spouse (through a corporation – "Mayday" – the shares of which were equally owned by the spouse and her sister) provided assistance in the business in the form of administrative duties. In the computation of his income for the 1999 and 2000 taxation years, the appellant deducted "fees" in respect of services provided by his spouse in the amount of $34,500 for the 1999 taxation year and $38,000 for the 2000 taxation year. In reassessing the taxpayer, the Minister denied the amount of $25,650 of management fees for 1999 and $29,150 for 2000, asserting that such amounts were not reasonable pursuant to section 67 of the Act. The administrative services provided by the taxpayer's spouse in respect of the taxpayer's accounting business included reception, typing, tax return assembly, proofing, mailing, dealing with mail, photocopying, filing, etc. After deducting the management fees, the profit from the accounting business was nominal. Finding in favor of the taxpayer, the Judge stated the following noteworthy comments:

> Finally, it should be pointed out that many professionals and businessmen make less money from their businesses than their secretaries do. Often that occurs occasionally. Sometimes it occurs frequently.
>
> The deal with Mayday is a common and reasonable business deal that is not unusual or untoward in the business world. It is not appropriate for the Court to interfere in such a transaction. Therefore, the appeal respecting this matter is allowed.[51]

Aessie is interesting given that the taxpayer's facts appear consistent with the pattern that the CRA finds disturbing but the taxpayer was successful at trial.

Muhammedi[52] is another Informal Procedure decision heard by the Tax Court of Canada involving reasonableness of owner-manager remuneration. The case involved the 1999 and 2000 taxation years of Mr. Muhammedi. Mr. Muhammedi reported net business income in the amounts of $332 and $346 for the 1999 and 2000 taxation years respectively. In computing his net business income, Mr. Muhammedi claimed deductions for "casual labor" in the amounts of $12,000 and $3,500 for the 1999 and 2000 taxation years respectively. In 1999, a "management fee" of $3,500 was paid to the spouse of Mr. Muhammedi. For 2000, no management fee was paid to the spouse. The balance of the "casual labor" for the 1999 and 2000 taxation years appeared to have been paid to the taxpayer's two children who were ages 17 and 12 in 1999. It appears that cheques were issued to the children but such funds were deposited back into the bank account of either the taxpayer's business, the personal account of the taxpayer or the spouse of the taxpayer. None of the cheques issued to the children were endorsed by them. In addition, there was no formal written loan agreement between the appellant and the children in regard to the amounts deposited back into the bank accounts of the business or the taxpayer. In reassessing Mr. Muhammedi, the Minister relied on paragraph 18(1)(a) and section 67 of the Act submitting that Mr. Muhammedi was not entitled to deduct the amounts of $12,000 and $3,500 in computing the income for the 1999 and 2000 taxation years as Mr. Muhammedi had not shown that the amounts were incurred for the purpose of gaining or producing income. The Minister further submitted that Mr. Muhammedi and the children were not engaged in a bona fide business arrangement and further submitted that, to the extent that the Tax Court found that the amounts paid constituted salaries to the children, such payments were not reasonable pursuant to section 67 on the basis of the children's ages, the dates the said payments were made and the amounts of the payments in comparison with the amounts paid to the spouse during the same period. After reviewing the facts and finding that the cheques issued to the children were either not paid to them, or upon being paid to them, were immediately deposited into the bank accounts of either the business or one or both of the parents, there was no loan documentation and the children did not declare such "casual labor" amounts on their personal income tax returns, the Judge stated the following:

> One is left with the impression that what was involved was tax planning designed to reduce, as much as possible, the overall tax burden of the family. This is not necessarily the end of the matter but when the operations are carried out in the fashion that they were, it smacks of a sham and does not meet the requirements of paragraph 18(1)(a) and section 67 of the Income Tax Act.[53]

After stating the above and citing related case law, the Judge dismissed the appeal of the taxpayer and denied the deduction of the casual labor amounts. Although Informal Procedure cases, *Prefontaine, Aessie and Muhammedi* should serve as a reminder to practitioners that formality and reasonableness are critically important in ensuring that section 67 and paragraph 18(1)(a) do not apply to remuneration planning.

Given the continuing uncertainty regarding the reasonableness of owner-manager remuneration, one questions whether it is finally time for the Department of Finance to legislate the criteria (perhaps that as outlined in Technical News No. 22) so as to provide taxpayers certainty as to when owner-manager remuneration will not be subject to the provisions of section 67 or paragraph 18(1)(a).

Management Fees

For years, taxpayers and their advisors have attempted to utilize management fees as a flexible form of remuneration. The payment/accrual of management fees often takes the form of payments or accruals to related corporations. Often the recipient corporation will have a different taxation year-end than that of the payor corporation. Accordingly, the objective of such a payment may be income tax deferral. An example helps explain this. Assume the situation of Mr. Apple. Mr. Apple also owns all of the issued shares of a related corporation, "Holdco." Holdco enters into a contractual arrangement with Opco to provide management services to Opco. Opco has a December 31 taxation year end. Holdco has a November 30 taxation year end. In practice, advisors may sometimes recommend that the accrual of a lump sum management fee be made by Opco to Holdco at Opco's December 31 year end. The argument is that Holdco will need to report the receipt of such management fee in its November 30 taxation year thereby affording a significant deferral since Holdco would not report such income until approximately 11 months later. However, such a simple plan is fraught with problems. Upon audit, the CRA will often argue that the management fee reported by Holdco was earned proportionately throughout its taxation year thereby trying to tax a significant portion of such accrued management fee in its prior taxation year resulting in the elimination of the deferral.

Management fees are also utilized by taxpayers and their advisors in a simple but often times crude attempt to multiply access to the small business limit. An example can help explain this. Consider again the situation of Mr. Apple. Assume further that Mrs. Apple owns 100% of the shares of Holdco. Holdco and Opco enter into a contractual arrangement whereby Holdco provides administrative and management services to Opco. Holdco therefore receives amounts from Opco and takes the position that it is not associated with Opco.[54] To the extent that Holdco and Opco were associated, the small business limit[55] would need to be shared by Holdco and Opco. In this example, Holdco and Opco would need to carefully consider the possibility of deemed association.[56]

Practitioners and their advisors sometimes also use management fees to try to avoid the withholding requirements under the Act.[57] Consider again the situation of Mr. Apple. During the year, Mr. Apple withdrew $100,000 from Opco and did not characterize such amounts as salaries (thereby avoiding the withholding requirements that Opco would otherwise have had to withhold from such payments) or dividends. Accordingly, Mr. Apple's shareholder loan account is in a debit position of $100,000. In order to avoid a subsection 15(2) inclusion, Mr. Apple enters into a contractual arrangement with Opco and takes the position that the $100,000 amount was paid to Mr. Apple at the end of its taxation year as "management fees." Accordingly, the corporation makes a journal entry in its accounting records entry to offset the shareholder debit amount and expenses the $100,000 as management fees. Mr. Apple then reports the $100,000 as business income on his personal return in the taxation year in which the shareholder debit was offset. Such a plan is also fraught with problems. For example, it is highly debatable as to whether or not the subsection 153(1) withholding requirements are escaped.[58] Under paragraph 153(1)(g), any person paying fees or other amounts for services must withhold from the payment the amount determined under regulations. However, given that the regulations do not contemplate a withholding requirement regarding payments to independent contractors, there is no withholding under 153(1)(g) on such payments. This was confirmed in *Liu v. Canada*.[59] It is this aspect upon which some plans hinge to try to avoid the withholding requirement.[60] In other words, in the example, Mr. Apple would need to argue that he was an independent contractor when he received the management fees. The GST considerations would also need to be considered in such a plan.[61]

In all of the above management fee examples, there are numerous issues that need to be considered. Some of them are as follows:

1. Are the management fees a sham?[62]

2. Are the management fees reasonable? Were they incurred for the purpose of earning income from a business or property? If not, section 67 or paragraph 18(1)(a) could deny the deduction of the payment of the management fees by the payor. As stated earlier in

this paper, the CRA has confirmed recently that its administrative policy as outlined in Technical News No. 22 does not apply to management fees.[63]

3. As mentioned above, the CRA takes the position that management fees paid to a related corporation will have to be reported under the "earned method"[64] or for greater certainty the "receivable method."[65] Accordingly, to the extent that the CRA's position is correct, the deferral opportunities that might have otherwise been enjoyed by the payment of management fees to a related corporation with a differing taxation year would be eliminated.[66]

4. In the example provided above wherein a shareholder debit is eliminated by the payment of management fees in an attempt to escape the withholding requirements, one must argue that Mr. Apple is truly providing management services (as opposed to employment services) and that the amounts received are management fees. There is very little case law on what the term "management fees" means.[67] In addition, there is no statutory definition of "management fees." The CRA provides its views on what it considers the phrase "management or administration" fee to mean in paragraph 5 of IT 468R as follows:

> A management or administration fee or charge is not defined in the Act. For the purposes of paragraph 212(1)(a) the Department considers that the term "management or administration" generally includes the functions of planning, direction, control, coordination, systems or other functions at a managerial level. These functions may involve services for various departments of a business such as accounting, financial, legal, electronic data processing, employee relations, management consultation, labour negotiations, taxation, etc. relating to the management or administration. It is not possible to provide an all-inclusive definition of management fees in an interpretation bulletin, and it is suggested that the above comments be read together with the comments below in order to determine whether an amount paid or credited to a non-resident in a particular set of circumstances constitutes a management fee that is subject to a non-resident tax under paragraph 212(1)(a).

Accordingly, to the extent that a payment is to be referred to as a "management fee" it would be important to ensure that the appropriate factual situation exists. In addition, it would also be highly advisable to ensure that such payment be contractually documented.

5. As mentioned above, GST issues would need to be considered. In certain provinces, the applicable provincial sales tax legislation should also be reviewed for possible application.

A recent case involving management fees was decided by the Federal Court of Appeal in *Fillion*.[68] *Fillion* involved a case whereby a husband, his wife and their two sons formed a general partnership. The amount invested by each member of the partnership was $100. It appears that the purpose of the general partnership was to do business development, seek out clients, do public relations work and to sell financial products. During the taxation years at issue, the husband was the only partner who held an insurance broker's license and was the only partner authorized to manage the general partnership. The children were full-time students and did not do any work for the partnership. At Court, it was also found that the spouse did very little work for the partnership. The income from the partnership appears to have been derived almost exclusively from a corporation of which the husband was the sole shareholder. The corporation sold insurance products. During 1994, it appears that the corporation paid "management fees" of $19,100 to the husband. To justify the management fees expenditure, the corporation submitted two invoices dated December 31, 1994. The Minister disallowed the deduction of the management fees expense of $19,100 claimed by the corporation for its 1994 taxation year on the basis that the outlay was not incurred to produce business income in accordance with paragraph 18(1)(a) of the Act. The Court made the following comments that were reproduced by the Federal Court of Appeal in finding for the Minister in disallowing the deduction of the management fees:

> In order to claim an expense, it is not enough to make an accounting entry backed by a vague invoice. In order to deduct an expense from income, it must be established that the evidence was real, fully supported and justified and, moreover, that the expenditure was incurred in order to produce business income in accordance with paragraph 18(1)(a) of the Act.

> As was the case with the other aspects of the appeal, the appellant was unable or simply unwilling to explain the relevance of the nonetheless significant expense of $19,100. He simply stated that to earn money he had to spend money, a statement that in itself is not necessarily false, but is certainly not sufficient to establish that this was a genuine expenditure.
>
> If the appellant had provided certain details, explained why and how he arrived at this amount and, at the same time, had connected it in some way to his income, the Court might have been able to make certain corrections but the evidence was so deficient that it is not possible to make any correction, if only to confirm that it was appropriate to disallow the management fees expense established by the appellant at $19,100.[69]

Accordingly, taxpayers and their advisors should be aware of the recent example of *Fillion* in that formality, reasonableness and appropriateness apply when dealing with management fee planning. Although management fees can be an appropriate and powerful tool in the right circumstances, practitioners should exercise caution when dealing with management fees as the desired form of remuneration for their owner-manager clients.

The recent informal procedure case of *Lecerf*[70] is another recent example of the risks involved with management fee type planning. *Lecerf* involved Mr. Robert Lecerf who was the sole shareholder of 774638 Alberta Ltd. 774638 Alberta Ltd. owned a real estate property in Rocky Mountain House, Alberta. The corporation rented the property to Mr. Lecerf in the 2000 taxation year for $8,470. Mr. Lecerf sublet the property to another business during the 2000 taxation year and received $5,350 in rent. The business that Mr. Lecerf sublet the property to was owned and operated by Rhoda Smith. Mr. Lecerf deducted a "management fee" of $34,000 that was paid to Rhoda Smith on December 29, 2000. Such management fee increased the rental losses that were incurred by Mr. Lecerf. The Minister, upon review of the rental losses, denied the deduction of the management fee paid to Rhoda Smith asserting that such fees were not reasonable pursuant to section 67. After reviewing the evidence, the court found that the management fees were incredibly high given that the property was purchased for $75,000 and was located in a small rural town. The court found that a normal rental property management fee, to the general knowledge of the public, is a contingency fee of around 5% of rent collected. The court also found that the alleged management contracts were not in writing and they did not appear to represent ordinary or customary market terms. Accordingly, the court found that the management fee in question was not reasonable and therefore such deduction by Mr. Lecerf was denied.

Creative Remuneration Strategies

As noted earlier in this paper, capital gains are often the desired form of remuneration for shareholders. This is obvious due to the large reduction in the capital gains inclusion rate pursuant to the October 18, 2000 Federal Mini-Budget. As outlined in the tables previously referred to in this paper, it is also the least expensive method to distribute funds to a shareholder when combined with the distribution of the capital dividend account balance ("CDA")[71] to the shareholder. In general terms, the CDA balance is the non-taxable portion of capital gains. Consider, then, the situation of Mr. Apple:

1. Mr. Apple has withdrawn $200,000 from Opco and, therefore, has a $200,000 debit balance in his shareholder loan account.
2. Opco has marginal earnings for the year.
3. The asset profile of Opco is as follows:

	Fair Market Value	Cost
a. Goodwill	$400,000	$ 0
b. Other assets	$300,000	$100,000

If Opco sold its goodwill to a newly incorporated corporation – "Newco" – Opco will realize active business income of $200,000 (i.e. 50 percent of $400,000) pursuant to subsection 14(1).[72] In addition, Opco will now have a $200,000 CDA balance since the non-taxable portion of the goodwill sale will be credited to such balance. The CDA could then be removed as a tax-free capital dividend[73] which would be utilized to offset the funds withdrawn by Mr. Apple. Given that the disposition of the goodwill will result in active business income by Opco, the resulting tax would need to be paid by Opco.[74] To the extent that the $200,000 debit balance was withdrawn by Mr. Apple as a taxable dividend, the resulting personal tax liability to Mr. Apple would approximate $50,000.[75] Accordingly, this strategy results in an approximate $16,000 income tax savings for Mr. Apple. However, whereas Newco prior to December 20, 2002 would be able to amortize the goodwill acquired pursuant to the normal amortization provisions,[76] the December 20, 2002 Technical Amendments released by The Department of Finance significantly reduce the amount able to be amortized for tax purposes.[77] In addition, Newco will have to ensure that it enters into a contractual relationship with Opco so that Opco can utilize its goodwill to carry on its business operations. Once a reasonable fee has been determined (and all of the issues with respect to such fees dealt with as discussed earlier), Newco will charge such fee to Opco and utilize some of the amortization of the goodwill to offset the income realized from the fee charged to Opco.[78]

A similar strategy to that above could also be utilized to the extent that Opco disposed of its other capital assets with the $200,000 pregnant capital gain. To the extent that the assets were disposed of for a $200,000 capital gain, a $100,000 capital dividend could be paid out to the shareholder, Mr. Apple. Opco would pay approximately $50,000 of corporate tax,[79] but generate approximately $26,667 of refundable dividend tax. When the taxable dividend is paid to recover a portion of the refundable tax, the overall effective tax rate on the capital gains will approximate 23 percent. Using an approximate provincial dividend tax rate of 25 percent, this will produce an approximate two percent saving.

Consider another situation involving Mr. Apple. Mr. Apple had purchased his shares of Opco from an arm's length person in 1994 for $200,000. Mr. Apple could, therefore, repatriate his adjusted cost base by transferring his shares of Opco to a "Holdco" pursuant to the tax-deferred provisions of section 85. In consideration, Mr. Apple will receive shares of Holdco and a promissory note from Holdco in the amount of $200,000 which could be utilized to offset his shareholder debit account.[80] If Mr. Apple did not have a shareholder debit issue, Opco could then pay a dividend to Holdco[81] in the amount of $200,000 whereby Mr. Apple could extract the $200,000 tax-free. However, this plan has its downsides including the fact that the shares of Opco would now be held by a corporation which may make it difficult to utilize the capital gains deduction in the future.[82] In addition, Mr. Apple's cost base of the Holdco shares will be nominal, thereby causing capital gains to be realized in the future whereas the first $200,000 of proceeds realized on a disposition of Opco shares would have been non-taxable to the extent that such a plan had not been entered into.

Consider another capital gains creation plan. Assume that Opco's common shares are wholly owned by a discretionary *inter-vivos* trust for the benefit of the Apple family.[83] Given that capital gains are taxed at a preferential tax rate and also given that capital gains do not meet the definition of split income[84] for purposes of the kiddie tax,[85] it may be ideal to try to create capital gains so that the trust could distribute such capital gains to the family members.[86] Consider the following plan:

1. The trust exchanges its common shares of Opco for a new class of preferred shares and common shares.[87]
2. The trust will elect to realize a capital gain[88] on the preferred shares upon such disposition of its "old" common shares for preferred shares.
3. The trust will then sell the preferred shares of Opco to "Holdco" for a promissory note.[89]
4. Opco will redeem its preferred shares held by Holdco for a promissory note.
5. Holdco repays the promissory note to the trust.
6. The capital gains are then allocated to the beneficiaries of the trust.[90]

However, one would have to consider the possible application of the general anti-avoidance rule (the "GAAR")[91] and also the CRA's administrative position with respect to GAAR.[92]

One is only limited by one's imagination with respect to creative remuneration strategies. However, one should also be cognizant of the many anti-avoidance rules that are contained in the Act.

<u>Employees Profit-Sharing Plans</u>

General

The use of employees profit-sharing plans ("EPSPs") in owner-manager remuneration planning has become very common. Accordingly, the purpose of this section is to comment on certain issues that must be reviewed to ensure technical integrity when utilizing EPSPs in owner-manager remuneration planning.

Definition of EPSP

An EPSP[93] is defined to be an arrangement under which payments computed by reference to an employer's profits from the employer's business (or a corporation that does not deal at arm's length with the employer) are required to be made by the employer to a trustee under the arrangement for the benefit of employees[94] of the employer or of a corporation with which the employer does not deal at arm's length. The definition of an EPSP also requires that the trustee of the EPSP annually allocates to the beneficiaries all amounts (i.e. before December 31 of each calendar year) received by the EPSP from the employer, or from a corporation with which the employer does not deal at arm's length, any profits from property realized by the trust, and any capital gains or losses of the trust.[95] The employee beneficiary of the EPSP includes the amounts in his/her income that are contingently, or absolutely, allocated to the employee by the trustee of the EPSP at any time in the year.[96]

An EPSP trust is an *inter-vivos* trust.[97] Normally, any income realized by an *inter-vivos* trust would be subject to the highest rate of tax on such income.[98] However, no tax is payable by a trust on the taxable income of the trust for a taxation year throughout which the trust is governed by an EPSP.[99]

One key component that must be met with respect to the definition of EPSPs is that the payments which are required to be made by the employer to the trustee must be computed by reference to an employer's profits from the employer's business. In the absence of certain relieving provisions, one could speculate as to what the phrase "profits" means. For example, does "profits" mean profits as outlined in section 9 of the Act? Must profit be calculated using generally accepted accounting principles? Alternatively, must the principles as outlined in recent Supreme Court of Canada cases dictate the computation of profit?[100] One can therefore expect that it would become a question of fact as to whether or not a particular payment from an employer to an EPSP would be considered to be by reference to the employer's profits.[101]

Subsection 144(10) of the Act is a provision that will deem an arrangement under which an employer makes payments to a trustee whereby the arrangement specifically provides for payments to be made "out of profit" to have met the requirement that payments are computed by reference to the employer's profits to the extent that the employer elects in prescribed manner.[102] Such a deeming provision can provide considerable flexibility and a relieving opportunity where the trustee of the EPSP does not want to be constrained by an otherwise rigid formula. The election will allow a plan to qualify as an EPSP even though the payments are not computed by reference to profits if the payments are limited by the level of profits.[103]

Deductibility of Employer Contributions to an EPSP

An amount paid by an employer to a trustee under an EPSP is deductible by the employer if the payment is made during the year, or is made within 120 days after the taxation year to the extent that it was not deductible in computing income for a previous taxation year.[104] As compared to a bonus that would otherwise be paid to the individual shareholder, the bonus payable must be paid within 179 days of the employer corporation's taxation year end in order to be deductible.[105]

As discussed earlier in this paper, a common issue that must be considered whenever an employer corporation makes contributions to an EPSP, is whether or not the contribution is subject to the reasonableness provisions of section 67 of the Act. Whether or not an employer contribution to an EPSP is subject to the limitation provisions of section 67 but granted relief under CRA's administrative policy has been the subject of debate over the years. The CRA has commented in numerous technical interpretations that their belief is that an employer contribution to an EPSP is subject to the reasonableness provisions of section 67.[106] Many tax authors are also of the view that contributions to an EPSP by an employer are also subject to a reasonableness test as outlined in section 67.[107] However, in a technical interpretation released by the CRA in 1996,[108] the CRA opined that it was willing to extend the administrative position applied to remuneration paid to owner-managers to EPSPs.[109] However, subsequent technical interpretations released by the CRA and the Agency's revised administrative position outlined in Technical News No. 22, call into question the continued validity of the 1996 technical interpretation.[110] A careful review of the criteria outlined by the CRA in Technical News No. 22 calls into question whether or not payments to an EPSP will be afforded the same administrative relaxation as that offered for shareholder remuneration or other similar type payments. Caution!

Allocations to Employee Beneficiaries

As outlined in the definition of EPSP, the employee beneficiaries must be allocated, either contingently or absolutely, amounts no later than the end of the taxation year in which the contributions to the EPSP were made[111]. To the extent that a beneficiary meets the definition of an employee,[112] the trustee will allocate amounts to the beneficiary using its discretion. Are amounts allocated by the trustee subject to the reasonableness provisions of section 67? Again, this issue has been the subject of debate over the years. However, a careful review of section 67 reveals a technical argument that section 67 should <u>not</u> apply[113] to the allocation by the trustee to the employee beneficiaries. At face value, this would appear to open the door to income splitting opportunities with other family employee beneficiaries of the EPSP. To the extent that the family employee beneficiaries of the EPSP are at lower marginal income tax rates than that of the principals, income tax savings could occur to the extent that amounts were allocated out to such lower income employee beneficiaries. However, caution should be exercised in this type of planning.[114]

Source Withholdings

Subsection 153(1) of the Act requires the withholding of income tax for certain amounts paid by payors. A review of subsection 153(1) reveals that amounts paid by an employer to an EPSP, and allocations made by an EPSP to employee beneficiaries, are not captured by the withholding requirements.[115]

The requirement to withhold CPP is created under the CPP Act.[116] Under subsection 21(1) of the CPP Act, every employer paying remuneration to an employee employed by the employer in pensionable employment must deduct and remit the employee's CPP contribution for the year. The CRA has taken the position that allocations to a beneficiary from an EPSP are not subject to CPP withholding.[117]

The obligation to withhold EI premiums is created in the EI Act.[118] Pursuant to subsection 82(1) of the EI Act, every employer paying remuneration to a person they employ in insurable employment must deduct and remit the employee's EI premium. Using the CRA's logic[119], there should be no EI withholdings on allocations to an employee from an EPSP, given that an allocation is not a "payment."

Hence, some practitioners design owner-manager remuneration so that the owner-manager is remunerated wholly through employer contributions to an EPSP so as to avoid withholding requirements such as income tax, CPP and EI. For plans designed to avoid CPP and EI withholdings entirely, all of the owner-manager's remuneration would have to be directed through an EPSP. This leads to an obvious question as to whether or not such a position would be challenged by the CRA. The CRA has opined in two recent technical interpretations that whether or not the payment of an employee's total remuneration through an EPSP is acceptable is a question of fact.[120] Accordingly, caution should be exercised in this type of planning.

Some practitioners have also suggested that an EPSP be established for the benefit of the sole shareholder of the owner-manager corporation. Although the EPSP definition does not exclude this possibility,[121] the CRA has called into question the legitimacy of such an approach.[122] Accordingly, caution should also be exercised with this type of planning.

Income Tax Deferral Opportunities

Given the above framework, it should now be apparent that income tax deferral opportunities can arise with careful planning. The use of an EPSP can result in a greater deferral of taxes for the employee or owner-manager of a CCPC than would have otherwise been possible with the declaration of a bonus. An EPSP can potentially provide a tax deferral of one year beyond which would have been achieved through the accrual of a bonus.[123] The deferral of federal and provincial income tax, and the non-withholding of CPP, and EI premiums, results in more funds in the employee's hands for a longer period of time, thus allowing greater investment returns on such retained funds.

Consider the situation of Mr. Apple and Opco. Opco wishes to obtain a deduction for its taxation year ending December 31, 2004 and, accordingly, accrues a bonus at this year-end date. Opco will therefore obtain a deduction for the year ending December 31, 2004 assuming that the bonus is paid within 179 days of the corporation's year-end. Accordingly, Federal and Provincial income taxes in addition to CPP and EI will have to be remitted by the corporation on the accrued bonus within approximately six months of December 31, 2004.

If, on the other hand, Opco makes a similar payment to an EPSP, the amount of money allocated to the respective employee(s) would be taxable in the 2005 calendar year (to the extent that the payment was made to the EPSP in the 2005 calendar year and no later than 120 days after December 31, 2004), but the taxes need only be remitted by the employee when the employee files his/her 2005 personal income tax return due by April 30, 2006 – a considerable deferral and advantage for the employee.[124] Accordingly, given the inherent flexibility and possible income splitting opportunities with the use of an EPSP, consideration should be given to utilizing an EPSP in owner-manager remuneration planning.

However, caution should also be exercised given the above-noted comments throughout this section and also given the fact that EPSPs appear to have become a "tax product."[125] Careful planning should be done on a case-by-case basis to avoid the various tax risks associated with the use of an EPSP, but at the same time enjoy all the inherent opportunities that come with the use of such a vehicle.

In addition, certain non-tax issues should be considered by the practitioner when utilizing EPSPs as the desired form of remuneration for owner-managers. For example, consider the situation of a minority shareholder or "ordinary" employee. If a minority shareholder or "ordinary" employee had received most of his/her remuneration via allocations from an EPSP, the question becomes whether or not such a claim for wrongful dismissal would be compromised. Legal advice should be considered in such a situation. In addition, the use of an EPSP as the desired form of owner-manager remuneration may compromise or reduce the beneficiaries' abilities to receive benefits from CPP and EI into the future.

Retirement Compensation Arrangements

General

The use of retirement compensation arrangements ("RCA") is becoming more and more popular in owner-manager remuneration planning. Accordingly, the purpose of this section is to comment on certain issues that must be reviewed in order to ensure technical integrity when utilizing RCAs in popular remuneration strategies.

Definition of RCA

An RCA[126] is defined as a plan or arrangement under which contributions (other than payments made to acquire an interest in a life insurance policy) are made by an employer or former employer of a taxpayer, or by a person with whom the employer or former employer does not deal at arm's length, to another person or partnership in connection with benefits that are to be or may be received or enjoyed by any person on, after or in contemplation of any substantial change in the services rendered by the taxpayer, the retirement of the taxpayer or the loss of an office or employment of the taxpayer. The definition of an RCA excludes from its definition registered pension plans, deferred profit-sharing plans, EPSPs, RRSPs, an employee trust, a salary deferral arrangement[127] and other statutory plans. It is noteworthy that the statutory definition of a salary deferral arrangement ("SDA") does not exclude an RCA.

An SDA, in respect of a taxpayer, means a plan or arrangement, whether funded or not, under which any person has a right in a taxation year to receive an amount after the year where it is reasonable to consider that one of the main purposes for the creation or existence of the right is to postpone tax payable under the Act by the taxpayer in respect of an amount that is, or is on account or in lieu of, salary or wages of the taxpayer for services rendered by the taxpayer in the year or a preceding taxation year. The SDA rules also have various exclusions but as one can see from the partially reproduced definition of an SDA, such wording is very broad. To the extent that a plan or arrangement is considered an SDA, a taxpayer will include in their income[128] any benefits received or receivable under the SDA. Accordingly, when planning with RCAs, one must ensure that the SDA rules do not "trump" the RCA planning.

When dealing with RCAs, it is important to understand that an RCA is deemed to be an *inter-vivos* trust.[129] However, the RCA trust is not subject to Part I tax.[130] It is also not subject to Part XII.2 tax.[131] Instead, RCA trusts are subject to tax under Part XI.3.[132] Contributions by an employer to an RCA are specifically deductible within certain parameters.[133] Contributions made by an employee to an RCA are also deductible.[134] However, the contributions made by the employer will trigger tax under Part XI.3. Generally, the Part XI.3 tax will equal 50% of all contributions made under the RCA during the year. However, the tax under Part XI.3 is a refundable tax. If, after calculating the refundable tax[135] for the year the refundable tax balance is less than the refundable tax balance for the RCA for the immediately preceding taxation year, the difference is available as a refund to the RCA.[136]

Conceptually, the mechanics of the refundable tax – including the payment and refund thereof – reflect the policy behind such RCA rules. The RCA rules were introduced into the Act by the Department of Finance in 1986. The RCA rules were originally introduced as anti-avoidance rules to preclude the circumvention of the limits on tax assisted retirement savings primarily by tax exempt employers or corporations in loss positions.[137] Accordingly, the RCA rules prevent tax deferral that would otherwise be available if amounts were paid to a plan or arrangement for the benefit of employees instead of paying the employees directly. Once amounts are distributed from the RCA to the employee beneficiaries or to the employer, such amounts are included in the income of the recipient and therefore taxed under Part I of the Act.[138]

It is also important to note that all contributions made by an employer to an RCA are subject to a withholding requirement such that the refundable tax under Part XI.3 must be remitted on a timely basis by the employer.[139] The custodian of the RCA must also withhold source remittances when distributions are made from the RCA to the employee beneficiaries.[140] An RCA must also file a Trust Return in prescribed form on a timely basis.[141]

Deductibility of Employer Contributions to an RCA

As already stated, employer contributions to an RCA are generally deductible. However, are they subject to the test of reasonability under section 67? The answer is yes since generally all outlays or expenses which are otherwise deductible are subject to a test of reasonableness. However, are such contributions captured within the CRA's administrative policy to not challenge reasonableness under section 67 pursuant to the terms as outlined in Technical News No. 22? A strict reading of the criteria outlined in Technical News No. 22 suggests that the answer is no. In other words, the amounts contributed to an RCA are not captured within the administrative guidelines outlined in Technical News No. 22. A recently released Technical Interpretation by the CRA[142] makes no mention of contributions to an RCA being covered by the CRA's administrative policy in Technical News No. 22. However, prior technical interpretations released by the CRA have confirmed that, under their previous 1981 policy, such contributions could be covered by their administrative policy in certain cases.[143]

Accordingly, what can taxpayers and their advisors do to mitigate risks that contributions to an RCA will be challenged pursuant to section 67 to the extent that the CRA's administrative policies no longer cover reasonableness challenges? In the author's opinion, first and foremost, the plan or arrangement needs to be a valid RCA. To the extent that it is not a valid RCA, all contributions will likely fall under the SDA rules.[144] Accordingly, it would be highly advisable to ensure that the arrangement is in contemplation of the employee's retirement, loss of office or a substantial change in the services rendered by such taxpayer. It would also be highly advisable to have actuarial support in order to make such assertion that the arrangement was in contemplation of the requirements set out in the definition of an RCA.

Planning Considerations with RCAs and the Owner-Manager

In recent years, RCAs have sometimes been used as "bonus replacements." In other words, to the extent that a CCPC would be required to pay a bonus to its active shareholder (in order to preserve integration) down to the CCPC's small business limit, some practitioners have suggested that instead of paying taxable bonus amounts to shareholders, amounts could be paid to an RCA for the benefit of the employee/owner/shareholder. However, there are some obvious downsides to such planning. The first is whether or not such a plan or arrangement would be considered to be an RCA or whether or not such a plan or arrangement would be considered to be an SDA. In addition, given that all provinces and territories highest personal income tax rate on salaries is now less than 50%, the financial analysis of such a plan would need to be reviewed given that, in the absence of additional planning, a pre-payment of tax would always occur given that the RCA would need to pay refundable tax of 50%.

However, a “twist” is often utilized to enhance the bonus-down plan utilizing an RCA. Given that the taxes paid under Part X1.3 by the RCA are refundable, some financial institutions are willing to utilize such refundable taxes as security in providing financing to the RCA. Some financial institutions provide loans to the RCA of amounts between 80% to 90% of the refundable tax. Assuming that a financial institution would be willing to loan 80% of the refundable tax and a $1 million contribution was made by Opco to an RCA for the benefit of Mr. Apple, the amount of cash that would remain in the RCA, after the payment of Part XI.3 tax and the financing, would be $900,000. Often times, the net cash retained by the RCA – in this example $900,000 – is loaned back to Opco to be utilized in Opco’s business. Alternatively, or in conjunction with such a plan, often times a life insurance product is utilized to provide security to the bank or to invest in the tax exempt account of such a policy. The advantage of investing the cash assets of an RCA in an exempt insurance policy[145] is that the growth within the tax exempt account of the life insurance policy will not be subject to the refundable tax under Part XI.3. Such growth can therefore occur on a tax deferred basis (ignoring mortality, administrative and special tax costs). If additional planning was done to perhaps creatively leverage the cash assets of the life insurance policy and further return some of the cash to Opco, one must be mindful of the risks.[146] The CRA has previously questioned whether or not such an arrangement would be considered to be a valid RCA where the amounts paid to the RCA are returned in one form or another to the employer.[147] Accordingly, caution in a bonus-down and leverage type plan with an RCA should be exercised.

An additional use for an RCA in the context of owner-manager remuneration might be to help to reduce the value of a related corporation upon an eventual sale of either the shares of the corporation or the business assets. For example, assuming that a valid RCA was to be established for the benefit of Mr. Apple, contributions could be made from Opco to the RCA thereby reducing the overall value of the shares of Opco or underlying assets owned by Opco. A deduction could be claimed by Opco for the contribution, assuming that such contribution is reasonable, thereby reducing the corporate tax under Part I that Opco would eventually pay on the sale of its business assets or, alternatively, reduce the tax that would be exigible upon the sale of Opco shares by Mr. Apple. If Mr. Apple could receive such distributed amounts from the RCA in a subsequent taxation year where he or she is in a lower taxation bracket, such planning may be beneficial.

If an owner-manager was contemplating exiting Canada at some time in the foreseeable future, the use of an RCA could provide a significant tax advantage. Upon exit from Canada, the beneficial right that the employee owner-manager would have under the RCA would not be deemed to be disposed of.[148] However, once the amounts were distributed to the non-resident beneficiary, such amounts would be subject to a withholding tax.[149] Accordingly, such planning should be considered by the owner-manager who is contemplating emigrating from Canada.[150]

An RCA could also be utilized in a simple attempt to avoid the cost base averaging rules under the Act. As most readers know, subsection 47(1) of the Act requires taxpayers to average their adjusted cost base to the extent that they own identical properties that were acquired at different costs. A simple example can help explain the downside of the cost base averaging rules. Let us assume that Opco had acquired shares of "IPco" at a very low cost. Such shares were acquired by Opco by purchasing them at market on the Toronto Stock Exchange. Opco holds a significant number of IPco shares. Opco now has the ability to acquire more IPco shares which it would like to do. However, the value of IPco has increased significantly. If Opco were to acquire a small number of IPco shares at a proportionately much higher cost, such shares would be pooled with the "original" shares and the cost base averaged pursuant to the rules as set out in subsection 47(1). If Opco were to acquire such "new" shares and immediately "flip" such shares, a much higher gain than would otherwise be expected would result due to the fact that the "new" shares of IPco that were just acquired would not carry a high cost but rather such cost would be averaged down. This fact can catch some taxpayers by surprise. However, if a contribution was made by Opco to an RCA (assuming that such an RCA was a valid RCA) and the RCA were to acquire the "new" IPco shares, the RCA's adjusted cost base on its IPco shares would be high (assuming that it does not own any other IPco shares) and therefore the gain realized on the immediate disposition of such IPco shares would be lower. However, a downside of such a strategy would be that the gross capital gain – as opposed to the taxable capital gain – would be subject to the Part XI.3 refundable tax. Such downside should be reviewed before it would be implemented.[151]

Accordingly, taxpayers and their advisors should consider the use of an RCA in owner-manager remuneration planning.

Structural Considerations to Enhance Owner-Manager Remuneration Planning

General

Now that the paper has reviewed recent issues in owner-manager remuneration planning, EPSPs and RCAs, the "home-stretch" of this paper will focus on a few structuring ideas that can assist in enhancing owner-manager remuneration planning.

Collapse in Professional Partnerships

Over the last five years, a number of positive advance tax rulings have been issued that assist professionals in enhancing their remuneration planning.[152]

As most readers know, it is common for professionals to operate practices together as a partnership. There are a number of reasons for this including the ease of entry into and exit from a partnership and the lack of provincial legislation that have traditionally prohibited the carrying out of a professional practice through a corporation and other reasons not documented here. Recently, however, many provincial professional bodies have allowed members to carry on their practices through a corporation. Some provinces, such as Alberta, have long allowed the incorporation of professional practices. However, for other provinces, it has not been until quite recent that such a possibility has existed. For example, Ontario allowed the incorporation of professional practices in year 2000. For Saskatchewan, medical professionals were able to incorporate effective January 1, 2000 whereas all other professionals were able to incorporate effective January 1, 2001. Manitoba varied its provincial legislation to enable professionals to incorporate effective January, 2000.

An example can help illustrate the tax disadvantages of operating a professional practice through the structure of a partnership. Consider the situation of ABC Professional Partnership. There are three corporate partners – "ACo," "BCo" and "CCo" – the shares of which are respectively owned by Ms. A, Ms. B and Mr. C. ACo, BCo and CCo are considered professional corporations under their relevant provincial statutes. The partnership agreement for ABC dictates that the net income of the partnership is shared equally amongst the partners. Let us further assume that ABC, for its 2004 taxation year,[153] has taxable income of $1,800,000. Given that the partnership agreement for ABC dictates that all of the income of ABC is to be shared equally, each corporate partner will include $600,000 in their respective incomes. If we further assume that each corporate partner has nominal expenses, then a bonus in the amount of $516,667 would have to be paid out of each corporation in order to maintain integration. This is true since the partnership income included in each corporate partner's taxable income would be considered to be "specified partnership income"[154] and therefore, generally, each corporate partner would need to share one available small business limit.[155] Accordingly, assuming for the calendar year ended that the available small business limit as a whole was $250,000 and further assuming that each corporate partner's available small business limit was therefore one-third of $250,000, the excess taxable income over such amount would need to be bonused. One can therefore see that the larger the partnership and the more profitable the partnership, carrying on business through a partnership is less attractive from a tax perspective.

Accordingly, taxpayers and their advisors have long sought ways to overcome such issues. One of the main objectives in any type of planning would be to try to increase the available small business limit of each of the partners and ensure that the personal services business rules would not apply.[156] In addition, if the objective would result in the elimination of the use of the partnership as the business structure, the objective would also be to try to collapse the existing partnership on a tax deferred basis in order to ensure that the tax cost of exiting the existing relationship does not exceed the future benefits. The recent rulings,[157] referred to earlier, give positive results in all instances. The plan, generally, involves the following transactions:

1. Incorporate "Newco."
2. The existing partnership will sell, at fair market value, all of its assets to Newco in return for shares of Newco. Newco and each partner will jointly elect pursuant to subsection 85(2) of the Act. Such an election will generally cause the disposition of the partnership assets to Newco to occur on a tax deferred basis.
3. The partnership will wind up its affairs the day immediately following the transfer of all of its assets to Newco. Each former partner will receive, in full satisfaction of their interest in the partnership, respective shares in Newco.
4. Newco and each of the former professional individual partners will then enter into a contractual relationship with Newco (Newco has acquired a permit to carry on professional services with its respective professional body). Alternatively, the shares of Newco would have been transferred to a professional corporation ("PCco"), such shares wholly owned by one of the professionals, and the contract to provide professional services would be entered into by PCco and Newco.

As one can see, the plan is conceptually simple. Of course, attention would need to be paid to the details in order to ensure that many of the risks discussed in this paper, such as deductibility of payments by Newco to PCco, personal services business risks, etc., would be mitigated. However, in provinces that prohibit professional corporations from owning shares of another professional corporation, the above plan is not as simple. This is true since in the previously outlined plan, if one or more of the partners of the existing partnership was a professional corporation, the corporate partner would end up owning shares of Newco. In such a situation, one could look to a recently released advance tax ruling for ideas.[158] In the subject ruling, it appears that the existing partnership consisted of five professional corporations. In order to wind up the partnership and have each partner achieve their desired objectives, the following proposed transactions were ruled on:

1. The partnership will wind up its operations and cease to exist by distributing its property to each of the partners. Each of the partners would jointly elect such that each partner's proceeds of disposition of the interest in the partnership and the cost to each partner of the property received on the winding up would be determined in accordance with the rules in subsection 98(3). In order for the provisions of subsection 98(3) to apply, each former partner would receive an undivided interest in its interest in the former partnership property (including goodwill).
2. Each of the corporate partners of the partnership would then enter into a contract to acquire a divided interest in the former partnership's goodwill. The contractual division of goodwill would be governed by general commercial common law principles and would constitute a partition under the applicable provincial laws. This step would be important in order to ensure that the partitioning rules under subsection 248(21) would apply so that the partition would result in a tax deferred transaction.
3. A new corporation, Opco, would be incorporated. Each of the individual professionals (not the professional corporations) would subscribe for the shares of Opco for a nominal cost.
4. Opco would apply for a permit to its appropriate provincial body so that it would be considered to be a professional corporation and thereby be allowed to carry out professional services.
5. Each of the former corporate partners would enter into a contractual licensing arrangement with Opco whereby Opco would be able to utilize the partitioned goodwill and related assets of each former corporate partner in order to carry out its professional services. The fee that would be received by each party under the licensing agreement would be a negotiated fee.
6. Upon entering into the licensing arrangement, Opco would carry out the practice by providing professional services through either individuals who are licensed to practice or

independent contractors. The independent contractors would include the former corporate partners of the partnership.

In the subject ruling, a positive ruling was given that subsection 98(3) would apply to the partnership dissolution. Provided that the partitioning of the goodwill would constitute a "partition" within the applicable provincial laws, subsection 248(21) of the Act would apply. In addition, the income of each former corporate partner received from Newco would not be considered to be income from a personal services business.

One can therefore see that there are creative ways to unwind professional partnerships with powerful, positive results.

The "Triangle" Structure

In a closely held family situation, there are usually a number of objectives that are desired to be met by the family. Such objectives are generally as follows:

1. Creditor protection;
2. Income splitting with lower income family members;
3. Future capital gains splitting;
4. Tax deferral upon an untimely death; and
5. The desire for confidentiality.

Consider the situation of Mr. Apple. Recall that Mr. Apple has three Canadian resident children and a spouse who works in the business of Opco. Mr. Apple would like to achieve some of the objectives described above. Accordingly, consider the merits of the following plan:

1. Mr. Apple exchanges his Opco common shares for a class of preferred shares.[159]
2. A discretionary *inter-vivos* trust for the benefit of Mr. Apple's family is settled.[160]
3. The "Apple Family Trust" would subscribe for nominally valued common shares of Opco. For purposes of this example, let us assume that The Apple Family Trust subscribes for 99 "new" Class "A" common shares of Opco and that the Articles of Incorporation of Opco have a discretionary dividend clause that enables dividends to be paid on one class to the exclusion of the other.
4. A new corporation, "Holdco," would be incorporated. Holdco would be a CCPC.

5. The Apple Family Trust would subscribe for 100% of the issued common shares of Holdco.
6. Holdco would then subscribe for one class "B" common share of Opco.

Once the above transactions have been completed, the corporate structure will be that as graphically depicted in Appendix Figure 1. The advantages of the revised corporate structure are as follows:

1. Creditor protection, subject to legal advice, can be enhanced by having Opco's directors declare dividends on its issued class "B" share[161] which will be received by Holdco tax free[162] and thereby shield the assets (that would otherwise by held by Opco) from Opco's unsecured creditors.
2. Income splitting can be enhanced by paying dividends from either Holdco's retained earnings or Opco's retained earnings to The Apple Family Trust shareholder. To the extent that dividends were paid from Opco, the dividends could be paid on the issued Class "A" shares held by The Apple Family Trust. The trustees of the trust could then selectively choose which beneficiary would be allocated such dividend income.[163] Careful consideration of the "kiddie tax" rules would need to be undertaken by the trustees of The Apple Family Trust.[164]
3. To the extent that growth on the issued common shares of Opco occurs, The Apple Family Trust may be able to arrange a disposition of such shares into the future thereby realizing a capital gain. Such a capital gain could be allocated to the applicable beneficiaries of the Trust[165] thus enhancing capital gains splitting. Capital gains realized by a trust and allocated to its beneficiaries are not subject to the "kiddie tax" rules.
4. The common shares of Opco and Holdco held by the Trust may not be subject to the implications of the otherwise deemed disposition rules[166] that would apply on any beneficiary's death. Instead, Mr. Apple would be subject to the deemed disposition rules for only the value of his preferred shares that he continues to hold. Although Mr. Apple's capital interest in The Apple Family Trust would be deemed to be disposed of on death pursuant to subsection 70(5), Mr. Apple would argue that his interest would be worthless given the discretionary nature of his interest.[167]
5. Given that a trust is not required to register with any government body (other than file appropriate T3 income tax returns), the Trust will be able to accumulate assets and not have other parties become aware of the existence of such assets which may be the case to

the extent that assets were held personally.[168] Accordingly, confidentiality can be enhanced with the use of a trust.

However, the resulting structure is more complex and difficult to maintain from a compliance perspective than the existing structure. The implementation costs may also be high. In addition, in a non-closely held situation, Holdco may be required to hold more shares of Opco in order to become connected.[169] The Trust would be subject to the "21-year deemed disposition" rule.[170]

Accordingly, given the relatively simple nature of the triangle structure, practitioners should consider its use in closely held family situations.[171]

Business Trusts

In situations where an entrepreneur desires to start a new business and the small business limit is already being utilized or otherwise not available, consideration should be given to perhaps operating such new business through a personal discretionary trust rather than a corporation. Assuming that the creditor protection that a corporation may offer is comparable to that in a trust situation, many tax issues are obviated to the extent that a trust is utilized to carry out the business activities of the entrepreneur as opposed to a corporation. For example, the following may provide an advantage to carrying out the business through a trust as compared to a corporation:

1. There would be no need to pay bonuses to active persons in the business. Such income realized by the trust would either be taxed at the highest personal tax rate or could be allocated to desired beneficiaries of the trust with no resulting section 67 reasonableness issues.
2. Income splitting without the incidence of "kiddie tax" could be improved. This would be true to the extent that the business activities of the trust would not meet the definition of split income in section 120.4.
3. The incidence of corporate tax would be eliminated thus reducing the overall exposure to possible double taxation.[172]
4. Capital gains splitting can be enhanced since any capital gains realized by the business trust on a disposition of the business assets could be allocated to the desired beneficiaries of the trust.

However, one of the significant downsides of the utilization of a business trust to carry out the operations of a business directly would be that the possible use of the capital gains deduction would not be available.[173] However, such a downside may also be mitigated by proper planning.[174]

Concluding Comments

Owner-manager remuneration planning is constantly evolving. Governments respond to changing economic and social dynamics with changes in fiscal policy which ultimately result in legislative amendments to the Act. Legal decisions and administrative positions emanating from a review of real life responses to such amendments further compound the complexities and opportunities in the area. This paper has attempted to highlight some of the recent critical developments in the area of owner-manager remuneration planning that can assist in cautioning taxpayers and their advisors from aggressive planning and also assist in advising them of ever present opportunities.

APPENDIX TABLE 1: Highest Marginal Individual Personal Income Tax Rates by Province – Effective January 2004

2004	BC	AB	SK	MB	ON	QC	NB	NS	PE	NF
Dividend	31.58	24.08	28.33	35.08	31.33	32.81	37.26	29.85	31.96	37.32
Capital gains	21.85	19.50	22.00	23.20	23.20	24.11	23.42	22.84	23.69	24.32
Interest / salary income	43.70	39.00	44.00	46.40	46.41	48.22	46.84	45.69	47.37	48.64

APPENDIX TABLE 2: Corporate Income Tax Rates by Province Effective January 1, 2004

Province	General non - M&P income	General M&P income	CCPC Active business income up to $250,000	CCPC Active business income from $250,000 to $300,000	Provincial small business limit
British Columbia	35.62%	35.62%	17.62%	26.62%	$300k
Alberta					
• **Pre April 1**	34.62	34.62	17.12	26.12	$400k
• **Post April 1**	33.62	33.62	16.12	25.12	$400k
Saskatchewan	39.12	32.12	18.62	27.62	$300k
Manitoba	37.62	37.62	18.12	27.12	$360k
Ontario	36.12	34.12	18.62	27.62	$400k
Quebec	31.02	31.02	22.02	31.02	--
New Brunswick					
• **Pre July 1**	35.12	35.12	16.12	25.12	$400k
• **Post July 1**	35.12	35.12	15.62	24.62	$425k
Nova Scotia	38.12	38.12	18.12	38.12	$250k
Prince Edward Island	38.12	29.62	20.62	38.12	$250k
Newfoundland and Labrador	36.12	27.12	18.12	36.12	$250k

APPENDIX TABLE 3: Tax on Distribution of $10,000 of ABI to Individual Shareholder via Dividends – 2004 Personal income > $110,000

Dividends	BC ABI eligible for SBD $	BC ABI not eligible for SBD or MPD $	AB ABI eligible for SBD $	AB ABI not eligible for SBD or MPD $	MB ABI eligible for SBD $	MB ABI not eligible for SBD or MPD $	ON ABI eligible for SBD $	ON ABI not eligible for SBD or MPD $
Corporate taxable income	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Corporate tax	(1,762)	(3,562)	(1,612)	(3,362)	(1,812)	(3,762)	(1,862)	(3,612)
Funds available for distribution	8,238	6,438	8,388	6,638	8,188	6,238	8,138	6,388
Individual tax (dividend rate)	(2,602)	(2,033)	(2,020)	(1,598)	(2,872)	(2,188)	(2,550)	(2,001)
After tax Dollars	5,636	4,405	6,368	5,040	5,316	4,050	5,588	4,387

APPENDIX TABLE 4: Tax on Distribution of $10,000 of ABI to Individual Shareholder via Salary – 2004 Personal income > $110,000

Salary	BC ABI eligible for SBD $	BC ABI not eligible for SBD or MPD $	AB ABI eligible for SBD $	AB ABI not eligible for SBD or MPD $	MB ABI eligible for SBD $	MB ABI not eligible for SBD or MPD $	ON ABI eligible for SBD $	ON ABI not eligible for SBD or MPD $
Corporate taxable income	0	0	0	0	0	0	0	0
Personal (salary) income	10,000	10,000	10,000	10,000	10,000	10,000	10,000	10,000
Individual tax (highest rate)	(4,370)	(4,370)	(3,900)	(3,900)	(4,640)	(4,640)	(4,641)	(4,641)
After tax Dollars	5,630	5,630	6,100	6,100	5,360	5,360	5,359	5,359
Tax savings (cost) of dividend	6	(1,225)	268	(1,060)	(44)	(1,310)	229	(972)
Tax deferral by retaining funds in corp.	2,608	808	2,288	538	2,828	878	2,779	1,029

APPENDIX TABLE 5: Tax on Distribution of $10,000 of Portfolio Dividends Earned in a CCPC to Individuals – 2004 Personal Income > $110,000

2004	BC	AB[(a)]	MB	ON
Dividend to CCPC	10,000	10,000	10,000	10,000
Individual tax	(3,158)	(2,408)	(3,508)	(3,133)
After tax Dollars	6,842	7,592	6,492	6,867
Tax (cost) deferral by retaining funds in corp	(175)	(925)	175	(200)

APPENDIX TABLE 6: Tax on Distribution of $10,000 of Capital Gains Earned in a CCPC (1/2 Taxable) to Individuals – 2004 Personal Income > $110,000

2004	BC	AB[(a)]	MB	ON
Capital gain to CCPC	10,000	10,000	10,000	10,000
Corporate tax	(1,131)	(1,043)	(1,231)	(1,156)
Cash available for dividend	8,869	8,957	8,769	8,844
Capital dividend	4,869	4,957	4,769	4,844
Taxable dividend	4,000	4,000	4,000	4,000
Individual tax	(1,222)	(953)	(1,322)	(1,204)
After tax Dollars	7,647	8,004	7,447	7,640
Tax cost of dividend	(168)	(56)	(231)	(40)
Tax (cost) by retaining funds in corp	(280)	(427)	(245)	(169)

APPENDIX TABLE 7: Tax on Distribution of $10,000 of Interest Earned in a CCPC to Individuals – 2004 Personal Income > $110,000

2004	BC	AB[(a)]	MB	ON
Interest to CCPC[(b)]	10,000	10,000	10,000	10,000
Corporate tax				
Part 1	(2,262)	(2,086)	(2,462)	(2,312)
Part 1 (RDTOH)[(b)]	(131)	(44)	(232)	(157)
Total corporate tax	(2,393)	(2,130)	(2,694)	(2,469)
Cash available for dividend	7,607	7,870	7,306	7,531
Individual tax	(2,402)	(1,895)	(2,563)	(2,359)
After tax Dollars	5,205	5,975	4,743	5,172
Tax cost of dividend	(425)	(125)	(617)	(187)
Tax (cost) by retaining funds in corp	(559)	(854)	(489)	(338)

[(a)] Assumes the corporate income tax rate applicable to income earned after April 1, 2004.
[(b)] RDTOH is only recoverable to the extent of 1/3 of the dividend paid. Integration is not perfect and therefore a portion of the RDTOH is left behind.

APPENDIX TABLE 8 A Summary of CRA's Comments on Reasonableness of Remuneration – Payments from the CCPC[a]

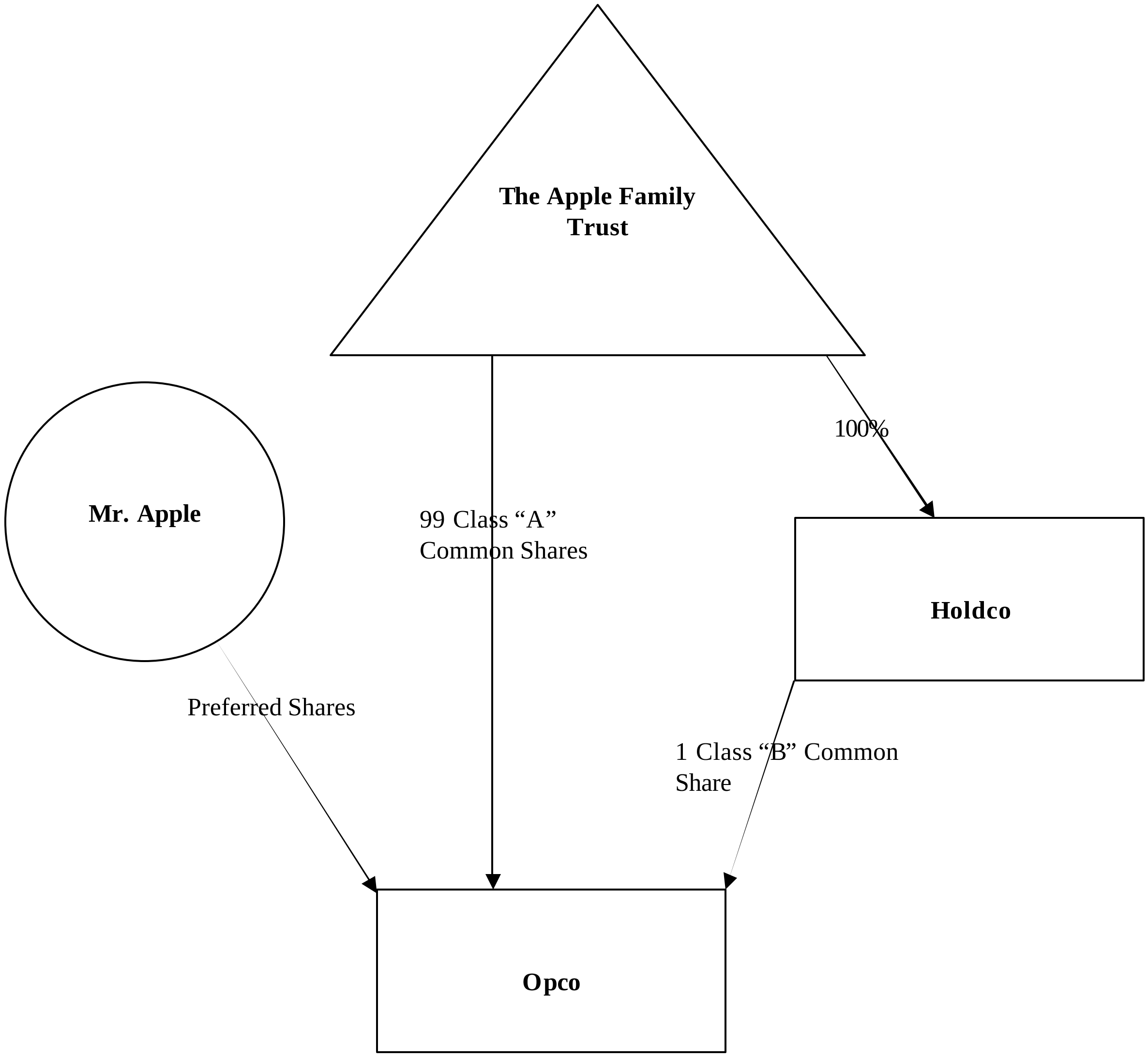
	The declaration of this type of payment to the owner-manager will meet the conditions of CRA's administrative policy to not apply section 67 or paragraph 18(1)(a)		
Type of payment from the CCPC	Yes	No	Maybe
1. Salaries/bonuses	✓		
2. Payments to EPSP		✓	
3. Management fees		✓	
4. Payments to RCA		✓	

APPENDIX TABLE 9 A Summary of CRA's Comments on Reasonableness of Remuneration[a] – Source of Income that Bonus is Paid From

	The declaration of a bonus to the active owner-manager from this source of income from the CCPC will meet the conditions of CRA's administrative policy		
Source of income for the CCPC	Yes	No	Maybe
1. Active business income	✓		
2. Inter-corporate dividends		✓	
3. Management fees		✓	
4. Capital gains		✓	
5. "Non-active business income"			✓
6. Recapture of CCA or eligible capital property			✓

[a] It is assumed that the criteria outlined in Technical News No. 22 are otherwise met.

APPENDIX FIGURE 1 Graphic Depiction of "Triangle" Structure



[1] Of Moody Shikaze Boulet LLP Chartered Accountants. The author would like to thank Gord Squire, MBA, LLB, TEP, Sarah Hawco, CA, Marissa Halil, LLB, BCL, Howard T Shikaze, CA, TEP, Bert Boulet, CA, William Evans, CA (all of Moody Shikaze Boulet LLP), Paul Lebreux, LLB, LLM, TEP, Lance Armstrong, LLB, TEP, Dennis Nerland, LLB, TEP, Michael Cadesky, FCA, FTIHK, TEP, Larry Frostiak, CA, TEP, Rachel Colabella, LLB, and Jehad Haymour, LLB, for their helpful comments in the writing of this paper. All statutory references, unless otherwise indicated, are to *The Income Tax Act*, R.S.C. 1985, c1 (5th Supp.) as amended (the "Act"). References to the Canada Revenue Agency will be referred to as the "CRA".

[2] See Perry Truster, CA, "Owner-Manager Remuneration and Related Issues", *1999 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 1999), 7:1-30; Susan L. Leach, CA, "Remuneration Issues for Owner-Managed Businesses", *1999 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 1999), 7:1-48; Howard Berglas, "Owner/Manager Remuneration – An Update", *in Tax Planning for Owner-Managed Businesses, 1995 Ontario Tax Conference* (Toronto: Canadian Tax Foundation, 1995), 18:1-71; Craig K. Hermann, CA, "Owner/Manager Remuneration – An Update", *1993 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 1993), 2:1-50; Andre R. Lemieux, CA, "Owner-Manager Remuneration", *1992 British Columbia Tax Conference* (Toronto: Canadian Tax Foundation, 1992), 12A:1-35; and Greg G. Wiebe, CA, "Owner-Manager Remuneration", *1992 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 1992), 6D:1-32 for excellent examples of papers dealing with owner-manager remuneration issues.

[3] One common method of owner-manager remuneration income splitting was to have a trust shareholder loan money to the corporation. The trust would charge interest on such loan. The trustees of the trust could then allocate such interest income to the beneficiaries of the trust including minor beneficiaries. However, effective for fiscal periods and taxation years that begin after December 20, 2002, the definition of "split income" under subsection 120.4(1) is amended so that such interest income will now be considered split income. See Technical Interpretation 2003-0181705-March 3, 2003 wherein the CRA confirms that in such a plan, they are of the opinion that the interest income would be split income.

[4] Under Division E.1 of Part I of the Act.

[5] As defined under subsection 110.6(1) of the Act. The existence of a cumulative net investment loss account will impair the ability of an individual to claim the capital gains deduction under subsections 110.6(2) or (2.1) of the Act.

[6] As outlined in section 120.4 of the Act.

[7] Certain types of remuneration such as dividends, interest, capital gains and withdrawals from shareholder loan accounts will not meet the definition of "earned income" for RRSP purposes under subsection 146(1) of the Act.

[8] Subsection 15(2.6) of the Act states that subsection 15(2) (which will require an income inclusion for loans or indebtedness made by a corporation to a shareholder, a person "connected" with a shareholder or a member of a partnership, or a beneficiary of a trust, that is a shareholder of a particular corporation) will not apply to a loan or indebtedness that is repaid within one year after the end of the taxation year of the lender or creditor in which the loan was made or the indebtedness arose to the extent that the repayment was not part of a series of loans or other transactions and repayments. See Interpretation Bulletin IT-119R4 for the CRA's administrative comments regarding subsection 15(2).

[9] Subsection 78(4) requires that a bonus declared by an employer corporation must be paid within 179 days of the accrual in order to be deductible by the payor.

[10] See for example *Ronald D. Berube*, 1994 1 C.T.C. 2655. Such a case involved management fees accrued by a corporation that were not paid on a timely basis, and therefore the deduction was denied on the basis of subsection 78(4). In addition, see recently released Technical Interpretation No. 2004-0060641E5-March 22, 2004, where the CRA opines that subsection 78(4) would apply to wages that remain unpaid after the 180 days that are specified in subsection 78(4) unless:

1) The payor has remitted the applicable payroll withholdings;
2) The employer has issued a T4 Information Return to the employee; and
3) The employee has included the amount of the unpaid wages in income for income tax purposes.

Where these requirements are not met, the CRA believes that subsection 78(4) of the Act will apply to deny the deduction of the accrued wages in the year the wages were accrued. A portion of the above comments was also made at the 1987 Canadian Tax Foundation Revenue Canada Round Table.

[11] See the definitions of "active business carried on by a corporation" and "income of the corporation for the year from an active business" under subsection 125(7) of the Act.

[12] As provided for under subsection 125(1) of the Act.

[13] As defined under subsection 89(1) of the Act.

[14] As defined under subsection 125(7) of the Act.

[15] As defined under subsection 125(7) of the Act.

[16] As defined under subsection 95(1) of the Act.

[17] As defined under subsection 125(2) of the Act.

[18] As outlined in subsection 129(1) of the Act.

[19] Notice of Ways and Means Motion to amend the *Income Tax Act* – October 18, 2000.

[20] The 2003 Federal Budget increased the small business limit so that the business limit was calculated proportionally (based on a calendar year) as follows:

2003	$225,000
2004	$250,000
2005	$275,000
2006 forward	$300,000

[21] For calendar year ended 2005, the 2003 Federal Budget proposed to increase the small business limit to $275,000. However, the 2004 Federal Budget now proposes to raise the limit to $300,000 for the calendar year ended 2005 and forward.

[22] See Appendix Table 2 that discloses each province's small business limits for the 2004 taxation year.

[23] Pursuant to the provisions of section 67 of the Act. To the extent that an outlay or expense is not reasonable in the circumstances, the expense or outlay is not deductible. In addition, paragraph 18(1)(a) of the Act will deny an outlay or expense as a deduction to the extent that it was not made or incurred for the purpose of gaining or producing income from the business or property.

[24] See the response to Question 42 of the 1981 Revenue Canada Round Table.

[25] See, for example, question 82 of the 1984 Revenue Canada Round Table, question 16 of the 1985 Revenue Canada Round Table, question 56 of the 1990 Revenue Canada Round Table, question 21 of the 1993 Revenue Canada Round Table, Technical Interpretation 9308795-June 9, 1993 and Technical Interpretation 9805745-May 26, 1998.

[26] See, for example:

i) *Mépalex Inc. v. HMQ* 2002 DTC 1389
ii) *Safety Boss Limited v. HMQ* 2000 DTC 1767
iii) *Pioneer Designs Corporation v. MNR* 91 DTC 293 (TCC)
iv) *La Compagnie Idéal Body Inc. v. The Queen* 89 DTC 5344 (FCTD)
v) *Maduke Foods Ltd. v. HMQ* 89 DTC 5458
vi) *Grant Babcock Limited et al v. MNR* 85 DTC 518
vii) *Doug Burns Excavation Contracting Limited v. MNR* 83 DTC 528
*viii) Roymac Mobile Homes Limited v. MNR*77 DTC 204
*ix) Gabco Limited v. MNR*68 DTC 5210
*x) Dr. Edward Gordon Murphy v. MNR*68 DTC 5178
*xi) Mulder Bros. Sand & Gravel Limited v. MNR*67 DTC 475
*xii) Laverne Clifford Kindree v. MNR*64 DTC 5248
*xiii) No. 712 v. MNR*60 DTC 329

The above is a non-exhaustive list of the cases in this area.

[27] The three technical interpretations released were as follows:

i) 2000-0013085-April 10, 2000. This technical interpretation addressed whether the administrative policy as outlined in the 1981 Round Table would apply in the situation where the shares of "Opco" were owned by one individual and two "Holdcos" which were ultimately owned by two different discretionary family trusts. The CRA replied that the administrative policy would <u>not</u> apply and the normal test of reasonableness would apply in the situation of bonuses paid to the indirect active shareholders where their interests are held through a trust and a holding corporation.
ii) 2000-0016035-August 28, 2000. This technical interpretation dealt with a situation where three arm's length "Holdcos" owned 100 percent of the shares of Opco. The CRA stated that the 1981 Round Table position would generally be respected if the shares of Opco were held through holding companies. They stated that this would hold true only in circumstances involving "principal shareholder-managers" where the existence of the holding company or companies does not result in a different relationship between the shareholder-managers and Opco.
iii) 2001-0072825-May 15, 2001. This technical interpretation dealt with the criteria that must be met relative to the ownership and management structure of a CCPC before reasonableness of a owner-manager bonus/salary would be challenged. The CRA stated that there are no specific criteria in place, but the more complex the structure the more likely that reasonableness would be challenged, especially if there is an undue tax advantage. See also 2001-0064055-March 26, 2001 and 2001-0074115-May 8, 2001.

[28] 2000 DTC 1767.

[29] This is consistent with question 25 of the 1991 Revenue Canada Round Table whereby the CRA stated that if the management fee from Opco to Holdco was not reasonable in light of the services rendered, the portion that was unreasonable would not be deductible by Opco pursuant to section 67 of the Act. The CRA also confirmed such a position in Technical Interpretation 2001-0114993-January 18, 2002**,** which dealt with whether or not the recently released administrative policy on bonuses in Technical News No. 22 would be respected where management fees were paid from Opco to Holdco and then bonuses paid out of Holdco. The CRA opined that their position outlined in Technical News No. 22 is limited to situations in which salaries and bonuses are paid directly to individuals resident in Canada who are active shareholder-managers of a CCPC.

[30] This appears to directly contravene the Agency's past practices as outlined in question 56 of the 1990 Revenue Canada Round Table, question 26 of the 1991 Revenue Canada Round Table, Technical Interpretation No. 9808707 dated June 10, 1998, and numerous other comments with respect to this issue. However, such contravention assumes that "non-active business income" includes property income in its definition, which might not be the case.

[31] See Technical Interpretation No. 2002-0128875-April 8, 2002.

[32] As defined in subsection 125(7) of the Act.

[33] Technical Interpretation 2002-0128865-April 10, 2002.

[34] See paragraph 53 of *Avis Immobilier GMBH v. HMQ* 94 DTC 1039.

[35] The willingness to rule on the reasonableness of shareholder/manager remuneration was somewhat of a surprise for some practitioners given that the CRA Rulings Directorate stated on numerous occasions that it would not rule on questions of fact in such cases. See the CRA's documented position in Information Circular IC 70-6R5 and in particular paragraphs 8 and 15(j) that discuss when the CRA would be prepared to rule on questions of fact. The CRA went on to further disclose in question 7 of Income Tax Technical News No. 30 that when a taxpayer requests an advance income tax ruling on the reasonableness of shareholder/manager remuneration, such ruling requests should include a complete disclosure of all relevant facts, the purpose of the proposed transaction, and a discussion on why the request should be considered in the context of the relevant provisions of the Act, jurisprudence and CRA policy.

[36] The CRA opines that in situations where the income from a CCPC is derived from management fees or dividends from a complex structure, the income used to pay the remuneration is not derived from the normal business operations of the CCPC.

[37] See Technical Interpretation 2003-0046624-November 7, 2003.

[38] See Ruling 2004-0060191R3.

[39] Subsection 14(1) of the Act will tax amounts that are dispositions of eligible capital property that exceed the corporation's "cumulative eligible capital" balance prior to the sale. In the subject ruling, the disposition of the franchise rights and goodwill triggered an amount which was included in the corporation's income pursuant to subsection 14(1) of the Act.

[40] The use of the word 'certainty' in this sentence is generous given that an advance tax ruling relies upon an interpretation of the facts. To the extent that such an interpretation of the facts is incorrect, the CRA will almost always reserve the right to renege on the ruling at hand.

[41] See ruling 2003-0039873. Such ruling also dealt with the payment of management fees by the corporation that disposed of its assets to a management corporation. The payment of such management fees also received a positive ruling that such payment would not be subject to section 67 nor paragraph 18(1)(a).

[42] See 2004-0072741R3.

[43] See Technical Interpretation 2001-0114905-March 20, 2002 which states that a bonus paid to a trust would be subject to the provisions of section 67. Technical Interpretation 2002-0141115-June 12, 2002 also states that bonuses to a family trust are not covered by the CRA's administrative policy. Technical Interpretation 2002-0128985-April 25, 2002 also commented on a situation where one of the active shareholders of a CCPC died during the CCPCs taxation year and whether or not the CRA would deny the deduction of the entire bonus payment or a portion thereof for bonus payments relating to the period after the shareholder's death. The CRA commented that its administrative policy does not cover such a situation and they therefore would not confirm in advance whether or not the quantum of such a bonus would be accepted as reasonable in the circumstances.

[44] 2002 DTC 1389.

[45] 2002 DTC 1389 at paragraph 30.

[46] 2001 DTC 306.

[47] *Petrovic* was decided based upon the doctrine of reasonable expectation of profit, and was decided before the Supreme Court of Canada's decision in *Stewart*, 2002 SCC 6969 and *Walls*, 2002 SCC 6960.

[48] Given that such cases were heard under the Informal Procedure, such decisions have no precedential value. See section 18.28 of The Tax Court of Canada Act, RSC 1985, C.T-2. For some interesting comments regarding section 18.28 of The Tax Court of Canada Act, see Justice Bowman's comments in paragraphs 17 to 20 of *Mourtzis v. HMQ* 94 DTC 1362.

[49] 2001 2 CTC 2206.

[50] 2004 TCC 421.

[51] 2004 TCC 421 at paragraphs 7 and 8.

[52] 2004 TCC 408.

[53] 2004 TCC 408 at paragraph 3.

[54] Pursuant to the provisions of section 256.

[55] Pursuant to subsection 125(2).

[56] See subsections 256(2.1), 256(5) and (5.1).

[57] Subsection 153(1) of the Act requires a person paying certain amounts such as salary, wages or other remuneration to withhold income tax pursuant to the prescribed rules under regulations 100 to 108 of the Act. The CCP Act and the EI Act also impose withholding requirements for CPP and EI respectively.

[58] For example, paragraph 153(1)(a) states that every person paying at any time in a taxation year, salary, wages or other remuneration…shall deduct or withhold from the payment the amount determined in accordance with the prescribed rules. In addition, paragraph 153(1)(g) also states that every person paying at any time in a taxation year fees, commissions or other amounts for services…shall deduct or withhold from the payment the amount determined in accordance with the prescribed rules... . Could it be argued by the CRA that the "management fees" paid by Opco to Mr. Apple were other remuneration or fees?

[59] [1995] 2 CTC 2971D No. 2 .

[60] Although there may be no withholding requirement for payments to independent contractors, there still may be a reporting requirement under section 200 of the regulations to the Act. See the CRA's recent views on such issue in Technical Interpretation 2004-0082901E5-August 16, 2004.

[61] Given that the argument is that the recipient of the management fees, Mr. Apple, is self-employed and not an employee, the question becomes whether or not such management fees are a taxable supply for purposes of the *Excise Tax Act*. In most cases, the answer will be yes.

[62] For an excellent paper discussing the deductibility of management fees and related issues, see Donald N. Cherniawski, CA and Marvin L. Toy, "Income Splitting" *Report of Proceedings of 48th Tax Conference, 1996 Tax Conference* (Toronto: Canadian Tax Foundation, 1997), 52:1-70. Such paper provides a thorough review of many of the issues that should be considered when attempting to utilize management fees.

[63] See for example response 5 in Technical News No. 30-May 21, 2004 wherein it states that the policy will not apply in a situation where the income of a CCPC is derived from management fees. See also Technical

Interpretation 2001-0115135-January 29, 2002 wherein it states that it will always be a question of fact whether a management fee based on the payer's profit otherwise earned is reasonable. The CRA therefore offered no comments as to whether any of the inter-corporate management fees being proposed to be paid in the situation at hand were reasonable. See also Technical Interpretation 2002-0141115-June 12, 2002 wherein the CRA states that "the payment of management fees or bonuses to a family trust is not covered by the CRA policy…, we cannot confirm whether or not the quantum of a management fee or bonus will be accepted as reasonable in the particular circumstances." See also Technical Interpretation 2004-0070121E5-June 4, 2004 wherein the CRA states that the payment of management fees from Opco to a personal services business corporation does not fall within the CRA's administrative policy as outlined in Technical News No. 22.

[64] Pursuant to the provisions of subsection 9(1).

[65] Pursuant to paragraph 12(1)(b).

[66] See Technical Interpretation 2003-0054061I7-February 20, 2004 and Technical Interpretation 2004-0070121E5-June 4, 2004 wherein the CRA states that its position regarding management fees is to follow the earned method or receivable method.

[67] One of the few decisions dealing with the term "management or administration fees or charges" was reviewed in the case of *Peter Cundill & Associates Limited*, 91 DTC 5085. However, this case dealt with withholding tax issues pursuant to section 212 of the Act, and not in an owner-manager remuneration type issue.

[68] 2004 FCA 135 on appeal from the Tax Court of Canada 2003 DTC 61.

[69] 2004 FCA 135 at paragraph 10.

[70] 2004 TCC 626

[71] As defined under subsection 89(1) of the Act.

[72] The CRA provides its views in IT-73R6 as to when a disposition of eligible capital property that results in taxable income can be viewed to be active business income. See, for example, paragraph 9 of IT-73R6. See also Technical Interpretation No. 2000-0016035-August 28, 2000.

[73] Pursuant to subsection 83(2) of the Act.

[74] In Alberta, this tax will approximate $32,000 (i.e. – 16.12% x $200,000).

[75] This assumes that Mr. Apple is resident in a province that has a maximum dividend tax rate of 25%. This, of course, varies by province.

[76] Pursuant to paragraph 20(1)(b) of the Act.

[77] Variable A of the definition of "cumulative eligible capital" under subsection 14(5) of the Act is amended effective December 20, 2002 to ensure that the taxpayer's pool does not include any portion of the non-taxable portion of a gain of a non-arm's length transferor that has been realized upon the transfer of an eligible capital property to the taxpayer. Variable A is generally reduced by one-half of the gain of the transferor in respect of the property.

[78] Practitioners will need to ensure that the goodwill is appropriately valued in order to avoid obvious valuation issues. To the extent that the goodwill is overvalued, this could cause the CDA balance to be overvalued, thus causing a 60 percent tax on the excess pursuant to subsection 184(2) of the Act. In

addition, the amortized amount will be excessive thereby reducing the deduction for amortization under paragraph 20(1)(b).

[79] This, of course, would depend upon which province Opco was resident.

[80] However, section 84.1 should always be considered in a plan like this. To the extent that Mr. Apple had acquired his shares from a non-arm's length person and such person had claimed the capital gains deduction under subsection 110.6(2.1) of the Act, section 84.1 could apply. The application of section 84.1 would result in Mr. Apple realizing a taxable dividend in the amount of $200,000 in the example shown.

[81] The provisions of section 55 should always be considered when declaring an inter-corporate dividend.

[82] As provided for under subsection 110.6(2.1) of the Act.

[83] As defined under subsection 108(1) of the Act.

[84] As defined under subsection 120.4(1) of the Act.

[85] As outlined in subsection 120.4(2) of the Act.

[86] Pursuant to subsection 104(21) of the Act.

[87] This could be done pursuant to subsection 85(1) of the Act.

[88] Caution – is this a capital gain or profits from inventory?

[89] The capital gains deduction under subsection 110.6(2.1) is not being utilized, therefore section 84.1 of the Act should not apply to re-characterize the capital gain to a taxable dividend. However, in a somewhat suspect Technical Interpretation recently released by the CRA (Technical Interpretation 2003-0035435-November 14, 2003), when commenting on a similar fact pattern and strategy as outlined, the CRA opined that section 84.1 could apply in a situation where each year Mr. A would sell a portion of his preferred shares of Opco to Mr. B and Mr. C receiving promissory notes as consideration. Such a sale would trigger a capital gain in the applicable year for Mr. A that would be reported appropriately. Mr. A would <u>not</u> claim the capital gains deduction on such sale. Mr. B and Mr. C are the sons of Mr. A. Mr. B would then transfer his shares of Opco to “BCo” – a corporation wholly owned by Mr. B utilizing the elective provisions of subsection 85(1) of the Act. In consideration for such transfer, Mr. B would receive a promissory note from “BCo” equal to the approximate amount of the value of the shares of Opco and nominally valued preferred shares of “BCo”. Mr. C would also enter into a similar transfer of his Opco shares with “CCo” – a corporation wholly owned by himself. Opco would then redeem its preferred shares held by “BCo” and “CCo” with the resulting deemed dividend received by each corporation being deductible against their respective incomes pursuant to subsection 112(1) of the Act. Each of “BCo” and “CCo” would then utilize the proceeds to repay the promissory notes that it owes to Mr. A. The CRA stated that “depending on the circumstances, Mr. A may be considered to have transferred his beneficial interest in the preferred shares of Opco directly to “BCo” and “CCo” thereby causing subsection 84.1 to apply and deeming each of “BCo” and “CCo” to have paid a dividend to Mr. A.” This logic seems somewhat suspect. In addition, the CRA notes that the GAAR may apply to the series of transactions.

[90] Supra, footnote 86.

[91] As outlined in section 245 of the Act.

[92] The CRA's administrative comments are provided in Information Circular IC-88-2. In addition, one should also be aware of the Department of Finance's comments when the new “kiddie tax” rules were introduced pursuant to the 1999 Federal Budget wherein they stated that income splitting techniques with minors would be the subject of further review and possible legislative amendment.

[93] As defined in subsections 248(1) and 144(1).

[94] See the definition of "employee" under subsection 248(1) of the Act. In addition, the EPSP allows flexibility for employers to share profits with all or only a designated group of employees. For an example of the CRA's views on this topic see IT-379R. In addition, the CRA has recently stated that a trust established for the benefit of employees cannot be a beneficiary of an EPSP since such a trust will not meet the definition of an employee – see Technical Interpretation No. 2001-0114625-February 22, 2002. See also Technical Interpretation 2001-0067315-February 14, 2001 wherein the CRA comments that an arrangement set up for the benefit of the employer's children where rights under the arrangement will be contingent on non-employment related conditions would likely not be considered an EPSP since the CRA would view the non-employment conditions to imply the arrangement to not be for the benefit of the employees.

[95] See paragraph (b) of the definition of employees profit sharing plan under subsection 144(1) of the Act.

[96] See subsection 144(3) and paragraph 6(1)(d) of the Act. It is important to understand that it is the allocation to the employee beneficiary that results in taxation and not the payment to the employee beneficiary from the EPSP.

[97] An *inter-vivos* trust is defined under subsection 108(1) of the Act.

[98] An *inter-vivos* trust is taxed on its taxable income at the highest tax rates applicable to individuals pursuant to subsection 122(1) of the Act.

[99] As outlined in subsection 144(2) and paragraph 149(1)(p) of the Act.

[100] See, for example, *Canderel Ltd. v. Her Majesty The Queen* 98 DTC 6100; *Toronto College Park Ltd. v. Her Majesty The Queen* 98 DTC 6088; and *IKEA Ltd.v. Her Majesty The Queen* 98 DTC 6092. These cases indicated that the determination of profit is a question of law not to be delegated to the accounting profession. In many cases, the profit will be computed using the same principles as generally accepted accounting principles as set out in the Canadian Institute of Chartered Accountants CICA Handbook – however, this is not always the case.

[101] The CRA provides its views on this topic in paragraph 2 of Interpretation Bulletin IT-280R which states that contributions computed by reference to profits have to be expressed as a percentage of profits for the year and the minimum contribution permitted cannot be less than 1% of the profits. Paragraph 3 of IT-280R also states that the Supreme Court of Canada decision of *Lade v. The Minister of National Revenue* 65 DTC 5297 is the authority for the requirement that employer contributions that are made to an EPSP cannot be dependant upon factors or conditions other than profits. For example, the CRA takes the position that a plan that provides that payments will be made by an employer only after contributions have been made by the employee members of the plan or that provides that the employer's contribution will be based on a percentage of employee contributions will not meet the requirements of subsection 144(1).

[102] The prescribed manner for the election is outlined in Regulation 1500(3) of the Act.

[103] The CRA outlines its administrative comments in IT-280R. Paragraph 6 of IT-280R states that the formula may be expressed in various ways and profits may be defined either as profits of the year or as undistributed profits of the year and previous years. Examples that the CRA provides for "out of profit" formulas are:

1. A percentage of members' salaries in wages (subject to a minimum of 1%);
2. An amount equal to members' contributions (subject to a minimum of 1% of each member's salaries or wages); and
3. A fixed dollar amount per member per year (subject to a minimum of $100 per member).

Paragraph 7 of IT-280R also states that other formulas will receive consideration, but a formula must not result in merely a nominal employer contribution so that the plan becomes primarily a savings plan for employees.

[104] As outlined in subsection 144(5) and paragraph 20(1)(w) of the Act.

[105] As outlined in subsection 78(4) of the Act.

[106] See, for example, Technical Interpretation No. 9313525-July 20, 1993 wherein it states that amounts deductible by two or more employer participants pursuant to subsection 144(5) and paragraph 20(1)(w) of the Act would be governed by the reasonable test in section 67 of the Act.

[107] See, for example, Evan Shoforost, CA, "Professional Incorporation", *2002 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 2002), 9:1-50; Susan L. Leach, CA, "Remuneration Issues for Owner-Managed Businesses", *1999 Prairie Provinces Tax Conference* (Toronto: Canadian Tax Foundation, 1999), 7:1-48; Neil S. Colquhoun, CA, "Executive Compensation Update", *2002 British Columbia Tax Conference* (Vancouver: Canadian Tax Foundation, 2002), 17:1-21; Leonard R. Vandenberg, CMA, "Year-End Tax-Planning Considerations for the Owner-Manager", Report on Proceedings of the Forty-Eighth Tax Conference, *1996 Tax Conference* (Toronto: Canadian Tax Foundation, 1997), 55:1-46.

[108] See Technical Interpretation 9528435-March 7, 1996.

[109] In Technical Interpretation 9528435, the CRA stated that in applying section 67 to EPSP contributions, the Department would use the same criteria that it had applied with respect to the deductibility of bonuses and other remuneration paid to individual Canadian-resident owners of private corporations who are actively involved in the day-to-day operations of the active business carried on by the private corporations.

[110] See, for example, Technical Interpretation 2000-0055055 and Technical Interpretation 2000-001711. The comments made in these technical interpretations, although not explicit, call into question whether or not the CRA was prepared to continue to extend the administrative position that it outlined in 1996.

[111] For a recent case involving allocations from an EPSP to an employee beneficiary, see the case of *Fischer*, 2003 TCC 272 [Informal Procedure]. The case involved a situation where an employer contributed $1,000 to an EPSP and allocated to the taxpayer employee pursuant to subsection 144(3) the $1,000. However, the $1,000 would not vest to the employee until 2 years later. The Court found that the $1,000 was taxable to the employee notwithstanding such allocation did not immediately vest. See also *Aspinall*, 86 DTC 1281.

[112] Supra, footnote 94.

[113] The reasoning behind the argument that section 67 should not apply to an allocation of amounts received by an EPSP to employee beneficiaries is that section 67 applies to deductions in respect of outlays or expenses. An allocation to beneficiaries of the trust by the trustee is not an outlay or expense.

[114] For example, consideration should be given as to whether or not subsection 56(2) of the Act could apply to the extent that amounts were allocated to employee beneficiaries by a taxpayer who is a trustee of the EPSP and perhaps is also an officer or director of the employer contributor corporation. Arguably, subsection 56(2) of the Act should not apply since subsection 56(2) only applies to a payment or transfer of property. It is the allocations from the EPSP that results in the tax liability to the employee beneficiary and not payments or property transfers out of an EPSP, thereby making it arguable as to whether or not subsection 56(2) would apply. In addition, one could speculate that to the extent that the CRA was offended by an allocation which resulted in obvious income splitting opportunities that the CRA may challenge the deductibility of the original contribution to the EPSP under section 67 of the Act.

[115] See Technical Interpretation 2000-0036107-September 8, 2000 and paragraph 15 of IT-379R which confirms the CRA's views that no withholding requirements are needed on payments to EPSPs by an employer nor on the allocation by the EPSP to the employee beneficiary.

[116] RSC, 1985, c. C-8.

[117] See T4001 – Employers Guide – Payroll Deductions, 2003. Presumably, the CRA arrives at this conclusion because an allocation from an EPSP to an employee is not the same as a payment to an employee. This is the reason cited by the CRA as a basis for its position that subsection 153(1) withholdings do not apply to allocations from an EPSP to an employee.

[118] S.C. 1996, C. 23 as amended.

[119] Supra, footnote 117.

[120] See Technical Interpretation 2000-0055055-December 4, 2000 and Technical Interpretation 2000-0017116-April 6, 2000.

[121] However, the definition of EPSP in subsection 144(1) reads "*… for the benefit of employees …*" thereby indicating the plural and not the singular variable. Notwithstanding such plural language, subsection 33(2) of The Interpretation Act, (RSC 1985 c.11 (1st Supp.)) states that words in the singular include the plural, and words in the plural include the singular.

[122] See, for example, Technical Interpretation 2000-0056145-January 9, 2001. The CRA opines that, generally, EPSPs are established for the benefit of several employees of the employer. They further state that they are not aware of any EPSPs that are established for the benefit of a single employee and that they have previously opined that an EPSP has to be established for the benefit of more than one employee.

[123] As outlined throughout the paper, a bonus must be paid within 179 days after the end of the taxation year in which the expense was incurred (with applicable source deductions being paid shortly thereafter). See subsection 78(4) of the Act.

[124] Personal income tax installments for the 2006 calendar year would also be due by the employee in this example to the extent that he/she owed more than $2,000 of income tax when he or she filed his or her 2005 personal income tax return – see subsection 156(1) of the Act.

[125] A review of the worldwide web utilizing a search of "employee profit-sharing plan" reveals numerous organizations that appear to "sell" EPSPs as products. As recent evidence of the CRA reviewing EPSP issues, one should review Technical Interpretation No. 2004-0062831I7-April 6, 2004. This technical interpretation is an internal memo between the Rulings Directorate and the CPP/EI Appeals Division Directorate. It appears that CPP/EI Appeals asked a question as to whether or not amounts contributed by an employer to an EPSP are always included in the beneficiaries' employment income when allocated under section 144 or whether there is a possibility that the CRA would recharacterize the nature of the employer's contributions when received by the employees as something other than employment income because of the type of income generated in the trust or in cases where the distributions were not made by the trust immediately after the allocation. The CRA responded that for tax certainty to exist, the nature of the amounts for the purposes of determining the tax treatment must be determined at the time that the incidence of tax arises which is at the time of the allocation. Consequently, the CRA opined that they would not recharacterize the amounts for tax purposes. However, in a follow-up technical interpretation (2004-0062833I7-April 14, 2004) the CRA clarified that its comments in the April 6, 2004 technical interpretation only describe the mechanism of the EPSP provisions and that such opinion does not preclude the application of any other provision of the Act depending on the circumstance.

[126] As defined in subsection 248(1) of the Act.

[127] As defined under subsection 248(1).

[128] See subsection 6(11) and subparagraph 6(1)(a)(v). In addition, see also paragraph 6(1)(i).

[129] See paragraph 207.6(1)(a). Subsection 207.6(1) also deems the subject property of the RCA to be property of the trust and not to be property of any other person and also deems the custodian of the RCA to be the trustee having ownership or control of the trust property. The definition of "RCA trust" in subsection 207.5(1) relies on the deemed trust definition in subsection 207.6(1).

[130] See the exclusion for Part I tax under paragraph 149(1)(q.1).

[131] See paragraph 210.1(c) for the exclusion of RCA trusts from Part XII.2 tax.

[132] Specifically, the charging provision for tax under Part XI.3 is under subsection 207.7(1) of the Act.

[133] See paragraph 18(1)(o.2) and paragraph 20(1)(r).

[134] See paragraph 8(1)(m.2). However, in order for the contributions by the employee to be deductible, the employee must have been required by the terms of the taxpayer's office of employment to contribute the amount.

[135] The definition of "refundable tax" is in subsection 207.5(1) of the Act and is generally defined to be 50% of all the contributions made under the RCA during the year plus 50% of the net income (including capital gains) of the trust less 50% of all amounts paid as distributions to one or more persons during the year.

[136] See subsection 207.7(2).

[137] William J. Strain, FCA, "Life Insurance - RCAs and Back-to-Back Arrangements" *2000 Prairie Provinces Tax Conference*, (Toronto): Canadian Tax Foundation, 2000, (16:1-31).

[138] See the requirement for income inclusion under paragraph 12(1)(n.3) and paragraphs 56(1)(x)-(z).

[139] See paragraph 153(1)(p).

[140] See such requirement under paragraph 153(1)(q).

[141] Given that an RCA is deemed to be a trust, paragraph 150(1)(c) requires a trust to file a return of income in prescribed form (see regulation 204) within 90 days from the end of the year.

[142] 2003-0046025-November 28, 2003.

[143] See for example Technical Interpretation 9418455-November 17, 1994 wherein the CRA stated that in their view the 1981 position would apply equally to the determination, for the purposes of section 67 of the Act, of the reasonableness of a contribution made by a company to an RCA in respect to benefits to be received by an employee-shareholder. Similar comments also were made by the CRA in Technical Interpretation 9428145-December 5, 1994. See also Technical Interpretation 9807000-May 12, 1998.

[144] See Technical Interpretation 9807000-May 12, 1998 for a useful insight into what the CRA views the difference is between an RCA and an SDA.

[145] See subsection 12.2(1) for the exclusion from income under Part I of the Act and regulation 306 of the Act which defines an "exempt policy".

[146] When trying to access the cash value of a life insurance policy, one must be mindful of not causing such a policy to be disposed of – see the definition of "disposition" in subsection 148(9) – which could cause income to be received pursuant to subsection 148(1). One must also be aware of the definition of "policy loan" under subsection 148(9) which could cause such a disposition.

[147] See Technical Interpretation 9807000-May 12, 1998. See also Technical Interpretation 2003-0000797-February 6, 2003 wherein the CRA states the following:

> "The Act does not provide any specific restriction on the use of property held by a trust governed by an RCA as security for a loan. However, an RCA is intended to provide secure funding for benefits to be provided as a consequence of the retirement of an employee, the loss of an office or employment of an employee, or a substantial change in the services provided by an employee. Accordingly, if an employer can use the funds to secure some other obligation, it raises a concern that the arrangement is not, in fact, a valid RCA. In this respect, we would also note that there might be a concern under trust law, on the legal basis by which an employer can use funds held in a trust established for the benefit of employees, to secure personal obligations of an employer."

See also Technical Interpretation 9730067-December 11, 1997.

[148] See the exclusion from the deemed disposition rules pursuant to sub-paragraph 128.1(4)(b)(iii) and the definition of "excluded right or interest" under subsection 128.1(10) which specifically defines an interest of an individual in a trust governed by an RCA under sub-paragraph (ix) to be an excluded right or interest – such rights are not deemed to be disposed of.

[149] See paragraphs 212(1)(j). Such withholding tax would be subject to a maximum withholding rate of 25% - possibly reduced by treaty.

[150] See similar comments by Perry Truster, CA, "Owner-Manager Remuneration and Related Issues," *1999 Ontario Tax Conference*, (Toronto: Canadian Tax Foundation, 1999) 7:1-30.

[151] In subparagraph (b)(i) under subsection 207.5(1) of the definition of "refundable tax", 50% of a capital gain as opposed to a taxable capital gain is captured into the definition of refundable tax.

[152] See, for example, the following recent advance rulings:

1. 2003-0050493
2. 2003-0049893
3. 2003-0033363
4. 2002-0169973
5. 2002-0152593
6. 2002-0133063
7. 2001-0102663
8. 2001-0080983
9. 2000-0061203
10. 2000-0034813
11. 9915403

[153] Given that the partnership has partners that are professional corporations, paragraph 249.1(1)(b) will require that the partnership have a taxation year end that ends on December 31 of each year.

[154] As defined under subsection 125(7).

[155] See such requirement in the computation of the small business deduction under subparagraph 125(1)(a)(ii).

[156] See the definition of “personal services business” under subsection 125(7). To the extent that a corporation was carrying on a personal services business, such income would not be eligible for the small business deduction and expenses would be severely limited as a deduction pursuant to paragraph 18(1)(p).

[157] Supra, see footnote 152.

[158] See 2003-0033363.

[159] Such an exchange can be achieved on a tax deferred basis, for example, utilizing section 51, 85 or 86 of the Act. However, the possible implications of subsection 74.4(2) would need to be considered as a result of this exchange.

[160] Such a trust would meet the definition of an “*inter-vivos* trust” under subsection 108(1) of the Act. In addition, the characteristics of the trust would be established so that subsection 75(2) of the Act would <u>not</u> apply.

[161] Such dividends could be paid assuming that the corporate solvency tests under the relevant provincial corporate statutes are met.

[162] Pursuant to the provisions of subsection 112(1) and also assuming that the payment of such a dividend by Opco to Holdco has not triggered a dividend refund to Opco. Careful consideration of the provisions of subsection 55(2) would also need to be considered in each case of a payment of an inter-corporate dividend.

[163] In order for The Apple Family Trust to allocate such dividend income and create a deduction under paragraph 104(6)(b) of the Act, such amounts received by the Trust must be paid or be payable to the beneficiaries.

[164] The “kiddie tax” rules under section 120.4 would capture dividend income received by The Apple Family Trust from Opco if such income was allocated to the minor beneficiaries of the trust. Accordingly, in such a plan, the dividends received by The Apple Family Trust from Opco would be desired to be allocated only to the beneficiaries who are over the age of 18.

[165] See subsection 104(21).

[166] See subsection 70(5).

[167] Such an issue is not settled law and is really a question of value. Of course, such an issue is debatable.

[168] For example, to the extent that an individual dies and his or her Will is probated, a complete disclosure of assets would be required.

[169] In the example described, Holdco would be “connected”, as such term is defined in subsection 186(4) of the Act, by virtue of the extended control definition in subsection 186(2). Opco and Holdco must be “connected” in order for Holdco to receive dividends from Opco without the incidence of Part IV tax. In a situation where the existing shareholdings involve non-related parties, it may not be possible to connect Holdco with Opco with such nominal shareholdings by Holdco. Instead, Holdco may have to be connected by acquiring more than 10% of the issued share capital of Opco having full voting rights and value attached to such shares.

[170] See subsection 104(4) of the Act. However, with careful planning, the implications of the 21-year deemed disposition rule may be able to be mitigated.

[171] One would also have to be mindful of the calculation of “safe income” for the purpose of section 55 of the Act to the extent that it was desirable to pay a safe income dividend to Holdco. Given the relative

minor shareholdings that the triangle structure results in Holdco owning shares of Opco, the calculation of safe income attributable to Holdco would be nominal.

[172] This type of planning is similar in nature to that of publicly traded corporations that have transferred their business operations to a publicly traded trust thus eliminating the corporate level of taxation.

[173] This will be true since the trust would not own shares of a qualified small business corporation as defined under subsection 110.6(1) of the Act. However, to the extent that the trust owned qualified farm property, such planning would still be available.

[174] See, for example, clause 110.6(14)(f)(ii)(A) which enables a transfer of property by a trust to a corporation in exchange for shares with a subsequent disposition of shares being eligible for the capital gains deduction in the right circumstances.