CANADIAN TAX Highlights

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A PSB's ITC Allocation

The TCC has opined on the determination of a claim for input tax credits (ITCs) by a private business that provides both taxable and exempt services. (See, for example, *Sun Life*, 2015 TCC 37, and *British Columbia Ferry Services*, 2014 TCC 305.) For real property, a private business must determine the extent of its property's use in making taxable or exempt supplies and claim ITCs accordingly. The same general principles apply to a public service body (PSB), except that a PSB can usually claim ITCs in respect of real property only if 50 percent or more of the property is used in making taxable supplies. (Note that separate and distinct allocation rules apply to financial institutions.) However, the PSB can elect to use the general proportional allocation rules applicable to a private business. The TCC allowed ITCs to a PSB that made such an election in *University of Calgary* (2015 TCC 321), and it reached the same conclusion in *University of Alberta* (2015 TCC 336).

Because the University of Calgary (UC) was a PSB, and by virtue of section 209 of the ETA, the campus was treated as personal property. As a result, UC could claim ITCs in respect of the campus and additions or improvements thereto only if the campus had been acquired for use primarily (more than 50 percent) in UC's commercial activities (that is, in making taxable supplies). The campus was used to provide some taxable services, but it was used primarily to make GST-exempt educational supplies, and thus UC could not claim ITCs with respect to it.

On February 1, 2006, UC made a section 211 election, which deemed UC to have received a taxable supply of the campus by way of sale and to have paid GST thereon. UC claimed a proportional offsetting ITC by virtue of section 193. The deemed sale also triggered section 206, which entitled UC to ITCs equal to the degree to which the campus was acquired for use in its commercial activity. Thus, UC was allowed to claim at least some ITCs in respect of the campus, based on a calculation methodology that was "fair and reasonable."

The main issue was whether UC's allocation methodology for claiming ITCs was fair and reasonable. UC's methodology categorized the space on the campus into (1) space used directly in making exempt supplies, (2) space used directly in making taxable supplies, and (3) space used indirectly in making supplies. UC assumed that the percentage of the amount of space used directly in making exempt supplies (category 1) divided by the amount of space used directly in making taxable and exempt supplies (category 1 + category 2) reasonably reflected the extent to which all the land composing the campus was acquired for use in the course of UC's commercial activities. Implicit in that calculation was an assumption by UC that both internal and external common areas were spaces used indirectly in making supplies and that both were used for taxable and exempt activities in the same relative proportion as the internal space that was used directly in the making of taxable and exempt supplies.

The minister did not take issue with UC's characterization of the internal common areas, but she contended that the external common areas should be considered to have been used only in exempt activities because they were not used directly to make taxable supplies. The TCC disagreed: the minister's position seemed to be an "arbitrary administrative decision rather than a decision based on applying the provisions of the [ETA]."

The TCC also rejected the minister's contention that an additional indexing factor should be applied on the basis of the replacement value of the campus; the court noted that the indexing factor had no bearing on the purpose of the acquisition of the campus. Moreover, the court said that requiring the application of an additional indexing factor would place an unreasonable financial burden on UC because the university would need to hire a valuator to determine entitlement to ITCs.

In our view, the TCC's conclusion is sound. The minister's proposed treatment of the external common areas was inconsistent with its treatment of the internal common areas, and no rationale was given for the distinction.

The decision does not suggest that the minister focused on whether UC's methodology was fair and reasonable. Rather, the decision suggests that the minister focused on why her own methodology was preferable. The minister's approach forces the taxpayer to defend its methodology at trial even though the minister has not considered whether the taxpayer's approach is fair and reasonable. The minister's approach also seems to suggest that what is relevant is the considerably

In This Issue

A PSB's ITC Allocation	1
Jeopardy Order Overturned	2
Tax Dispute Resolution: Watch for US Issues	3
EU Anti-Tax-Avoidance Proposal	4
Draft Legislation on Spouse and Other Trusts	5
Relief for Canadian Investors in US Realty	6
CRA Relief for Short-Term TFSA Overdrafts	6
CCPC Tax Changes Starting in 2016	7
Education and Textbook Credit for Medical Resident	9

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higher standard of the best or perfectly accurate allocation methodology as opposed to what is fair and reasonable. Such cases will consistently and unnecessarily proceed to trial if the minister continues to ignore whether a taxpayer's methodology is fair and reasonable.

The case is perhaps most interesting to a PSB in circumstances similar to those of UC, less than 50 percent of whose real property was acquired for use in making taxable supplies. To avoid the all-or-nothing ITC allocation rule in section 209, which completely rules out ITCs, the PSB should consider a section 211 election to trigger the proportionate allocation methodology in section 206. The election appears to have benefited UC significantly, even though it had to defend its allocation methodology at trial.

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Jeopardy Order Overturned

The jeopardy order—an extraordinary remedy that may be granted to the minister of national revenue by the FC—allows the minister to initiate collection actions against a taxpayer in circumstances not otherwise permissible under the Act. The jeopardy order regime is intended to protect the minister's interests. An amount may be ultimately uncollectible if the taxpayer liquidates or transfers his or her assets, and the order allows the minister to implement collection actions without delay. A jeopardy order may be sought ex parte before the FC, but the taxpayer may challenge it within 30 days via a motion before the FC. The motion in *Canada (National Revenue) v. Grenon* (2015 FC 1050) summarized key principles of the jeopardy order regime.

First, the FC confirmed that the minister must establish reasonable grounds to believe that delay may jeopardize the collection of some or all of the minister's debt. The threshold of "reasonable grounds" places a lesser onus on the minister than the usual civil balance-of-probabilities threshold.

Second, a jeopardy order is sought ex parte. Thus, the Crown must apply to the FC in good faith and make full and frank disclosure that is reasonable in the circumstances. Full and frank disclosure obliges the Crown to bring to the court's attention the relevant case law; all facts in issue, including those that may be unhelpful to the Crown's position; and foreseeable weaknesses in the Crown's case. This required disclosure is reasonable because the taxpayer is not otherwise represented in an ex parte application and the court must therefore rely solely on the representations of the Crown counsel, who is an officer of the court. However, a taxpayer can seek a review of the application judge's decision to issue a jeopardy order.

Third, the minister's onus on a motion to review a jeopardy order is unclear. On the initial application to the FC, the minister must only demonstrate reasonable grounds that collection may be jeopardized by delay. According to the FC in *Grenon*, some FC judges reviewing a jeopardy order require only that the minister support her earlier position that there are reasonable grounds to believe that collection may be in jeopardy. In other cases, if the taxpayer establishes reasonable grounds to doubt the basis for a jeopardy order, the minister must prove, on a higher balance-of-probabilities standard, that collection "would be" jeopardized by delay. In *Grenon*, the FC said that the relevant provisions do not support a higher onus on the minister on review and that a higher onus should be established by statute rather than by judicial innovation. However, regardless of the threshold that the minister must meet, the FC decided in the taxpayer's favour and vacated the jeopardy order.

In *Grenon*, the FC issued a jeopardy order authorizing collection actions against the RRSP trust of James T. Grenon. The trustee was the CIBC Trust Corporation. The trust did not take a position on the FC motion, and the annuitant Mr. Grenon, as intervenor, advanced the arguments. Mr. Grenon is a Canadian who resides in New Zealand. The trust is a Canadian taxpayer, and it and the trustee are subject to the Act; in particular, the trustee is exposed to third-party liability pursuant to section 159.

In February 2012, Mr. Grenon obtained permanent residence status in New Zealand and put his Canadian home up for sale; he moved to New Zealand in October 2012. In April 2012, the CRA sent him a proposal letter regarding income generated from trust investments. In February 2013, after Mr. Grenon had expatriated to New Zealand, he received a second CRA proposal letter, and later that month both he and the trust received very substantial notices of reassessment. In March 2013, the minister obtained the ex parte jeopardy order. The CRA's affidavit set out transactions that suggested that collection might be jeopardized. For example, in late 2012, Mr. Grenon transferred trust funds into another RRSP account; in February 2013, around the time that the CRA issued the assessments, Mr. Grenon transferred $55 million of those funds to a New Zealand account; and, later in February 2013, he transferred a further $15 million from the trust into a high-interest account.

On the motion to review the jeopardy order, Mr. Grenon established that there were legitimate reasons underlying the transactions. The FC confirmed that certain facts—including the transactions described above, the cancellation of Mr. Grenon's Canadian driver's licence, and the sale of his Calgary home—may have attracted the minister's attention. However, jeopardy orders are more typically upheld in situations involving "an element of criminality or otherwise questionable or nefarious behaviour." The FC said that the transfers involving the trust, along with Mr. Grenon's relocation, may have initially created concern that the trust might be depleted before collection actions could be imposed. However, the FC ultimately concluded that the minister did not establish that there were reasonable grounds to believe that the assets in question were currently in danger of being depleted before any tax debts

could be resolved. The FC noted in particular that the trustee was jointly liable if the trust assets were distributed before any tax debts were resolved (subsection 159(2)). The FC also noted that the transactions in question were initiated before the CRA issued reassessments.

In the course of resolving a tax dispute, a practitioner may sense that a jeopardy order is being contemplated. In such a situation, it may be advisable for him or her to inform the minister, in writing, of all relevant facts supporting the conclusion that the taxpayer is not depleting or transferring assets in order to jeopardize collection. Written confirmation of key facts may persuade the minister not to seek a jeopardy order and must also form part of any ex parte application that the minister makes to the FC, in accordance with the full and frank disclosure principle, and thus will assist the taxpayer's position at the ex parte application or on a later review of a jeopardy order.

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Tax Dispute Resolution: Watch for US Issues

The US crackdown on citizens with foreign accounts has renewed most Canadian tax planners' awareness of the importance of identifying US tax issues before a plan's implementation. In addition, when resolving tax disputes by litigation or less formal means, a practitioner must identify and analyze US tax issues before and during the defence of a taxpayer. The practitioner may be tempted to settle (or even concede) a dispute with the CRA in Canadian dollars and hope to recoup some of the loss by claiming a refund of previously paid (and substantially appreciated) US dollars, but the US refund may be denied if appropriate procedures are not followed.

Assume that the CRA claims that the taxpayer owes an additional Cdn$100; the taxpayer paid the US$100 to the IRS when the currencies were at par. A tax litigator may advise the client to pay Cdn$100 to the CRA and then claim a US$100 refund from the IRS. If the US$1.00 now buys Cdn$1.35, this strategy leaves the taxpayer 35 percent better off. However, the IRS will not grant a foreign tax credit for monies paid to the CRA unless the taxpayer has exhausted its remedies, including the involvement of the competent authorities. This situation occurs most often in transfer-pricing cases, but it also applies whenever a taxpayer seeks credit for Canadian tax paid.

Generally, the United States grants a tax credit for Canadian taxes paid unless the taxpayer is not legally obliged to pay those taxes (Treas. reg. section 1.901-2(e)(1)). The policy behind the rule assumes that the taxpayer has no incentive to challenge a foreign tax that is not compulsory, regardless of whether it was properly imposed. The shift in tax liability from Canada to the United States that results from a US foreign tax credit is now compounded by the dramatic devaluation of the Canadian dollar relative to the US dollar.

A claim for a credit for Canadian taxes paid requires that the taxpayer show (1) that the tax has been determined in a manner consistent with a reasonable interpretation and application of the substantive and procedural provisions of Canadian law (including the treaty); and (2) that the taxpayer has exhausted all effective and practical remedies, including the "invocation of the competent authority procedures" (Treas. reg. section 1.901-2(e)(5)(i)).

Article XXVI of the Canada-US treaty includes the mutual agreement procedure (MAP) for requesting competent authority assistance, a request that is usually required to demonstrate that the taxpayer has exhausted its effective and practical remedies. Rev. rul. 76-508 provides that if the taxpayer does not request competent authority relief, it bears the burden of proving that it has exhausted its remedies. However, MAP is not necessary in every controversy to establish that a taxpayer's remedies have been exhausted. For example, Rev. proc. 2006-54 sets out circumstances where MAP need not be invoked, including where the amount in controversy is below a de minimis threshold, where other administrative remedies have been successful, and where the taxpayer has received the opinion of local counsel that it is in compliance with foreign laws.

Because the IRS may deny a credit for Canadian taxes paid, a Canadian tax practitioner in dispute with the CRA must do the following:

1) Identify US persons who are, or may be, stakeholders in the litigation. Were the individual and his or her parents born in the United States? How much time does he or she spend in the United States? Has he or she ever had a US green card? If the US person is a corporation, was it registered in the United States? Other questions may apply.
2) Identify US property. Does the taxpayer own US real estate, US stock (even if traded on a Canadian exchange), any other US intangible (such as intellectual property, a chose in action, or a mineral interest), or a tangible personal property located in the United States?
3) Analyze the procedural issues. Is it necessary to invoke MAP and notify the competent authority? Has the US statute of limitations expired? If not, should a protective claim be made in order to preserve a refund claim?
4) Analyze the impact of US tax rules. Does a reduced Canadian tax increase US tax when the impact of currency fluctuation is considered? If the CRA prevails, is the taxpayer eligible for a US foreign tax credit refund?

Canadian tax litigators are not immune from the obligation to identify and analyze US issues. The sudden and dramatic

devaluation of the Canadian dollar relative to the US dollar may suggest that a settlement with the CRA is advantageous if the IRS will grant a refund of US tax paid. Settlement may benefit the taxpayer in theory, but the taxpayer must properly adhere to procedural rules in order to receive a US foreign tax credit.

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EU Anti-Tax-Avoidance Proposal

On January 28, 2016, the European Commission released draft anti-tax-avoidance (ATA) measures to address aggressive tax planning and create a level playing field within the European Union. Direct taxation is reserved for sovereign member states, but the commission believes that an EU-wide approach is appropriate to address harmful tax competition and aggressive tax planning. The draft ATA directive responds to the OECD's BEPS (base erosion and profit shifting) proposals. Most member states have already endorsed the BEPS initiative, but the commission is concerned that unilateral and divergent implementation of the BEPS initiative may result in national policy misalignments, distortions, and tax obstacles for businesses in the European Union, and may create new loopholes and mismatches that taxpayers seeking to avoid tax will exploit. The ATA directive requires the unanimous approval of all member states; the commission set an aggressive deadline of July 2016 for approval.

The draft ATA directive contains six income tax proposals that require implementation by each member state. The proposals must be principle-based because each country has its own tax laws and will determine the specific implementation language. The commission intends that each of the six proposals should set a minimum standard and that each state may implement rules that set a higher standard.

1) **Interest deductibility.** To combat base erosion, an interest expense limitation rule is proposed. The proposal limits net interest (net of interest income) to 30 percent of EBITDA (the somewhat similar US earnings-stripping rule currently limits net interest to 50 percent of EBITDA). It is not clear how the rules in member states can be consistent when some of those states already have thin-cap-type restrictions for related-party debt. The proposal does not currently apply to financial institutions. The proposal is not limited to interest paid to member states or to a related person: interest paid to a non-EU country may also be restricted.
2) **Exit tax.** A departure tax is proposed for a corporation that transfers assets or its tax residence from one member state to another or to a state outside the European Union.
3) **Switchover clause.** It is proposed that a member state be restricted from granting a participation exemption in respect of a dividend or capital gain from a non-EU entity or branch in a jurisdiction that imposes tax on the underlying income at less than 40 percent of the statutory rate applicable if the income was earned in that member state. Although each member state will require a minimum ownership percentage or value in the particular foreign participation before granting exemption, the proposal contains no such share ownership requirements.
4) **GAAR.** Effective in 2016, a GAAR was added to the EU parent-subsidiary directive. The ATA GAAR proposal is similarly worded: it applies to the entire domestic tax law of each member state, for situations that either are totally within the European Union or involve third countries.
5) **CFC rules.** Controlled foreign company (CFC) rules are similar to Canada's FAPI regime. The income of a CFC is proposed to be taxable in the member state if (a) the effective rate is less than 40 percent of the member state's rate; (b) more than 50 percent of the income is income from property, financial services income, or group services income; and (c) the CFC is not publicly traded.
6) **Hybrid mismatches.** For intra-EU transactions, it is proposed that if a payment's legal characterization in the payer jurisdiction differs from its characterization in the payee jurisdiction, the former characterization should govern in both jurisdictions.

On January 28, 2016, the commission also issued a revised draft country-by-country (CbC) reporting directive. In addition to the automatic sharing of cross-border tax rulings and APAs provided for in the existing information exchange directive, the draft CbC reporting directive encompasses the automatic sharing provision from the BEPS CbC reporting guidance. The commission's draft directive also provides that CbC reporting applies to both an EU MNE group and a non-EU MNE group if one or more of the group's entities are located in the European Union. Both the BEPS guidance and the draft CbC reporting directive are effective for years commencing after calendar 2015.

The broad political support for the BEPS proposals implies similar support for the BEPS CbC reporting directive. The ATA directive may be more controversial: member states want to combat aggressive tax planning, but some elements of the ATA directive have a wider scope than BEPS and arguably encroach on a member state's authority to levy income taxes. Moreover, implementation of the ATA measures may introduce significant complexity and uncertainty concerning each member state. Thus, it is still unclear whether the ATA directive proposals will be implemented as drafted. Nonetheless, Canadian corporations with EU operations should closely monitor developments that may adversely affect group treasury, group

IP operations, and the management of the EU taxation of subsidiaries.

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Draft Legislation on Spouse and Other Trusts

The graduated rate estate (GRE) and other major additions and amendments to the taxation of trusts and estates, which became effective January 1, 2016, have been much discussed since their release in August 2014. One controversial provision (paragraph 104(13.4)(b)) deems income from certain life interest trusts to be taxable on the death of the life interest beneficiary in his or her hands and not in the trust. On November 16, 2015, the CBA-CPA Joint Committee on Taxation, STEP Canada, and CALU received a letter from Finance that foreshadowed draft legislation. The draft legislation, released on January 15, 2016, limits the application of the deeming rule.

If the draft is enacted, the deeming rule applies only in very limited circumstances and only by choice. The trust must be a testamentary spouse (or common-law partner) trust that was created by the will of a taxpayer who died before 2017, and the trust and the spouse's (or common-law partner's) GRE must jointly elect to have the rule apply. The parties may choose not to elect for certain non-tax reasons, as in the case of blended families. However, election may be the prudent tax decision for many estate plans.

A testamentary spouse (or common-law partner) trust that is not a GRE is taxed at the top marginal rate, which increased by 4 percent federally in 2016. When that federal increase is combined with provincial increases, particularly in Alberta, a testamentary spouse (or common-law partner) trust may take a major tax hit on the death of the spouse beneficiary. An election allows for the deemed income to be taxed at the now deceased spouse's (or common-law partner's) marginal rate, possibly decreasing the overall tax liability on death and increasing the amount available to the beneficiaries. The estate can also file a "rights or things" return and double up on graduated rates and personal tax credits.

A number of other issues must be considered. The legislation seems to contemplate an all-or-nothing election: an election cannot be made for some and not all of the trust's income and thus may have far-reaching implications. Assume that the trust assets include shares of a qualifying small business corporation (or qualified farm or fishing property) that are eligible for the lifetime capital gains deduction. The election could shelter $824,176 ($1 million for qualifying farm or fishing property). The ability to use the capital gains deduction would otherwise be lost because subsection 110.6(12), which formerly allowed a spouse (or common-law partner) trust to claim the life interest spouse's unused capital gains deduction, was repealed as of January 1, 2016. If the estate and trust beneficiaries are the same, failure to elect depletes the aggregate assets available for distribution and may give rise to a claim for breach of fiduciary duty against the trustee or its advisers. On the other hand, if the beneficiaries are different, the estate beneficiaries may be unwilling to assume the full tax liability of the trust on the death of the spouse (or common-law partner).

Another legislative change effective after 2015 provides that an election exposes both the estate and the trust to joint and several liability under new subsection 160(1.4). The estate and the spouse (or common-law partner) trust are now jointly and severally liable for a portion of tax payable if the income is included in the spouse beneficiary's terminal return. The trustee should take steps to eliminate or reduce potential liability, including deferral of the trust assets' distribution until the trustee is satisfied that the spouse beneficiary's estate has paid the tax liability arising from the election.

An election may also leave charitable tax credits stranded in a trust that does not have sufficient income (and therefore income tax payable) against which to deduct the donation tax credit.

There are other practical considerations. For example, if the trust holds shares of a privately held corporation, the deemed disposition on the spouse's death may result in a capital gain. Those shares are usually redeemed in the trust, which triggers a deemed dividend and an allowable capital loss to offset the capital gain on death. An amended T3 is then filed by the trust. If the new election is made, the procedure is more complex. The trust must make a late designation under subsection 104(13.2) to have the capital gain—previously taxed in the estate—taxed in the trust. The trust must also amend its T3 return to include the gain, and the estate must file an amended terminal T1 return to delete the previously reported capital gain. The income tax refund to the estate will no doubt be a matter of interest to all beneficiaries. Moreover, there is the matter of timing. The trust must file its tax return within 90 days after the spouse beneficiary's death. An election may require some quick decision making on the part of both the trustee and the personal representative.

Finance invited interested parties to provide comments by February 15, 2016. One hopes that the next federal budget will provide some future certainty for estate planners.

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Relief for Canadian Investors in US Realty

On December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (the PATH Act). The PATH Act includes revised income tax rules that are favourable to Canadians investing in US real property and in US real estate investment trusts. The act demonstrates that the US government is committed to making US tax rules more favourable to Canadian and other foreign investors in US real estate.

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) subjects foreign investors to US federal income tax on certain income and sales proceeds from US real property interests (USRPIs). The income or sales proceeds are treated as effectively connected with a US trade or business and are therefore taxable at income tax rates (including individual capital gain rates) applicable to US persons. A USRPI includes an interest in US real property, in certain domestic corporations (referred to as "US real property holding companies," or USRPHCs), and in a real estate investment trust (REIT) that has the majority of its worldwide real estate and business holdings in USRPIs.

Before the PATH Act was enacted, a non-US investor (including a Canadian pension plan) was taxed on the sale of US real property and a USRPHC, with limited exceptions. Under the PATH Act, a "qualified foreign pension fund" (including a Canadian pension fund) and its wholly owned subsidiaries are completely exempt from FIRPTA taxation and withholding on the gain from the sale of a USRPI and also on a distribution from a REIT attributable to the gain from the disposition of a USRPI. A qualified foreign pension fund is a pension fund that (1) was created under the laws of a foreign country, (2) is subject to regulation and annual reporting in the foreign country where it was established or operates, (3) was established to provide retirement or pension benefits to current or former employees, (4) has no single beneficiary who has more than a 5 percent interest, and (5) enjoys tax benefits on contributions or on investment income in the foreign country where it was established or operates. It is not clear what type of regulation and annual reporting in the foreign pension fund's home country is sufficient to meet the exemption. The qualified foreign pension fund is still subject to US withholding tax on rental income earned from US real property and on an ordinary dividend distribution from a REIT that is not attributable to the gain from a USRPI disposition.

The PATH Act also provides relief to a foreign small "portfolio investor" in a publicly traded REIT. Previously, a FIRPTA exemption existed for a foreign investor who owned 5 percent or less of the stock of a publicly traded REIT at any time during the five years ending on the disposition date or the investor's shorter holding period. The PATH Act increases this exemption for a foreign investor who owns 10 percent or less of a publicly traded REIT and also exempts a distribution from such a REIT that is attributable to a gain from the disposition of a USRPI. Furthermore, "qualified shareholders" (which include certain publicly traded Canadian limited partnerships) that invest in publicly traded or private REITs may be wholly or partly exempt from FIRPTA on the disposition of a REIT interest and on a distribution from the REIT that is attributable to a gain from the disposition of a USRPI. A qualified shareholder must, among other things, be traded on the New York Stock Exchange or on NASDAQ.

The PATH Act includes helpful clarification of the FIRPTA exception applicable to a domestically controlled REIT. Under existing law, the gain from the sale or disposition of a publicly traded or private REIT in which US persons hold 50 percent or more of the stock is exempt from FIRPTA. Under the PATH Act, a publicly traded REIT can assume that all of its shareholders that hold less than a 5 percent interest are US shareholders unless it has knowledge to the contrary. Stock that is held by another publicly traded REIT or qualifying regulated investment company (RIC) is treated as held by a foreign person unless that REIT or RIC is also domestically controlled. Stock that is held by a private REIT or another type of RIC is treated as held by US persons in the same proportion that the shareholder entity is owned.

The PATH Act includes offsetting revenue-raising provisions that codify the so-called cleansing rule's inapplicability to REITs and RICs. The cleansing rule provides that a USRPHC is no longer treated as a USRPI if, at the date of disposition of its stock, all USRPIs previously held by the USPRHC have already been disposed of and the full amount of the gain has been recognized. The PATH Act also increases the FIRPTA withholding rate imposed on the sale or distribution of a USRPI from 10 to 15 percent of the amount realized; the increase does not apply to the sale of a personal residence if the amount realized is $1 million or less and the exemption for a purchase at no more than $300,000 does not apply. The increased FIRPTA withholding applies to a sale or disposition at least 60 days after the PATH Act's enactment.

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CRA Relief for Short-Term TFSA Overdrafts

A recent technical interpretation (2013-048649117, October 22, 2015) outlines the circumstances in which the CRA considers a TFSA trust to have borrowed money or other property. That borrowing may technically cause the TFSA to be de-registered. However, the CRA says that it gives administrative relief and does not de-register a trust that governs a TFSA in the case of certain short-term overdrafts that are infrequent, unintended, and lack the character of leveraged investing. The CRA also

says that when there is a deemed disposition that is caused by a TFSA's de-registration, no distribution is added back to the taxpayer's TFSA contribution room.

An arrangement must be a "qualifying arrangement," which is defined in subsection 146.2(1), in order to be registered as a TFSA. Paragraph (b) of the definition includes three alternative types of arrangements, one of which is an arrangement in trust with a corporation licensed or otherwise authorized to offer its services as a trustee to the public. If the arrangement is an arrangement in trust, the trust is also prohibited from "borrowing money or other property" for the purposes of the arrangement (paragraph 146.2(2)(f)).

Subsection 146.2(5) describes the circumstances in which an arrangement becomes and ceases to be a TFSA. An arrangement ceases to be a TFSA at the earliest of (1) the time when the last holder of the arrangement dies, (2) the time when the arrangement ceases to be a qualifying arrangement, and (3) the earliest time when the arrangement is not administered in accordance with the conditions in subsection 146.2(2).

Under subsection 146.2(8), if the arrangement that governs a trust ceases to be a TFSA, immediately before that particular time the trust is generally deemed to have disposed of each of its properties for proceeds equal to FMV, and to have acquired each such property at a cost equal to that FMV. In addition, the trust's current tax year is deemed to end immediately and a new tax year is deemed to begin at that particular time.

In the TI, the CRA says that the meaning of the term "borrowed money" is set out in *Income Tax Folio* S3-F6-C1, "Interest Deductibility." Paragraph 1.23 of the folio says that borrowed money requires a lender-borrower relationship, which is evidenced by the existence of an outstanding loan between the two parties. Whether this relationship exists in a TFSA overdraft scenario is a question of fact.

The TI considers a number of hypothetical situations in which infrequent, unintended, and brief overdrafts are created in a TFSA, and it says that a lender-borrower relationship exists in the case of overdrafts caused by a settlement mismatch, a trading error, a portfolio rebalancing, and a TFSA contribution made with insufficient funds. In each instance, funds are provided to the TFSA trust in order to complete a payment from the trust, and the TFSA trust is therefore considered to have borrowed money under paragraph 146.2(2)(f).

The TI also considers a situation where an overdraft occurs because account fees are charged to a TFSA, and it says that a lender-borrower relationship exists only if funds are provided to the TFSA trust to pay a third party (a broker). However, if an overdraft is created by fees charged to the TFSA and those fees remain unpaid, no lender-borrower relationship exists. The TI says that in this latter situation, a debtor-creditor relationship exists; but because no funds have been borrowed, the "borrowing [of] money or other property" has not occurred as required by paragraph 146.2(2)(f).

Furthermore, the TI says that an overdraft created by a cashless exercise of warrant is a form of buying on margin. That activity involves a lender-borrower relationship and thus constitutes the borrowing of money. In the TI's example, which is based on information provided to the CRA, the CRA concludes that the broker advanced the funds to the TFSA to exercise the warrants and then sold the shares to a third party. Then, after deducting an amount for funds used to exercise the warrants and also for fees and other charges, the broker paid the balance of the proceeds to the TFSA.

The TI says that under its administrative position the CRA does not de-register a TFSA under paragraph 146.2(5)(c) if the overdraft

1) is temporary in nature and covered without undue delay;
2) arises as a result of (a) a mismatch of cash flow due to differences in standard settlement cycles for securities, (b) a reasonable error, or (c) an unintended infrequent event; and
3) does not have the character of leveraged investing.

The TI also says that a comparable administrative position should apply to similar situations in other registered plans that have similar restrictions, including a trust governed by an RRSP (paragraph 146(4)(a)), a RRIF (subsection 146.3(3)), an RDSP (paragraph 146.4(5)(a)), and an RESP (paragraph 146.1(2.1)(d)).

Moreover, the TI says that if a trust ceases to be a TFSA and is de-registered, there is a deemed disposition of its property under paragraph 146.2(8)(a), but that disposition is not considered to be a distribution under the TFSA. Therefore, the amount realized on the deemed disposition is not added back to the taxpayer's TFSA contribution room in the following year. A distribution under a TFSA is defined in subsection 146.2(1) as a payment out of or under the TFSA in satisfaction of all or part of the holder's interest in the TFSA, and it is added back to the taxpayer's contribution room in the following year. The TI says that a disposition of the TFSA's property (whether deemed or actual) does not constitute a distribution, because the TFSA holder does not receive anything in satisfaction of his or her interest in the TFSA. As a result, a TFSA's de-registration causes a permanent loss of TFSA savings room.

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CCPC Tax Changes Starting in 2016

Federal Bill C-2, An Act To Amend the Income Tax Act (first reading December 9, 2015), introduces a top federal personal tax rate of 33 percent (up from 29 percent) on income over $200,000, starting in 2016. Bill C-2 also includes consequential amendments to the taxation of CCPCs, amendments that,

starting in 2016, modify (1) the rate of refundable tax on a CCPC's investment income, (2) the RDTOH definition, (3) the part IV tax rate, and (4) the dividend refund rate on taxable dividends paid by a corporation. According to the explanatory notes, the amendments are intended to "reduce personal income tax deferral possibilities that individuals earning investment income directly might otherwise obtain by earning such income through a CCPC."

Refundable tax on CCPC's investment income. The tax rate increases from 6 2/3 percent to 10 2/3 percent, raising the tax on investments earned in a CCPC by four percentage points from 34 2/3 percent to 38 2/3 percent, for taxation years ending after December 31, 2015 and prorated for taxation years straddling this date (section 123.3).

Refundable dividend tax on hand (RDTOH). For taxation years ending after December 31, 2015 and prorated for taxation years straddling this date, the definition of RDTOH in subsection 129(3) is amended to adjust (1) the percentage of a CCPC's aggregate investment income included in its RDTOH, from 26 2/3 percent to 30 2/3 percent (variable "A" in the formula in subparagraph 129(3)(a)(i)); (2) the non-business foreign tax credit reduction, from 9 1/3 percent to 8 percent of foreign investment income (subclause II in variable "B" in the formula in subparagraph 129(3)(a)(i)); (3) the factor for taxable income of a corporation that exceeds the total of the portions of that income that has benefited from either the small business deduction or foreign tax credits, from 26 2/3 percent to 30 2/3 percent (subparagraph 129(3)(a)(ii)); and (4) the gross-up factor for foreign non-business income, from 100/35 to 100/38 2/3 (clause B of subparagraph 129(3)(a)(ii)).

Part IV tax. The rate increases by five percentage points, from 33 1/3 percent to 38 1/3 percent, for dividends received after 2015 (paragraph 186(1)(a)). The increase approximates the additional personal income tax that an individual pays on taxable dividends as a result of the new 33 percent top federal personal tax rate and is based on the average of the gross-up factors that apply to eligible and non-eligible taxable dividends in 2019, when the federal small business tax rate will be 9 percent. The percentage of unused non-capital losses and farm losses that may reduce part IV tax also increases from 33 1/3 percent to 38 1/3 percent, for taxation years ending after December 31, 2015 and for taxation years beginning before 2016, losses that are applied to reduce part IV tax are first used to offset dividends subject to the higher 38 1/3 percent rate (subsection 186(1)).

Dividend refund rate on taxable dividends paid by a corporation. The dividend refund rate increases from 33 1/3 percent to 38 1/3 percent on taxable dividends paid for taxation years ending after December 31, 2015, and is prorated for taxation years straddling this date (subparagraph 129(1)(a)(i)).

Impact on integration. The table shows for calendar taxation years 2015 and 2016 (1) the income tax deferral (prepayment) if investment income is earned and retained in a corporation

Integration: $10,000 Investment Income—Portfolio Dividends, Capital Gains, and Interest[a] Deferral or (Prepayment)/Saving or (Cost)

	Portfolio dividends		Capital gains		Interest	
	2015	2016	2015	2016	2015	2016
	dollars					
Alberta[b]	(1,231)/ nil	(662)/ nil	(271)/ (187)	(133)/ (210)	(542)/ (373)	(267)/ (420)
British Columbia	(465)/ nil	(703)/ nil	7/ (199)	(98)/ (210)	13/ (397)	(197)/ (419)
Manitoba	(107)/ nil	(55)/ nil	(13)/ (311)	(13)/ (307)	(27)/ (622)	(27)/ (615)
New Brunswick	494/ nil	(206)/ nil	405/ (137)	57/ (191)	808/ (276)	113/ (382)
Newfoundland and Labrador	(176)/ nil	14/ nil	(268)/ (232)	(218)/ (222)	(537)/ (464)	(437)/ (443)
Northwest Territories	(1,052)/ nil	(1,000)/ nil	(155)/ (58)	(155)/ (60)	(312)/ (118)	(312)/ (120)
Nova Scotia[c]	273/ nil	325/ nil	(33)/ (291)	(33)/ (285)	(67)/ (582)	(67)/ (570)
Nunavut	(577)/ nil	(525)/ nil	(308)/ (223)	(308)/ (229)	(617)/ (445)	(617)/ (458)
Ontario[d]	49/ nil	101/ nil	168/ (114)	168/ (122)	336/ (228)	336/ (244)
Prince Edward Island	(463)/ nil	(411)/ nil	(164)/ (303)	(164)/ (298)	(330)/ (607)	(330)/ (597)
Quebec	189/ nil	150/ nil	170/ (90)	137/ (86)	340/ (180)	274/ (171)
Saskatchewan	(852)/ nil	(800)/ nil	(133)/ (196)	(133)/ (202)	(267)/ (393)	(267)/ (405)
Yukon[e]	(1,404)/ nil	(1,352)/ nil	(283)/ (304)	(283)/ (297)	(567)/ (609)	(567)/ (594)

[a] The table shows data for calendar taxation years 2015 and 2016. The table assumes that (1) the individual is taxed at the top marginal income tax rate; (2) portfolio dividends received are designated as eligible dividends; (3) no capital gains deductions are available; (4) the non-taxable portion of the capital gain is distributed as a tax-free capital dividend; and (5) the taxable dividend paid (eligible, for portfolio dividends; non-eligible, for capital gains and interest) generates a full refund of the refundable tax (for 2015: a $3,333 refund on $10,000 of dividends, a $1,333 refund on $4,000 of capital gains, and a $2,667 refund on $8,000 of interest; and for 2016: a $3,833 refund on $10,000 of dividends, a $1,533 refund on $4,000 of capital gains, and a $3,067 refund on $8,000 of interest).

[b] For Alberta, the figures in the table assume that the individual is taxed at Alberta's personal income tax rate on income over $300,000. If the individual's income is $300,000 or less but over $200,000, the figures are as follows: (1) for 2015—(a) portfolio dividends [prepayment ($1,266), saving or cost $0]; (b) capital gains [prepayment ($284), cost ($188)]; and (c) interest [prepayment ($567), cost ($374)]; and (2) for 2016—(a) portfolio dividends [prepayment ($800), saving or cost $0]; (b) capital gains [prepayment ($183), cost ($213)]; and (c) interest [prepayment ($367), cost ($426)].

[c] For Nova Scotia, the figures shown for 2016 assume that Nova Scotia will not table a budget surplus in its 2016-2017 fiscal year. If it does table a budget surplus, Nova Scotia will eliminate the $150,000 bracket and the 21% rate, and will reinstate the 10% surtax on provincial income tax exceeding $10,000; those changes will alter the figures shown.

[d] For Ontario, the figures in the table assume that the individual is taxed at Ontario's personal income tax rate on income over $220,000. If the individual's income is $220,000 or less, but over $150,000 in 2015 and over $200,000 in 2016, the figures are as follows: (1) for 2015—(a) portfolio dividends [prepayment ($166), saving or cost $0]; (b) capital gains [deferral $90, cost ($118)]; and (c) interest [deferral $180, cost ($236)]; and (2) for 2016—(a) portfolio dividends [prepayment ($114), saving or cost $0]; (b) capital gains [deferral $90, cost ($127)]; and (c) interest [deferral $180, cost ($253)].

[e] For Yukon, the figures in the table assume that the individual is taxed at Yukon's personal income tax rate on income over $500,000. If the individual's income is $500,000 or less, but over $138,586 in 2015 and over $200,000 in 2016, the figures are as follows: (1) for 2015—(a) portfolio dividends* [prepayment ($1,707), saving or cost $0]; (b) capital gains [prepayment ($393), cost ($314)]; and (c) interest [prepayment ($787), cost ($629)]; and (2) for 2016—(a) portfolio dividends* [prepayment ($1,655), saving or cost $0]; (b) capital gains [prepayment ($393), cost ($308)]; and (c) interest [prepayment ($787), cost ($615)].

* The figures assume that the combined federal/Yukon eligible dividend tax rate is 16.257% in 2015 (federal of 19.293% plus Yukon of −3.036%) and 21.7777% in 2016 (federal of 24.813% plus Yukon of −3.036%), and that the taxpayer has other income that can be sheltered by Yukon's negative eligible dividend tax rate. If the taxpayer has no other income, the combined federal/Yukon eligible dividend tax rate is 19.293% in 2015 (federal of 19.293% plus nil for Yukon) and 24.813% in 2016 (federal of 24.813% plus nil for Yukon).

as opposed to being earned directly by an individual; and (2) the tax saving (cost) if the after-tax corporate income is paid out as a dividend to the shareholder in the same year.

The table shows that for portfolio dividends, except in Alberta, British Columbia, New Brunswick, Newfoundland and Labrador, and Quebec, the tax prepayment decreased (or the tax deferral increased) by $52 (0.52 percent) from 2015 to 2016. This result follows because the top federal eligible dividend tax rate increased by 5.52 percent (from 19.29 percent in 2015 to 24.81 percent in 2016) and the part IV tax rate (which is netted) increased by 5 percent (from 33 1/3 percent in 2015 to 38 1/3 percent in 2016). For capital gains and interest, except in Alberta, British Columbia, New Brunswick, Newfoundland and Labrador, and Quebec, the tax deferral or prepayment remained unchanged in 2016 and the tax cost either increased or decreased minimally. The results differ in Alberta, British Columbia, New Brunswick, and Newfoundland and Labrador because of changes in provincial top personal income tax rates (in Alberta, the top rate increased from 11.25 percent in 2015 to 15 percent in 2016; in British Columbia, the top rate decreased from 16.8 percent in 2015 to 14.7 percent in 2016; in New Brunswick, the top rate decreased from 25.75 percent in 2015 to 20.3 percent in 2016; in Newfoundland and Labrador, the top rate increased from 14.3 percent in 2015 to 15.3 percent in 2016) and because of increases in provincial corporate tax rates (in Alberta, from 10 percent to 12 percent on July 1, 2015; in New Brunswick, from 12 percent to 14 percent on April 1, 2016). The Quebec results are anomalous because of the impact of the abatement that reduces by 16.5 percent the federal personal tax rates that apply in that province.

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Education and Textbook Credit for Medical Resident

A technical interpretation (2015-0592051I7, August 24, 2015) reverses the CRA's previous position and confirms that an individual who is registered in a medical residency program may now be eligible for the education and textbook tax credits. The change in position is based on a 2014 TCC decision. The CRA says that this new position applies prospectively to 2014 and subsequent tax years for a medical resident in a qualifying educational program. The revised position is consistent with that taken in a previously issued French TI (2014-0551931E5, February 4, 2015).

The CRA says that in order for the medical resident to be eligible for the credit, a designated educational institution must issue a valid form T2202A ("Tuition, Education, and Textbook Amounts Certificate") in respect of the medical resident. To issue a form T2202A, the educational institution must be satisfied that its medical residency program meets the definition of a qualifying educational program (or specified educational program) and that the medical resident is enrolled as a full- or part-time student. The TI does not address the tuition tax credit because a medical resident does not generally pay tuition.

The amount of the education credit is determined under subsection 118.6(2) by formula for each month in the calendar year during which the student is enrolled at a designated educational institution either in a specified educational program (which provides that a student spend not less than 12 hours per month on courses in the program) or as a full-time student in a qualifying educational program, which is defined in subsection 118.6(1). A qualifying educational program generally means a program of at least three consecutive weeks that requires each student to spend at least 10 hours per week on courses or work in the program; a specified educational program has no hours-per-week requirement.

For 2006 and subsequent years, under subsection 118.6(2.1) a student may claim a textbook tax credit determined by formula for each month in which he or she may claim an education tax credit. The CRA's previous position denied a medical student the education and textbook credits (TI 2011-0396601E5, October 3, 2011): in general, the CRA viewed a medical resident as an employee in a training program and not as a student in a qualifying educational program.

The TI says that the new position generally applies to situations that are similar or identical to the one considered by the TCC, which involved a postgraduate medical residency program administered through a school of medicine at a university in conjunction with an affiliated hospital. In that particular situation, under the supervision of senior physicians, a medical resident worked 50 or more hours a week in the hospital for salary and attended from two to four hours of academic courses per month. In addition, a medical resident paid a registration fee to the university but did not pay tuition.

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