Tax Notes - April

Some CRA Missives

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Since the New Year, the CRA has released a number of "interesting" missives – so interesting that a full-scale article could be written on each item I am about to discuss. But I will hit only the highlights.

Partnerships

In my last article, I talked about the changes to joint ventures – particularly the fact that the CRA now requires that income from joint ventures be calculated based on the fiscal period of the particular taxpayer (as opposed to fiscal periods of the joint venture ending in the particular year). This obviously puts pressure on tax reporting of corporate-owned real estate co-ownerships and the like. But apparently the CRA does not play favourites: it has beefed-up the reporting for partnerships. The revised schedule 50 requires disclosure of the adjusted cost base and the "at-risk amount" of each partner's interest in the partnership. Additionally, schedule 9 requires disclosure of all persons affiliated with the partnerships. Details are contained, for example, in a PWC tax memo dated March 3rd (#2012-10). Happily, as stated in the memo, the CRA has since confirmed that it will not impose penalties on T5013 returns for 2011 fiscal periods as a result of incomplete ACB or at-risk information, and if schedule 9 is prepared to the best knowledge and ability of the partnership and preparer. The CRA has also announced that it will accept returns containing either the 2010 or 2011 version of schedule 50 if the return is filed on the due date, and contains complete information on partner identification, and the annual transactions between the partners and the partnership.

So, subject to these caveats, preparers are off-the-hook - for now. However, the 2011 Guide for Partnership Information Returns (T4068(E)) reads like a course in partnership taxation, with a half dozen pages devoted to schedule 50. Also, the CRA requirements beg the question of whether, for many partnerships, it is possible to prepare this information. For example, the ACB balance might depend on transactions between partners, deemed dispositions (for example, on the death of a partner), etc. Also, for long-standing partnerships, the information may be, literally, ancient

history, requiring information to be called from storage, if in fact it is available and the documentation hasn't been lost or destroyed.

It's getting to the point where the complexity of tax compliance for partnerships and joint ventures could be a material impediment to the viability of these business structures. If the CRA had wanted the information, why didn't it tell us years ago, when the logistics of the calculations for longstanding partnerships were still reasonably feasible.

Having said this, I can see the CRA's new requirements being beneficial to many partners, particularly in professional partnerships: in many cases, the partnership interest's ACB will be in excess of its capital because of non-deductable items (e.g., 50% of most entertainment expenses), which effectively increase ACB but not partnership capital. I suspect that, when many partners terminate their interests in partnerships, this latent capital loss is ignored, due to the difficulties of doing the calculation. But over the course of a professional's career, these adjustments can really mount up. And the CRA's new requirements will, of course, make the calculation a cinch - not to mention that the capital loss may come in very handy.

Spouse Trusts

In the last few months, the CRA has released several missives pertaining to spouse trusts. One of these, Doc. No. 2011-0430261E5 (December 28th, 2011) caught my eye.

As many readers are aware, subsection 104(2) gives the CRA the power to lump multiple testamentary (and other) trusts together and treat them as a single trust. One of the main results is that, if there is a single trust, the ability to split income in low tax brackets for testamentary trusts will be restricted.

Over the years, the CRA has released several Technical Interpretations on this power. Likewise, my colleagues have written a number of articles on subsection 104(2), often focusing on the ability to multiply trusts, and thus gain multiple-access to lower tax brackets. Trouble is, in this era of low-interest rates, the capital required to pull off these manoeuvres is limited to families with summer homes on an island in Lake St. Joe's, and the like. Also, in many cases, complications will arise where family wealth is bottled up in corporations (e.g., drafting to facilitate post-mortem tax-planning options).

Anyway, the thing that caught my eye in the Technical relates to a seemingly-typical testamentary spouse trust will: trust number 1, spouse for life remainder to child X trust number 2, spouse for

life remainder to child Y, etc. The CRA indicated that it would indeed apply subsection 104(2) to bust the would-be multiplication of low tax brackets. Unlike the often-canvassed situation where separate trusts are set up for particular children, the CRA noted that there is a common beneficiary - i.e., the surviving spouse - even though the spouse has a only life interest[1]. But note the would-be income splitting advantages during the surviving spouse's lifetime.

Besides this, there have been a number of other intriguing Technicals relating to testamentary spouse trusts, including the availability of tax credits where a will provides for a spouse trust with a specific bequest to be made to charity upon the death of a spouse (Doc. No. 2011-0428021E5, December 14, 2011), and whether income earned by a testamentary spouse trust after the death of the surviving spouse is taxable to the trust or to the residual beneficiary (STEP 2011, Q 4, 2011-041851C6).[2]

Pipelines

It has been awhile since I have written about this topic. As a reminder, a "pipeline" involves the estate of a decedent swapping shares of an Opco to a Holdco for debt in order to extract corporate-level assets equivalent to the cost base of the Opco shares - which is bumped up when the shares pass on death to another generation. The CRA might be tempted to say that this process strips the corporate assets at capital gains rates. As I observed in previous issues of Tax Notes, the procedure was called to attention in a 2009 APFF Round Table Question which canvassed the possible application of subsection 84(2) – deemed dividend treatment - to the repayment of the aforementioned debt.

Trouble is, the issues raised by this antiquated and misunderstood anti-avoidance provision were addressed in a succession of often conflicting articles, CRA Round Tables awaiting formal answers, as well as mainly Francophone rulings. Alas, a comprehensive treatment on the topic would now be the subject of a full-scale paper.

However, a CRA missive recently occurred in the form of a written answer to Question 5 of the 2011 STEP conference (Doc. No. 2011-0401861C6), involving a hypothetical cash corporation, with no activities or business.

Not surprisingly, the CRA refused to confirm that the anti-avoidance provisions in subsection 84(2) would not apply.
Some additional facts and circumstances that could warrant the application of subsection 84(2) could include: the funds or property of the corporation being distributed to the estate in "a short

time frame" following death; and that the nature of the underlying assets would be cash and that original corporation would have "no activities or business ('cash corporation')".

It was also noted that several favourable rulings have been issued on the matter (including one in English, Doc. No. 2011-0403031R3). However, the CRA maintained that these situations, in contrast to the example in question, did not involve "cash corporations" (although perhaps the term differs from an actively managed investment portfolio). Furthermore, in each case, the taxpayers' proposed transactions contemplated, among other things, the continuation of the business for a period of at least a year, followed by a "progressive distribution" of the corporation's assets over an additional period of time. A similar draft answer given to a CRA Round Table question at the 2011 Canadian Tax Foundation annual conference states that the CRA continues to rule on subsection 84(2) on a "case-by-case basis" (and that the foregoing elements are part of the proposed transaction rather than "conditions").

My remarks will be particularly brief. First, although counterarguments may be made (and there are plenty of examples of incongruities from the literal application of this provision), arguments can also be made in favour of the CRA's position on the potential application of subsection 84(2) in this context. As interpreted by a long line of cases stretching back well over a half century, the provision potentially applies where funds or property of a corporation have been distributed or otherwise appropriated *in any manner whatever* to or for the benefit of shareholders of any class *on* the *winding-up, discontinuance, or reorganization* of its *business*[3]. But I stress that the above perquisites must be met. For example, I can see the CRA's objection to a "cash corporation" being stripped based on capital gains rates rather than those of dividends; however, the CRA should make its views on the application of the provision in this context more explicit (e.g., presumably that subsection 84(2) potentially applies because this is a "cash corporation's" business or it is part of the winding-up or discontinuance of its former business).

Also, I wonder if the CRA imposed impediments are really showstoppers? In many cases, the insistence in out-and-out stripping of corporations by beneficiaries of a decedent (i.e., in a manner that is offside subsection 84(2)) may be due to greed, rather than reason. Must the clients be in such a rush to buy a house in Forest Hill? Finally, I wish the Department of Finance would amend section 164(6) – the main alternative to the pipeline - to extend the time limit to three years to generate the capital loss "carryback" to the deceased taxpayer, rather than the first year of the estate. The trouble with this post-mortem procedure is its complications – coupled with the fact that, it often takes months before a grieving family member would even think to run an estate by a professional.

Rental Income and the Small Business Deduction

Another interesting missive is a Technical Interpretation dated February 14th (Doc. No. 2011-0407051E5). The Technical, which gives several hypothetical situations, relates to the issue of whether rental income is income from active business, or more specifically, whether it is "pertaining to" or "incident to" a business. The situations are as follows:

1. A construction company owns a building with a parking lot and receives rental income for the portion of the parking lot that is rented to a neighbouring company.

2. A used car dealership receives rental income from the rental of a portion of its previous location. The car dealership moved to a new location but continues to use a portion of the old location for storage and intends to sell it when the market value increases.

3. A small manufacturing corporation that moves to a larger location and receives rental income from the building where it was located for over 20 years.

4. A used car dealership owns two lots that are side by side. One lot has a trailer and the other a building with four units. The car dealership uses a portion of both lots and receives rental income from the remainder of the building and lot from sub-contractors.

5. The sole shareholder of a holding company owns a property that it rents to the holding corporation, which in turn is rented to an operating company. The two corporations are associated.

The CRA accepts situation 1 as active business income, and points out that situation 5 will be governed by subsection 129(6), which generally deems investment income from an associated corporation to be active business income. However, the CRA, in its wisdom deeds situations 2 through 4 to be ineligible for the small business deduction.

Part of me is saying, what do I think they were going to say? Be that as it may, the CRA cites no authority for its positions. The letter concludes that this determination is always a question of fact; whether a corporation qualifies for small business deduction can only be made "based on the complete review and the principal purpose of a corporation's business, which must be determined annually after all the facts relating to that business are considered".

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[1]See also Doc. No. 9714835 (June 30th, 1997), a similar situation, in which the CRA appears to be non-committal. Also, Doc. No. 9306245 (May 20, 1993), involved a situation where separate trusts were purported to be created for each of a testator's several children but the wife of the testator was made a "co-beneficiary of all the trusts". The CRA stated that applicability of subsection 104(2) of the Act would be more likely than if each trust had a separate and distinct beneficiary.

[2] See the November issue of *Tax Hyperion* for further discussion on recent Technicals relating to spousal trusts.

[3] For a recent discussion of the jurisprudence, see "Estate Planning – Hot Topics" Oakey, 2011 Atlantic Provinces Tax Conference (Canadian Tax Foundation, unpublished at time of writing).

The deemed dividend is based on the amount or value of the funds or property distributed or appropriated, in excess of the amount, if any, by which the paid-up capital in respect of the shares [it seems to me: of the particular corporation] of that class is reduced on the distribution or appropriation.