CCH Tax Notes – July 2012

Price Adjustment Clauses and Other Minutiae

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Only a tax drone would have the chutzpah to come up with a price adjustment clause. You'd think that such a clause would apply, say, if a beneficiary was being ripped off. But in most cases they're only operative in the event of a dust-up with the CRA, or other taxation authority. It's no wonder that these clauses have had a mottled history. In recent months, courts have struck down clauses as ineffective because they were deficient in dealing with a structural problem (when a retraction right required the cooperation of another party) or when values were not "determined" by a court or taxation authority as required by the clause itself.

In Doc. No. 2011-0429991E5, May 24th, 2012, the CRA was asked to comment on a situation where an estate freeze in favour of a taxpayer's child was done in year-1. The freeze was done as standard section 86 reorganization, and included price-adjustment clauses relating to the "Freeze Shares". After the death of the taxpayer in year-16, his estate requested a clearance certificate under subsection 159(2). The CRA then found that the Freeze Shares were undervalued.

The CRA stated that, assuming that it recognizes the PAC as being valid, its position is that the PAC would "generally have a retroactive effect back to the moment of the transaction to which the PAC is applicable." In other words, the CRA believes that it can adjust the value of the Freeze Shares on a taxpayer's death.

The CRA is of the view that generally, if there is a "significant discrepancy" between the FMV established by the CRA and the one established by the taxpayer, it may indicate that the taxpayer did not make a "real effort" to determine the FMV of the property; then the PAC would not be valid.

If the PAC is not valid, there would be no adjustment of the Freeze Shares back to Year-1, "but it could be argued that using an unfair and unreasonable valuation method with respect to the valuation of the Freeze Shares could be considered for the purposes of the application of subparagraph 152(4)(a)(i) as a misrepresentation attributable to neglect, carelessness or wilful default, thus allowing the CRA to make a reassessment in Year-1 in order to apply subsection 86(2) to the Taxpayer" - i.e., the excess between the FMV of the old common Shares and the redemption value of the Freeze Shares at the time of the freeze would be assessed as a benefit that the taxpayer desired to have conferred on the related person for the application of subsection 86(2) (a deemed capital gain for the taxpayer). Also not surprisingly, the CRA further indicated that in the absence of an operative PAC, the excess would consequently increase the FMV of the new common shares; thus when the related person would sell the new common shares of the capital of OPCO, the related person would probably be taxable on the excess. Finally, when the related person would subsequently sell the "new" common shares of the capital stock of OPCO, paragraph 110.6(7)(b) could apply to deny the capital gains exemption.

In reference to its position in respect of a valid PAC being retroactive to the time of the original freeze, the CRA cites *Gurberg* (2006 QCCA 867 (CanLII)), a French-language case involving Quebec provincial taxation[i]. However, the issue would presumably depend on the wording of the particular PAC. And the real point may be that this could be a sign of things to come.

Recapture – Active? Passive? Both?

Doc. No. 2012-0440781E5 (May 9) involved a corporation selling a building which for a significant period was rented to an associated company that was carrying on an active business, so that the rental income was considered to be active business income (under subsection 129(6)). However the active business was sold some years earlier, so that CCA was subsequently claimed against passive rental income. The CRA indicated that where subsection 129(6) deems rental income to be active business income and CCA on the rented building was deducted in calculating active business income, any recapture of CCA on the disposition of the building would also be considered to be active business income. However, since CCA was only deducted in calculating active business for some of the years of ownership, it is the CRA`s view that it would be "reasonable to allocate the recapture of CCA in the same manner in which it was claimed". Although no further elaboration was made as to the specific method of pro-ration[ii], a similar question recently released in French (2011-0413891I7, December 15, 2011) appears to indicate that the pro-ration could be based on the number of years the property generated income from an active business relative to the number of years it generated income from property. (It was also observed in the latter Technical that no provision in the Act specifically supports the basic pro-ration methodology in question.)

As noted, the situation involved Holdco renting to an Opco; one would think that similar comments would apply for a corporation with direct use of depreciable property in similar activities; however, several older Technicals provide different results, by and large focusing of use at the time of disposition rather than a historical determination (see, for example, 2000-0049105, AC58315 and AC57890; see also par. 9 of IT-73R6). Whether Doc. No. 2012-0440781E5 is a change of CRA policy in the more straightforward situation remains to be clarified.

RDTOH - The Three-Year Trap

As commentators have recently pointed out, if a corporate return is not filed within three years after the year of the payment of a dividend, the CRA will deny the dividend refund. This can be a real trap; consider, for example, a Holdco which pays dividends to offset its Part IV tax and neglects to file tax returns because they appear to be "nil". But it could get even worse: often, the CRA's pre-existing policy was not to add the amount of the denied dividend refund back to RDTOH. Happily, *Tawa Developments Inc.* v. *The Queen,* 2011 DTC 1324 (which also affirmed the above "three year trap"), held that the RDTOH is <u>not</u> reduced by the amount of the dividend refund was denied because the tax return wasn't filed within the three-year period.

The more recent case of *Ottawa Ritz Hotel* (2012 TCC 166) also supports the result in *Tawa* (although the case mainly concerns penalties for failure to file corporate tax returns, there is approving references to *Tawa* in pars. 4 and 5). By the way, the denied dividend refund cannot be applied to another tax liability under subsection 129(2) nor can it be re-appropriated for use against other tax debts under section 221.2 - see Doc. Nos. 2011-0421291I7, 2011-0405701I7, and 2011-0421291I7.

Canadian-controlled private corporations and Unanimous Shareholders Agreements

Per paragraph (b) of the definition of Canadian Controlled Private Corporation in subsection 125(7), non-residents' and public corporations' shareholdings must be notionally attributed to one "hypothetical person"; if that person would control the corporation then the corporation is not a CCPC. (This rule is to counter a case - *Silicon Graphics Ltd*., 2002 DTC 7112, FCA - which would require a common connection between non-residents and/or public companies.) The CRA has taken the position that a unanimous shareholders' agreement is irrelevant for the purpose of the determination of whether the "hypothetical person" would control the corporation (see 2009 RCRT Q. 13 & 14/ITTN #44). However, the validity of this position is questionable in view of the recent *Price Waterhouse Coopers Inc.* case (2012 DTC 1142, TCC). In that case, the court held that the hypothetical shareholder should have the same rights as the non-resident shareholders and would be bound by a unanimous shareholders' agreement. This case, of course, is significant as the terms of the agreement could restrict the voting rights of non-residents and/or public corporations and thus result in CCPC status. In the case of a corporation with investment income and/or capital gains, an interesting question is whether this is desirable: without the refundable tax system, corporate tax rates are lower.

RRSPs and the 2011 federal Budget

In previous months, many accounting and law firm releases have pointed out the pitfalls of the RRSP rules brought in by the 2011 federal Budget (including these pertaining to prohibited RRSP investments, "advantages", the "swap rules", etc.). A six-page comfort letter dated June 13th was sent by the Department of Finance to the Joint Committee on Taxation **[CCH – please insert internet link to document]**, containing details of proposed rules that would ameliorate some of the harshness of the new rules. For example, the rules would remove the ten-year period for so-called "transitional prohibited investment" rules, so that these rules will apply indefinitely. Furthermore, a new exclusion from "prohibited investment" status will be included[iii], and so on.

Trouble is, these rules are already law - implemented as part of Bill c-13 (which received Royal Assent back in December). The technical amendments will coincide with the effective date of the Budget 2011 measures, and apply likewise to TFSAs where relevant. So add one more piece of proposed legislation to the already considerable stockpile.[iv]

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[i] In that case, the PAC stated that the FMV would be subject to revision in accordance with any binding agreement with, or decision by, the appropriate taxation authorities, or any judgment of a court of competent jurisdiction. Because a binding agreement was reached with Revenue Canada, the Court was of the view that the PAC was also applicable for the Quebec provincial reassessment with retroactive effect to the date of the freeze, notwithstanding that the freeze date was statute-barred.

Gurberg was also cited in Doc. No. 2012-0437001I7 (also concerning price adjustment clauses), which was released shortly after Doc. No. 2011-0429991E5.

[ii] However, it might be inferred from the Technical that recapture is pro-rated based on percentage of CCA claimed against passive/active income.

[iii] An investment is excluded from "prohibited investment" status if all of the following are satisfied:

1. persons who deal at arm's length with the controlling individual of the registered plan hold at least

    a. 90% of the "equity value" (as defined in subsection 122.1(1) of the Act);

    b. 90% of the total of the "equity value" plus the outstanding debt of the organization; and

    c. 90% of the total votes associated with the "equity" (as defined in subsection 122.1(1) of the Act);

2. one or more persons who deal at arm's length with the controlling individual own equity that has terms and conditions that are substantially similar to the terms and conditions of the investment that is held by the registered plan, and if that equity owned by those arm's length persons was acquired by a particular individual, that individual would be a specified shareholder or a specified unitholder of the organization determined, if the class of equity owned by the controlling individual is separate from the class owned by those arm's length persons, as if those classes of equity were one class;

3. the controlling individual deals at arm's length with the organization; and

4. none of the main purposes of the controlling individual in the acquisition or holding of the investment by the registered plan is to obtain an advantage (other than income or capital gains on the investment).

[iv] A process which has recently come under criticism in terms federal Budget procedures – see “Is it Time for Finance to Revisit Draft Legislation Process?”, Ryan Keey, *General Corporate Tax*, June 2012, Carswell.