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UNIT #1 – AN OVERVIEW OF ESTATE PLANNING

Defining "Estate Planning"

- Commonly-used term to describe a variety of activities by a variety of different persons/professionals.
- For instance:
    - maximizing income/wealth generation
    - succession planning (transferring wealth between generations or selling/dissolving a business)
    - finding beneficial tax outcomes
    - testamentary planning – planning for death
    - trusts, wills, personal directives (health/non-financial decisions, kids, etc.)/powers of attorney (dealing with property)
    - planning for retirement
    - investment planning/management
    - life/disability insurance
    - powers of attorney/personal directives + will, trusts
        - Note: power of attorney empowers somebody with power over financial matters; personal directives empower someone with health/non- financial decisions

Definition of estate planning: lifetime and testamentary legal, financial and tax planning, directed at the accumulation of wealth, its use, and its disposition for the benefit of succeeding generations and, at all times, its protection from unnecessary erosion.

Who's involved?: lawyers, accountants, financial advisors, life insurance agents, family members, medical advisors, social workers

- Estate planning is a lifetime endeavor that all Canadians should be concerned with throughout their life.

OVERVIEW OF CANADIAN INCOME AND WEALTH:

- There are 2 primary measures that you can focus on to determine how an individual or family unit is doing financially–
    - **income** and **net worth** (fair market value of assets less debts)
- Important to look at both measures when planning:
    - both measures important; may be more important at different points in an individual's life (older people will have greater net worth)
        - Income – important to show how net worth can be built and to show how much can be disposed in short term
        - Net worth – important because many assets can hold more significant value than annual income e.g. houses, land
    - High income + low net worth – probably need to approach budgeting.
    - Low income + high net worth – need to help plan as to how to get income from assets

(i) Income in Canada:

- Individuals in the Top 1% need to make at least $215,700 pre-tax and $154,700 after-tax.
    - Collectively, they earn 10.3% (pre-tax) and 8.4% (after-tax) of all Canadians' income.
    - Finally, 80% of these individuals are male.
- Individuals in the **Top 10%** need to make **at least $86,700 pre-tax** and **$69,800 after-tax**.
    - Collectively, they earn 24.6% (pre-tax) and 22.8% (after-tax) of all Canadians' income.
    - The **average** pre- and after-tax income of the Top 10% is $118,100 and $107,250 respectively
- Individuals in the Top 50% need to make at least $30,700 pre-tax and $28,100 after-tax.
    - Collectively, they earn 48% (pre-tax) and 49.3% (after-tax) of all Canadian's income.
- **Single Persons:** bottom 20% - up to $13,300; top 20% - more than $51,601; **average - $37,800**.
    - average income for a single Albertan is roughly $47,300
- **Families:** bottom 20% - up to $39,100; top 20% - more than $119,001; **average - $91,500**
    - $110,900 average for an Albertan family
    - The top 10% of Alberta families get 28% of the after-tax income, whereas the bottom 10% of families get only 1.7%

(ii) Net Worth in Canada:

- Single Persons: bottom 20% - up to $2,468 (and likely most owe more than they own);
  - top 20% - $455,877 and up
- Families: bottom 20% - up to $67,970; top 20% - more than $1,139,488
- Another interesting (but not surprising) statistic:
  - most of Canadian's net worth is in real estate
- As article notes, it doesn't take much to be part of the so-called "middle class"

Summary points:

- When you are dealing with the masses, most are not at the highest levels
- Vast majority of Canadians do not have large net worth or income; so large portion of population can benefit from advice even though they are not dealing with large amount of assets

OVERVIEW OF THE ESTATE PLANNING PROCESS – GENERALLY 4 STEPS

STEP #1: INFORMATION GATHERING

- a large part of being a good estate planner is about being a good and active listener. A good estate planner will know a lot about their client – more than you might appreciate. Types of things you need to know:
  - What sort of financial resources they have; verification (they might not know)
  - Dependents
  - Goals (what they want to do)
  - Time frame
  - Relationships (financial – business, partners; personal)
  - Relevant history (financial, criminal)
  - Lifestyle – net worth, income
  - Needs (look after children, financial resources)
  - Health issues (the clients, kids – trust, ex. for disabled children, parents)
  - Spending habits
  - Income prospects (better to contribute into RSPs later in life when you are making greater income; save in another vehicle while in a lower income bracket)

STEP #2: DEVELOPING THE PLAN

- this will likely involve several different options for the client and you to consider. This will also involve a discussion of the tax and non-tax implications of each alternative
  - Note: in many cases getting the client involved makes them more integrated in the plan, they have more invested in the process (collaborative approach).
  - Goal: keep client involved throughout process; enhances the information gathering

STEP #3: IMPLEMENTATION OF THE PLAN

- while you might think this is an obvious and important step that is done by the estate planner, in many real life cases, the implementation is not done by the planner (or at least by the planner alone) but by the client himself/herself or other individuals (i.e. family lawyer, accountant, bank advisor, etc.)
  - The importance of this step cannot be overlooked or underestimated. Many great estate plans end up in court (or are re-assessed by the CRA) because they were not properly or completely implemented.
  - This was the key problem in ***Antle v. R.***, [2010] 4 C.T.C. 2327 (T.C.C.) which was affirmed by the FCA 2010 CarswellNat 3894 at para 58.
    - In concluding that the taxpayer's plan to avoid taxes on capital gains using a trust failed, Justice Campbell Miller stated, "With certainty of intention and certainty of subject matter in question and, more significantly, no actual transfer of shares, there is no properly constituted trust: the Trust never came into existence. **This conclusion emphasizes how important it is, in implementing strategies with no purpose other than avoidance of tax, that meticulous and scrupulous regard be had to timing and execution.**
    - Backdating of documents, fuzzy intentions, lack of transfer documents, lack of discretion, lack of commercial purpose, delivery of signed documents distributing capital from the trust

prior to its purported settlement, all frankly miss the mark — by a long shot. They leave an impression of elaborate window dressing. **In short, if you are going to play the avoidance game, it is not enough to have brilliant strategy, you must have brilliant execution.**"

- Often, an estate planner will develop a plan and issue a planning letter that will be implemented by the client's general lawyer, accountant, etc. Also common is the situation where the estate planner is effectively a member of a "team" that will implement the plan (i.e. accountant, financial advisor, life insurance consultant, etc.)
- In any case, a good estate planner will be actively involved in the implementation stage.
  - even if the client wishes it, it is a disservice to develop the plan and then walk away.
  - should try to be somewhat involved in the implementation, at least in oversight capacity; likely to blame planner if something goes wrong.
- **Important Point:** You should always consider whether your tax planning can be changed or undone if necessary - the more inflexible the plan, the more caution you should exercise before implementing it.

Question: what if a "mistake" is made in the implementation of estate plan? Can the affected parties apply to the court to exercise its equitable powers of "rectification"[1] to fix the mistake?

- This was the issue recently addressed by the Supreme Court of Canada in ***Attorney General of Canada v Fairmont Hotels Inc.***, 2016 SCC 56[2]

CANADA (ATTORNEY GENERAL) V. FAIRMONT HOTELS INC., 2016 SCC 56 – RECTIFICATION UNAVAILABLE TO CHANGE AGREEMENT TO AVOID UNPLANNED AND ADVERSE TAX LIABILITY, EVEN WHEN INTENDED FROM OUTSET OF CONTRACT

Ratio: rectification may not be used to change an agreement solely because a party has discovered that its operation generates an adverse and unplanned tax liability

Facts: Fairmont Hotels Inc. was involved in the financing of Legacy Hotels' purchase of two other hotels, in U.S. currency.

- As the hotels were purchased (and financed) with U.S. funds, it opened Fairmont to a potential foreign exchange tax liability. To mitigate this risk, Fairmont entered into various financial agreements (hedging transactions).
  - Its intention from the outset and at all times thereafter was to achieve foreign exchange tax neutrality (i.e. no Canadian tax gains or losses resulting from foreign currency fluctuations in respect of its financing of Legacy's acquisitions).
- When Fairmont was later acquired, that intention was frustrated, however, since the acquisition would cause Fairmont and its subsidiaries to realize a deemed foreign exchange loss.
- The parties to Fairmont's acquisition therefore agreed on a plan, which allowed Fairmont to hedge itself against any exposure to the foreign exchange tax liability, but not its subsidiaries. There was no plan for protecting them from such exposure because the plan was deferred.
- The following year, Legacy Hotels asked Fairmont to terminate their financing arrangement to allow for the sale of the two other hotels. Therefore, Fairmont redeemed its shares in its subsidiaries, by resolutions passed by their directors. This resulted however in an unanticipated tax liability.
  - Fairmont's decisions in 2007 to terminate its loan arrangements to Legacy and redeem certain preferred shares (on Legacy's urgent request in anticipation of selling the U.S. hotels) resulted in a large foreign exchange gain to Fairmont (as determined by the CRA in a subsequent review of the transactions)

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[1] Generally speaking, the doctrine of rectification in the tax context allows a court to correct a mistake in transactions that produces (or may produce in the future) unintended and adverse tax consequences. Put another way, it allows a court to give effect to the taxpayer's intentions, which were not properly implemented. Note: as this is an equitable remedy, it can only be granted by a court of equity (i.e. a superior court in a province); the Tax Court does not have equitable jurisdiction.

- As this was a "mistake" in Fairmont's view (i.e. contrary to its intentions, planning, and transactions to date), Fairmont brought an application to the Ontario Superior Court of Justice to "rectify" the 2007 transactions.
- The CRA opposed the application on the basis that this was not a proper case for rectification, but rather an attempt at retroactive tax planning.
- Both the application judge and the Court of Appeal granted that rectification on the basis of the parties' intended tax neutrality.
- The courts rectified Fairmont's transactions to eliminate the triggered foreign exchange gain.
    - This was accomplished by undoing Fairmont's share redemptions and instead creating loans between Fairmont and its subsidiaries (which would avoid triggering foreign exchange gains).

Issue: conditions under which a taxpayer may ask a court to exercise its equitable jurisdiction to rectify a written legal instrument, where the effect of that instrument was to produce an unexpected tax consequence

Decision: Appeal allowed; the parties' intention of tax neutrality could not support a grant of rectification.

- Rectification is an equitable remedy designed to correct errors in the recording of terms in written legal instruments. It is limited to cases where a written instrument has incorrectly recorded the parties' antecedent agreement; it is not available where the basis for seeking it is that one or both of the parties wish to amend the agreement itself.

Reasoning:

- rectification allows a court to achieve correspondence between the parties' agreement and the substance of a legal instrument intended to record that agreement, when there is a discrepancy between the two.
        - Its purpose is to give effect to the parties' true intentions, rather than to an erroneous transcription of those true intentions
    - For an error from a mistake common to both or all parties to the agreement, rectification is available upon the court being satisfied that, on a balance of probabilities:
        - there was a prior agreement whose terms are definite and ascertainable; that the agreement was still in effect at the time the instrument was executed; that the instrument fails to accurately record the agreement; and that the instrument, if rectified, would carry out the parties' prior agreement.
    - In the case of a unilateral mistake, the party seeking rectification must also show that the other party knew or ought to have known about the mistake and that permitting the defendant to take advantage of the erroneously drafted agreement would amount to fraud or the equivalent of fraud.
- clear that Fairmont intended to limit, if not avoid altogether, its tax liability in unwinding the Legacy transactions
    - And, by redeeming the shares in 2007, this intention was frustrated.
    - Without more, however, these facts do not support a grant of rectification.
    - they could not show that they had reached a prior agreement with definite and ascertainable terms.
- "…the court's task in a rectification case is…to restore the parties to their original bargain, not to rectify and belatedly recognized error of judgement by one party or the other" (para 13)
- position is consistent with the principle the Supreme Court enunciated in Shell Canada Ltd:
    - "that a taxpayer should expect to be taxed based on what it actually did, not based on what it could have done… taxpayers should not be judicially accorded a benefit based solely on what they would have done had they known better" (para 23)

STEP #4: REVIEW OF THE PLAN

- people change, people's situations change, change is a given. A good estate planner takes this into account and checks back with the client from time to time to see if the existing estate plan is still the best plan.
    - Important to consider whether the strategy you are advising can be undone; the more permanent, the more you want to emphasize that to your client.
        - Example: Harold Balor, wealthy man who owned T.O. Maple Leafs. Implemented an estate freeze to convert his common share equity interest in his business into preferred shares, issued new common shares to his kids - they had the votes in the corporation.
            - Eventually he was fighting with his kids, who he thought were ruining his business, but there was nothing he could do because he relinquished control over the corporations.

ESTATE PLANNING OVER A PERSON'S LIFETIME

- Depending on your stage in life, different things will be important (different resources, different needs; things you should be concerned with change)
- Lifecycle of an estate plan
- Certain types of estate planning are more appropriate at certain stages in a person's life

UNIT #2 – INTRODUCTION TO THE TWO FORMS OF ACCEPTABLE TAX PLANNING

INTRODUCTION TO ACCEPTABLE AND UNACCEPTABLE FORMS OF TAX PLANNING

- One very basic but still very important question that any tax practitioner (and indeed any lawyer) must continually ask himself/herself is **whether what he or she is doing (or being asked to do) is (a) legal and (b) ethical.**
    - **Can** I do what my client is asking me to do?
    - **Should** I do what my client is asking me to do?

CODE OF PROFESSIONAL CONDUCT (CODE)

- The Code has several rules which help lawyers address these questions, including:
    - **Rule 2.1-1 Integrity** - a "lawyer has a duty to carry on the practice of law and discharge all responsibilities to clients, tribunals, the public and other members of the profession honourably and with integrity".[3]
        - This is operationalized with a thorough information gathering step, ensuring there are no conflict of interests, knowing the client and their needs/objectives, staying within the law, recognizing your own resources, identifying limitations to the client, seeking counsel when required, being transparent
        - Think about whether, if what you were doing was exposed publicly, how would you, your firm, and the legal community feel/respond
    - **Rule 3.2- Honest and Candour** - "[w]hen advising a client, a lawyer must be honest and candid and must inform the client of all information known to the lawyer that may affect the interests of the client in the matter".[4]
    - **Rule 3.2-13 Fraud by Client,** which provides that "[w]hen acting for a client, a lawyer must not advise or assist a client to commit a fraud, crime, or illegal conduct, nor instruct the client on how to violate the law and avoid punishment".[5]

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[3] **Commentary 2** states, "[p]ublic confidence in the administration of justice and in the legal profession may be eroded by a lawyer's irresponsible conduct. Accordingly, a lawyer's conduct should reflect favourably on the legal profession, inspire the confidence, respect and trust of clients and of the community, and avoid even the appearance of impropriety".

[4] **Commentary 3** states, "[o]ccasionally, a lawyer must be firm with a client. Firmness, without rudeness, is not a violation of the rule.

[5] **Commentary 1** states, "[a] lawyer should be on guard against becoming a tool or dupe of an unscrupulous client, or of others, whether or not associated with the unscrupulous client".

Commentary 2 states, "[a] lawyer should be alert to and avoid unwittingly becoming involved with a client engaged in criminal activities such as mortgage fraud or money laundering.

Commentary 3 states, "[b]efore accepting a retainer, or during a retainer, if a lawyer has suspicions or doubts about whether he or she might be assisting a client in dishonesty, fraud, crime or illegal conduct, the lawyer should make reasonable inquiries to obtain information about the client and about the subject matter and objectives of the retainer. These should include verifying who are the legal or beneficial owners of property and business entities, verifying who has the control of business entities, and clarifying the nature and purpose of a complex or unusual transaction where the purpose is not clear. The lawyer should make a record of the results of these inquiries".

Commentary 4 states, "[t]his rule does not apply to conduct the legality of which is supportable by a reasonable and good faith argument. A *bona fide* test case is not necessarily precluded by this rule and, so long as no injury to a person or violence is involved, a lawyer may properly advise and represent a client who, in good faith and on reasonable grounds, desires to challenge or test a law and the test can most effectively be made by means of a technical breach giving rise to a test case.

- **Rule 3.2-14 Fraud when Client an Organization**, which provides that, "[a] lawyer who is employed or retained by an organization to act in a matter in which the lawyer knows that the organization has acted, is acting or intends to act fraudulently, criminally or illegally, must do the following, in addition to his or her obligations under Rule 3.2-13
  (a) Advise the person from whom the lawyer takes instructions and the chief legal officer, or both the chief legal officer and the chief executive officer, that the conduct is or would be fraudulent, criminal or illegal and should be stopped;
  (b) If necessary because the person from whom the lawyer takes instructions, the chief legal officer or the chief executive officer refuses to stop the conduct, advise progressively the next highest persons or groups, including ultimately, the board of directors, the board of trustees, or the appropriate committee of the board, that the conduct is or would be fraudulent, criminal or illegal and should be stopped; and
  (c) If the organization, despite the lawyer's advice, continues with or intends to pursue the unlawful conduct, withdraw from acting in the manner in accordance with Rule 3.7
- **Rule 3.3-1 Confidential Information,** which provides that "[a] lawyer at all times must hold in strict confidence all information concerning the business and affairs of a client acquired in the course of the professional relationship and must not divulge any such information unless:
  (a) expressly or impliedly authorized to do so by the client;
  (b) required by law or a court to do so:
  (c) required to deliver information to the Society; or
  (d) otherwise permitted by this rule".
- **Rule 3.3-4 Disclosure of Confidential Information by Lawyers,** which provides that "[i]f it is alleged that a lawyer or the lawyer's associates or employees:
  (a) have committed a criminal offence involving the client's affairs;
  (b) are civilly liable with respect to a matter involving a client's affairs;
  (c) have committed acts of professional negligence; or
  (d) have engaged in acts of professional misconduct or conduct unbecoming a lawyer;
  the lawyer may disclose confidential information in order to defend against the allegations, but must not disclose more information than is required.
- **Rule 3.3-6** provides that "[a] lawyer may disclose confidential information to another lawyer to secure legal or ethical advice about the lawyer's proposed conduct".

INCOME TAX ACT

- Arguably, the *Income Tax Act* (Act) is fairly definite about what types of tax planning constitute a criminal or civil offence, and hence are clearly things that a tax advisor cannot do or be involved with.

CRIMINAL OFFENCES – E.G. S. 239 OF THE INCOME TAX ACT

The primary provision is **section 239,** which generally provides that **anyone** who:

- Makes, participates in, assents to or acquiesces in the making of a false or deceptive statement (**paragraph 239(1)(a)**),

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Commentary 5 states, "[t]his rule is not intended to prevent a lawyer from fully explaining the options available to a client, including the consequences of the various means of proceeding, or from representing after the fact a client accused of wrongful conduct. However, a lawyer may not act in furtherance of a client's improper objective. An example would be assisting a client to implement a transaction that is clearly a fraudulent preference.

Commentary 6 states, "[t]he mere provision of legal information must be distinguished from rendering legal advice or providing active assistance to a client. If a lawyer is reasonably satisfied on a balance of probabilities that the result of advice or assistance will be to involve the lawyer in a criminal or fraudulent act, then the advice or assistance should not be given. In contrast, merely providing legal information that could be used to commit a crime or fraud is not improper since everyone has a right to know and understand the law. Only if there is reason to believe beyond a reasonable doubt, based on familiarity with the client or information received from other reliable sources, that a client intends to use legal information to commit a crime should a lawyer decline to provide the information sought".

- Willfully evades or attempts to evade compliance with the Act or payment of taxes imposed by the Act (**paragraph 239(1)(d)**), or
- Conspires with any person in one or both of these regards (**paragraph 239(1)(e)**)
- Is guilty of a criminal offence and may be subject monetary penalties and time in jail.

S. 239 Notes:

- **Section 239** is a hybrid offence. The Crown can proceed summarily or by indictment – see **subsection 239(2)**)
  - If the Crown proceeds summarily, then **paragraphs 239(1)(g) and (h)** set out the penalties
    - Up to two years in prison and/or monetary fine of not less than 50% and not more than 200% of the amount of the tax that was sought to be avoided
  - If the Crown proceeds by indictment, then **subsection 239(2)** sets out the penalties
    - Higher jail time of up to 5 years and higher minimum fine (not less than %100 and not more than 200% of the amount of tax sought to be avoided)
- Activities typically caught by this section include:
  - failing to report (or under-reporting) income/gains that are required to be included in preparing and submitting a proper and complete tax return and/or overstating deductible expenses
  - It also includes any other activity that evades (or attempts to evade) compliance with the Act or the payment of taxes imposed by the Act (i.e. destroying books and records) - **paragraph 239(1)(b)**
- This broadly-drafted provision can be applied not only against a taxpayer who engages in one of the listed activities, but also **any advisor** (as someone who participates in, conspires with, etc.) - **paragraph 239(1)(e)**

To be guilty of tax evasion, **the Crown has the burden** of proving all of the elements of the offence **beyond a reasonable doubt**

- One of these elements is that the accused had the requisite *mens rea* - the necessary "intention" to commit tax evasion. This is typically satisfied (by the Crown) by showing that:
  - The accused **knew** or was **wilfully blind** that tax was owing under the Act; and
  - The accused intended to avoid (or intended to attempt to avoid) payment of that tax.
    - Generally speaking, the courts have interpreted **section 239** to require a "high level of culpability" – beyond lesser forms of guilty knowledge such as "negligently or even recklessly".
- whether a "mistake" might be caught by **section 239,** the Ontario Court of Appeal in *Klundert* acknowledged that an **innocent or reasonable** mistake might not satisfy the *mens rea* component of the offence, stating:
  - *Considered in the legislative context, I have no difficulty in holding that a mistake or ignorance as to one's liability to pay tax under the Act may negate the fault requirement in the provision, regardless of whether it is a factual mistake, a legal mistake, or the combination of both*.[6] [Emphasis added]
  - That said, the Court also noted the general principle that a mistake of law does not usually "excuse the commission of a criminal offence".
- **Limitation period:**
  - no limitation period with respect to being charged for tax evasion.
  - **Subsection 152(4)** allows the Minister to charge a taxpayer as far back as it wants/needs
  - **BUT** see **subsection 244(4)**
    - sets out an 8 year limitation period where the Crown elects to proceed by summary conviction – which practically means that after that, the Crown must be elected to proceed by way of indictment if it wishes to prosecute someone for tax evasion).
- **Where criminal offences will be tried:**
  - Criminal offences will be tried in Provincial Court or in the Court of Queen's Bench

CIVIL OFFENCES

- In addition to **criminal offences**, the Act also sets out several **civil offences** which can result in financial penalties (but not incarceration) to a person found to have committed such an offence.

[6] *Ibid* at para 55.

PRIMARY CIVIL OFFENCE FOR TAXPAYERS – ITA S. 163(2)- GROSS NEGLIGENCE

- While **section 239** creates a criminal offence for certain types of behaviours/actions, if something doesn't meet the requirements of **section 239** (or the Crown does not think it can satisfy the criminal burden of proof – especially with regards to the *mens rea*), it might still be caught by **section 163**, which creates a civil penalty for certain types of behaviour.
- The most common of these civil penalties (but by no means the only one), is the gross negligence penalty under **subsection 163(2)**
- **Differences between tax evasion and gross negligence:**
    - Burden of proof: for evasion, it is beyond a reasonable doubt whereas gross negligence is BOP (but still on Crown)
        - **Crown must prove on a balance of probabilities** all the elements of the offence, including that the misrepresentation was made "knowingly or under circumstances amounting to gross negligence…",
    - The test of gross negligence in the case of **subsection 163(2)** is not simple negligence, namely, whether the taxpayer failed to exercise the reasonable care of a wise and prudent person in comparable circumstances.
        - Rather, there must be **gross negligence** - which has been defined as a "high degree of negligence tantamount to intentional acting, or an indifference as to whether the law is complied with or not" (*Venne)*
            - *Remember*, only the tax payer can be assessed with this offence
- **Limitation period:**
    - Like the case of tax evasion, under **subsection 152(4)**, there is no statute of limitations period for cases of gross negligence.
    - The Minister can assess at any time (but has the burden of proving gross negligence, in order to be able to assess beyond the statutory limitation period)
- **Penalty for gross negligence:** Greater of 50% of the tax that would have been payable or $100 (like the tax evasion penalty)
- **Assessment for both gross negligence and a criminal offence:**
    - Can be assessed gross negligence penalties and a criminal offence **ONLY** if gross negligence penalties are assessed first, and then the Crown proceeds with tax evasion charges (usually, the Crown charges tax evasion and argues gross negligence in the alternative)

SECTION 163.2 – MISREPRESENTATION OF A TAX MATTER BY A THIRD PARTY (E.G. TAX ADVISOR)

- Prior to the enactment of **section 163.2**, practically speaking, the Minister had only one real option to use to go after a fraudulent tax advisor (or other non-taxpayer person involved in what the Minister believed was "culpable tax conduct") - the tax evasion penalties in **section 239**.
    - Filled gap in 1999 by enacting civil penalty - this penalty was enacted as a civil penalty (rather than a criminal offence), meaning that the burden of proof is the civil standard (balance of probabilities), though still on the Crown.
    - if an advisor is involved in a "misrepresentation" for tax purposes (i.e. in a taxpayer's return or in respect of a "tax planning arrangement"), then the advisor may be liable for potentially very significant financial penalties.

Under section 163.2, there are two types of third party penalties, namely:

i. "**Planner Penalty**" in **subsection 163.2(2),** since it deals with persons who, generally speaking, make false statements that **could be used** by other persons (for tax purposes); and
ii. "**Preparer Penalty**" in **subsection 163.2(4),** since it deals with persons who make false statements (or participates in, assents to, or acquiesces in the making of such false statement) in respect of a "particular person" (i.e. the taxpayer) for tax purposes.

- **both cases:** the penalty provision will be triggered where the third party (i.e. a tax advisor) knowingly makes a false statement or makes a statement that the third party would reasonably have been expected to have known was a false statement "but for circumstances amounting to culpable conduct".
- **general/key difference** between these 2 penalties:

- the planner penalty doesn't contemplate a particular taxpayer or group of taxpayers (at the time the false statement is made, etc.), whereas the preparer penalty generally does.

- Financial penalties but no jail time. Burden again on Crown on BOP

SUBSECTION 163.2(2) – THE PLANNER PENALTY

Key Components:

[1] A person *makes, furnishes, participates* in the making or causes another person to make

- The first trigger is straightforward – if a 3rd party advisor makes a false statement that the person knows is a false statement, then this component of the penalty provision is satisfied

[2] *A statement* that the person (a) *knows is a false statement* or (b) *would reasonably be expected to know but for circumstances amounting to "culpable conduct"* is a false statement

- what is meant by "circumstances amounting to "culpable conduct"?
- **Answer:** in **subsection 163.2(1),** "**culpable conduct" is defined as** "an act or failure to act that :
  (a) is tantamount to intentional conduct,
  (b) shows an indifference as to whether this Act is complied with, or
  (c) shows a wilful, reckless or wanton disregard of the law"
  - Note: this provision used to say that culpable conduct was gross negligence, but was changed
- In the Supreme Court's decision in *Guindon,* it:
  - confirmed that this is a "high standard" more "exacting" than simple negligence, and
  - appears to accept the Minister's submission at the Supreme Court that it was not intended to be different than the "gross negligence standard in subsection 163(2)".[7]
  - **More specifically, at para 61, the Supreme Court concludes,** "…the standard must be at least as high as gross negligence under s 163(2) of the *ITA.*
    - The third party penalties are meant to capture serious conduct, not ordinary negligence or simple mistakes on the part of a tax preparer or planner".

[3] That *could* be used by another person for income tax purposes

Penalty

- Where it applies, the associated penalty (as set out in **subsection 163.2(3)**) is $1,000, unless the false statement is made in the course of a "planning" or "valuation" activity, in which case the penalty is the amount of the "gross assessments" in respect of that activity (if it is more than $1,000).
  - Takes away financial incentive to developing schemes/plans to promote to taxpayers
  - Who does this apply to: any "person" who is subject to the ITA, so is connected to Canada
  - Tax treaties allow for reciprocal enforcement of laws that exist in other countries

CRA gives the following two examples of when it believes the Planner penalty would apply:

- A tax shelter promoter holding a seminar or presentation to provide information in respect of a specific tax shelter (that does not actually comply with the Act or accomplish the tax objectives represented), and
- An appraiser or valuator preparing an inaccurate valuation report for a proposed scheme that could be used by unidentified investors

SUBSECTION 163.2(4) – THE PREPARER PENALTY

- Very similar to the Planner penalty – except that it is connected to another taxpayer (or identifiable group of taxpayers)

In IC 01-1, the CRA gives the following three examples of when it believes the Preparer penalty would apply:

- A tax preparer preparing a tax return for a specific taxpayer which contained a false statement (i.e. an overstated/non-existent deduction, understated income, etc.),
- A person providing tax advice to a specific taxpayer, and

[7] *Guindon v R,* 2015 SCC 41 at paras 57-62

- An appraiser or valuator preparing a report for a specific taxpayer or a number of persons who can be identified (like in the *Guindon* case).

Preparer penalty (potentially even greater than the planner penalty)

- set out in **subsection 163.2(5)** and provides that it is the *greater of:*
  - $1,000, and
  - The lesser of:
    - The penalty to which the other person would be liable under **subsection 163(2)** (taxpayer penalty for gross negligence – greater of 50% of tax amount sought to be avoided and $100) if the other person (i.e. the taxpayer) made the statement in a filed return and knew the statement was false, and
    - The total of $100,000 and the person's gross compensation at the time at which the notice of assessment of the penalty is sent to the person
- Subsections (2) and (4), concerning the planner penalty and the preparer penalty, could both apply to the same false statement
  - However, subsection (14) provides that a person who is liable to pay penalties under both subsections (2) and (4) for the same false statement is required to pay penalties that are not more than the greater of the penalty under subsection (2) and the penalty under subsection (4).

CONCERN ABOUT 163.2 FROM PRACTITIONERS:

- **Accountants**: concern that effectively turning them into CRA auditors – would have to essentially interrogate clients as could be held liable if there was a false statement on return. Would have to take extra steps to ensure that the information clients give them is correct
- **Lawyers**: in addition to the above-noted concern, they were concerned about having to violate solicitor-client privilege (and client confidentiality) in order to properly defend themselves against the imposition of this penalty.

TWO SAFEGUARDS FOR PROTECTION TO 3RD PARTIES (E.G. GOOD FAITH DEFENCE)

- To provide some protection to third parties potentially subject to these penalties, the CRA and Parliament have implemented **two safeguards.**

1) Third-Party Penalty Review Committee.

- To try to prevent abuse of this provision by CRA auditors, the CRA created the Third-Party Penalty Review Committee.[8]
  - This Committee reviews all proposals for 3rd party penalties being levied and must approve the use of them (so that an auditor can't flippantly threaten the third party with the imposition of these penalties to get the action/result the auditor is looking for).
  - Has approved 98 requests to propose a penalty, 95 were assessed, and only a little more than 20 were denied

2) Good Faith Defence

Subsection 163.2(6) sets out a "good faith defence"**,** which provides that a third party will not be found to have acted in circumstances amounting to "culpable conduct" *where:*

- *the advisor relied, in good faith, on information provided by or on behalf of the client and because of such reliance, failed to verify, investigate or correct the information* (paraphrased from provision)

Definition of Good Faith

- Unfortunately, "good faith" is not defined in the provision/Act and we do not have any case law to date which interprets this term for purposes of this provision.
- **IC 01-1** (para 35), the CRA defines "good faith" as:

[8] This Committee is comprised solely of government employees – almost exclusively from the CRA.

- honesty of intention and freedom from knowledge of circumstances which ought to have put the holder on inquiry
- good faith reliance exception is available when the information used by the advisor or tax return preparer is not, on its face, clearly false, or obviously unreasonable to a prudent person or does not raise obvious questions in the mind of the advisor or tax return preparer.

- Further, the Information Circular lists a number of facts that could affect an advisor's ability to claim the good faith defence in any specific situation, including:
  - The length of time the advisor has known the client
  - The knowledge the advisor had of the client's particular circumstances – with respect to a specific transaction
  - The amounts involved (the larger the amount, the more questions that should be asked), and
  - The expertise of the advisor (the more expertise, the easier it will be for the Minister to establish culpable conduct) – is this really right?
    - Do you have to exercise a greater degree of diligence if you have more experience? How much more? (these questions have not yet been answered)
- While the "good faith" defence is generally available in respect of both penalties contained in **section 163.2,** it is not available in tax shelter promotion arrangements (part of the Planner Penalty) due to **subsection 163.2(7)**
  - makes sense, since the promoter is generally not relying on information of an unknown quality from a taxpayer.
- Note: these offences have only been challenged once in court and over $65 million has been charged by the CRA, indicating a very high success rate from the CRA being very careful and selective about who and in which circumstances they charge

GUINDON V R, 2015 SCC 41 – S. 163.2(2) AND S. 163.2(4) ARE CIVIL OFFENCES; CULPABLE CONDUCT AT LEAST AS HIGH A STANDARD AS GROSS NEGLIGENCE

Ratio: section 163.2 constitutes a civil offence (and as such, does not engage Charter rights, criminal procedure, etc.); "culpable conduct", while similar to "gross negligence", is not exactly the same, it is at least as high of a standard as gross negligence;

- mens rea for preparer penalty (s 163.2(4)) is… (a) knows is a false statement or (b) would reasonably be expected to know but for circumstances amounting to "culpable conduct" is a false statement

Facts: The Appellant was a family and wills/estates lawyer (but not a tax lawyer).

- she was retained and ultimately prepared a legal opinion on a complicated leveraged charitable donation tax plan which purported to allow participants to acquire a time share, donate it to a charity (for an inflated charitable donation receipt) as well as obtain other tax benefits.
  - 1st $200.00 of charitable donations – multiple amount of donations claimed by lowest marginal rate (25% in AB); for any donations over and above $200.00 you multiply it by the highest marginal rate federally and 21% in AB for a total rate of 50%
- She rendered her opinion without reviewing all of the documents referred to in the opinion
- The Appellant was also the president of a charity that was involved in this scheme and she signed roughly half (approximately 62) charitable donation receipts the charity issued in respect of this scheme
- no timeshare units were ever legally created and, consequently, no timeshare weeks were donated to the charity.
- the promoter issued a letter to the participants (without the Appellant's knowledge) telling them that all issues would be resolved and that they could go ahead and use the donation receipts in filing their current tax returns
- A couple months after filing her return, the Appellant learned that the charitable donations in respect of this plan would not be accepted by the CRA; several years later, the CRA charged the Appellant under **subsection 163.2(4)** in the amount of $546,747 in respect of false statements made in the context of a charitable donation arrangement.[9]

[9] Note: this penalty was not covered by the Appellant's professional legal liability insurance as these penalties were not incurred while she was acting in her capacity as a lawyer in signing the charitable donation receipts

- This penalty amount represented the amount of tax that would have been owed if the participants had been assessed under **subsection 163(2)** for claiming a fraudulent charitable donation receipt

Judicial History:

- TCC: allowed lawyer's appeal and vacated penalty, ruling that s. 163.2 of Act was criminal proceeding and involved true penal consequence
- FCA: allowed the appeal and restored the assessment of penalties against the lawyer.

Issues at the Tax Court 2012 TCC 287:

1) does **section 163.2** create a criminal, rather than civil offence, which would engage all of *Charter* protections (particularly section 11), raise the burden of proof to the criminal standard, and require the hearing to occur in the appropriate provincial court? **No – it is a civil offence**

2) if **section 163.2** is a civil offence, did the Appellant violate it (i.e. did the Appellant knowingly, or in circumstances amounting to culpable conduct, make false statements that could be used by another person for tax purposes)? – **Yes,** Appellant acted with culpable conduct; she is subject to s. 163.2 penalties assessed by the CRA

Decision: Appeal dismissed; appellant held liable for an offence under s. 163.2(4)

Reasons:

Issue 1: criminal or civil offence

- both the **Federal Court of Appeal** and **Supreme Court of Canada** held that – that **section 163.2** constitutes a **civil offence** (and as such, does not engage *Charter* rights, criminal procedure, etc.)
- Note:
  - A "true penal consequence" is "imprisonment or a fine which by its magnitude would appear to be imposed for the purpose of redressing the wrong done to society at large rather than to the maintenance of internal discipline within [a] limited sphere of activity"
  - A proceeding is criminal by its very nature when it is aimed at promoting public order and welfare within a public sphere of activity.
  - Proceedings of an administrative nature… are primarily intended to maintain compliance or to regulate conduct within a limited sphere of activity
    - penalty imposed under s. 163.2 of the Act was not a true penal consequence, although a monetary penalty could be a true penal consequence if it was punitive.
      - <u>The purpose of the penalty was to promote compliance with the regulatory scheme.</u>

Issue 2: culpability

- With respect to this issue (which was technically *obiter* given the conclusion to the first issue), the Tax Court first identified the charitable donation tax receipts (that were signed by the Appellant) as constituting the false statements.
- **<u>Relevant time frame</u>**:
  - for determining whether the Appellant had actual knowledge that the receipts constituted false statements (or would be reasonably expected to know that they were false statements but for circumstances amounting to culpable conduct), the Court held that the **relevant time frame to apply this test was at the time the false statement was actually made**
  - Information learned or conduct after the fact was not relevant for purposes of determining whether the penalty was triggered.
  - Such subsequent events could constitute aggravating or mitigating factors (although they would have no impact on the amount of penalty assessed, since this is mechanical formula), but could not affect the application of the test itself.
- "culpable conduct", while similar to "gross negligence", is not exactly the same
  - the "strongest cases of gross negligence" – which requires a finding of the necessary *mens rea* of culpable conduct
    - **Culpable conduct is a high standard**

Mistakes Made (and Lessons Learned):

- Only provide advice within your qualifications and expertise
- Careful about who your client is and what their objectives/intentions are
- Don't even prepare the memo/opinion and don't associate with the party or individual if intentions are suspect
- Get a second opinion about legality concerns or to review your work or ask about ethical issues

ETHICAL TAX PLANNING

Criminal and civil offence provisions (and others that exist in the Act) help answer the **1st question** concerning what we can do – and the legislative answer is clear that **we can't**:

- Be involved in the commission of tax evasion, and
- Be involved in a misrepresentation for tax purposes where the misrepresentation was made knowingly or in "circumstances amounting to culpable conduct"

This leads to the 2nd question: assuming that what our client is asking us to do or be involved with what (at least arguably) complies with all existing tax law (legislative and jurisprudential) or is not (arguably) addressed/prohibited by the existing tax law, should we do it (or attempt to do it) and otherwise be associated with it?

DUKE OF WESTMINSTER PRINCIPLE – TAX AVOIDANCE PLANNING PERFECTLY ETHICAL BEHAVIOUR

- At one end of the spectrum is the view is that this type of tax planning is perfectly ethical and acceptable behaviour by taxpayers and those advisors that assist them in this regard.

Duke of Westminster (U.K.) [1936] A.C. 1 at 19 (H.L.)

- formally adopted by the Supreme Court of Canada in ***Stubart Investment Ltd. v. R.,*** [1984] 1 SCR 536 (at para 23)
- the House of Lords stated:

> **Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be.** If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

United States: similar view expressed by some of their most prominent jurists, including Justice Learned Hand in ***Commissioner of Internal Revenue v Newman***, 159 F.2d 848 (1947) (Circuit Court of Appeals, Second Circuit) at 850-51 who said:

- Over and over again courts have said that there is **nothing sinister in so arranging one's affairs as to keep taxes as low as possible.** Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant.

FAIR TAXATION/SOCIAL CONTRACT ARGUMENT – PERMITTED TAX AVOIDANCE PLANNING MAY BE UNETHICAL

- Alternate view to Duke of Wesminster:
  - Anyone who engages in such tax planning, even though it might be permitted (or at least not prohibited) by the law as it currently exists, is being unethical, immoral or otherwise socially inappropriate.
  - while technically "legal", it **violates the social contract** that we all implicitly have with each other and the State to fairly contribute to the costs of our society.
- In recent years, this view appears (at least in my opinion) to have become more strongly and often voiced.

Examples to support this observation:

- In 2013, the International Bar Association's Human Rights Institute Task Force on Illicit Financial Flows, Poverty and Human Rights issued a report entitled, "Tax Abuses, Poverty and Human Rights" which was very critical of tax avoidance strategies. Beginning on the very first page of the Executive Summary, it states,

> "…there is an important ethical dimension to the issue. Many politicians, advocacy groups and prominent individuals are questioning the fairness and morality of sophisticated tax planning strategies that result in individuals and corporations not paying a fair share of tax – and perhaps not paying tax at all. Especially in a context of persistent poverty and rising inequality between

and within nations, ***the fact that tax strategies that produce unfair results may be technically legal is no longer a sufficient justification for their continued use...***" [Emphasis added.]

- **Large multinational companies like Apple, Samsung, etc. have been called before governmental inquiry committees to defend their tax avoidance strategies (including Starbucks making a "voluntary" tax payment to the U.K.)**
  - Apple has shifted intellectual property rights, like patents, to its Irish subsidiaries, which means other divisions of Apple pay royalties to those subsidiaries for their sales.
  - Low standard corporate tax rate in Ireland
  - Microsoft has used "aggressive" transactions to shift assets to subsidiaries in Puerto Rico, Ireland and Singapore, in part to avoid taxes.
  - HP has used complex offshore loan transactions worth billions while using the money to run its U.S. operations, according to the panel.

- **The "Panama Papers"** – individuals and companies setting up off-shore corporations and bank accounts to hide income and wealth (and of course, save taxes)
  - By avoiding the duty to inquire about their clients, lawyers can turn a blind eye by focusing only on what the client wants without asking the harder questions about what led to seeking legal advice.
  - The attorney-client privilege is usually invoked as the reason to exclude lawyers from having to comply with the "know your customer" rules that would require disclosing the identity of their clients.

HARVEY CASHORE, DAVE SEGLINS & FREDERIC ZALAC, "KPMG OFFSHORE 'SHAM" DECEIVED TAX AUTHORITIES, CRA ALLEGES"

- CBC's ongoing investigation/story on a KPMG (and Dentons) Offshore Tax Plan involving the Isle of Man that is currently being challenged by the CRA
- **Facts:**
  - Prior to 2014: When immigrating to Canada, you could set up an immigration trust, transferring all assets into that trust; For 5 years after moving to Canada, the income on the assets in the trust would not be taxed in Canada, so you could be tax free for 5 years
    - This immigration trust rule was removed in February, 2014
  - Before emigrating to Canada (via the United States), the Coopers set up an "immigration trust" (under which they were the named beneficiaries) under the laws of Liechtenstein[10] to take advantage of both Liechtenstein's and Canada's favourable tax laws.
    - Collectively, laws effectively allowed the income earned by the trust to not be taxed either in Liechtenstein (when investment income was earned) or in Canada (when distributions of trust capital were made)
  - With the end of the benefits of this tax plan in sight, KPMG advised the creation of a special "hybrid" company (Ogral Company) under the laws of the Isle of Man.
    - Ogral Company was then named a beneficiary of the Ogral Trust and all of the trust's assets were distributed to Ogral Company (without any taxes being triggered).
  - A key feature of Ogral Company (as set out in its constating documents):
    - ability to make "gifts" to "eligible persons" on the unanimous decision of Ogral Company's board[11]
    - the Cooper family were named as "eligible persons".
    - As "gifts", the amounts the Coopers received from Ogral Company were not subject to Canadian income (or other) tax.

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[10] Historically, Liechtenstein has been known as one of a group of tax haven countries with very strong bank secrecy laws, which wealthy people and organizations used to hide their wealth (and sometimes income). In recent years, like Switzerland, it has had to revoke its secrecy laws due to extreme economic/legal pressure from other countries

[11] None of the Cooper family was a shareholder of Ogral Company either. The shareholders were limited in the amount of yearly distributions they could receive to a fairly nominal amount (4,000 GBP).

- In 2012, the CRA reassessed the Coopers 2003-2012 taxation years on the basis that the Coopers were the owners of the assets and income of Ogral Company.
  - In addition to adding outstanding taxes (and interest), the CRA also assessed penalties
  - This case has not yet been heard in court

- **Questions:**
  - Assuming that no Isle of Man or Canadian laws were (technically) contravened, do you think that this type of tax planning **should** be allowed?
    - Going back to **Code Rule 2.1-1 Integrity,** is this carrying on the practice of law "honourably and with integrity"?
      - Public sees this as people avoiding the burden that all other tax payers are paying
      - The advisors and lawyers are borderline as far as professional responsibility; these actions shine a poor light on the profession
      - Would appear negative because wealthy people are being assisted to escape their liabilities (and what some would consider a public duty) while less wealthy people are unable to do so

COMPARISON OF ARGUMENTS:

Duke pros:

- Letter of the law provides more certainty
- May not agree with how government spends funds, counter to the social contract (a.k.a. government is going to waste it anyways)
- Rule of law: government shouldn't meddle in people's lives beyond the law
- Doesn't discourage economic activity/investment

Fair Taxation pros:

- Hard for government to legislate fairness; the length of the current Act, e.g.
- Pushing the boundaries is costly to society (litigation, e.g.)
  - Forcing the tax burden on the middle class
- Reduces tax planning for the rich

ACCEPTABLE TAX PLANNING

- Strictly speaking, there are 2 main types of acceptable tax planning strategies, namely, "**tax avoidance**" and "**tax deferral**" strategies

For purposes of our class (and generally in practice):

1. **Tax avoidance** is an avoidance or savings of tax.
   - Is a permanent reduction or elimination of tax liability (ex. contributing your after-tax savings to a TFSA, getting disability, changing residency)
2. **Tax deferral** is when the taxpayer delays the recognition of income and calculation/creation of the associated tax liability until sometime in the future
   - **Example:** instead of selling one's house, which constitutes a "disposition", the trigger for calculating and recognizing a capital gain/loss, a taxpayer could, alternatively, use his/her home as security for a home equity line of credit.
   - This is a deferral strategy in that at some point, I will have to sell the shares (and trigger the associated tax consequences, or have disposition deemed to have occurred upon death) – just not now; you will have to pay the tax on your capital gains eventually

- **Note:** Simply not paying your taxes when properly due is not a tax deferral strategy; Neither is not reporting income (when you are legally obliged to do so) and the associated taxes that should properly be recognized.
  - The CRA has strong collection powers and if you don't pay your taxes, interest will accrue from when the tax liability was deemed to have been due
    - Even if you do not submit a tax return, CRA receives information from third parties and is free to make assumptions, so they can assess your tax liability without receiving a return
  - This is tax avoidance or at least gross negligence

- **Which category of tax planning is Preferable?**
    - **Tax avoidance because:** the taxes are permanently avoided or reduced (doesn't matter if legislation changes).
        - With deferral, a strategy can be frustrated by a change in legislation or the tax payer's situation (note this can also be a reason in favour of deferral as could lead to opportunities for later tax avoidance) and you end up paying taxes on the income eventually

Question: given that tax avoidance is the superior form of tax planning, why do tax planners (and taxpayers) also look for tax deferral strategies?

Answer -- Rationales for deferring taxes:

1. **'Wait and See'**: predicting that the tax rates will be more favourable in the future when the taxes actually have to be paid
    a. taxpayer is hoping that in the future, the law may change or the tax payer's circumstances may change so that a deferral strategy can be converted into an avoidance strategy
2. **Present Value of Money**: putting off the payment until later means that when you pay the set amount, that amount is worth less in present value than it is two years in the future due to inflation ($10,000 in 2020 is worth less than $20,000 in 2017 due to inflation); money you have in your hand now can be put to work for you (investments)
    a. It's worth more now because you can take that money and invest it; to the extent that you can invest it for a return that is better than inflation, you are better off;
3. **"Tax-free loan"**: by engaging in tax deferral, you may be able to use that deferred tax liability and consider this an "interest-free" loan; you can invest that money in an income producing unit that you could not otherwise have invested in
    a. You can gain interest by investing the money that you deferred from paying in taxes in the current year
4. Tax avoidance strategies are not always available; they may be rare or difficult to exploit

RRSP EXAMPLE

- RRSPs are always tax deferral but they can also be transformed in to tax avoidance
- **Start Point: 2017**
    - earning $500,000/year of taxable income
    - Applicable marginal tax rate: ~50%
    - Make a $20,000 RRSP contribution
        - RRSP reduces income, therefore it reduces tax liability
        - RRSP is a non-source specific deduction (it can be deducted from any source of income)
    - Tax savings (in year of contribution) = tax deduction x applicable marginal rate
        - For a $20,000 contribution, tax savings = $20,000 x 50% (highest marginal rate) = $10,000
        - Reducing income by $20,000, savings = $10,0000 from tax liability
- **Scenario 1: 2020**
    - Still earning $500,000/yr
    - Tax rate = 50%
    - Withdrew $20,000 from RRSP
    - Tax implications: $20,000 of "other" income that must be reported
    - This is added to taxable income, so it means that tax liability is increased by $10,000
    - So this is a case where you deferred the tax payment – Why?
        - Present value of money – putting off the payment until later means that when you pay the $10,000, that $10,000 is worth less in present value terms two years in the future, due to inflation ($10,000 in 2020 is worth less than $10,000 in 2017 due to inflation)
        - Gaining an interest free loan from the government – you would rather hold onto the money for longer and use it to gain interest by investing
            - Note: interest earned on an RRSP is also viewed as "other" income and is taxable upon being taken out of the RRSP
- **Scenario 2: 2040**
    - Annual income of $90,000 in pension income (other income)
    - Applicable marginal tax rate for RRSP: 36% (marginal rate for $90,000-125,000)

- If you withdraw $20,000, the tax liability is $20,000 x 36% = $7,200
- Tax Avoidance amount: $10,000 (original tax liability on the $20,000 in 2017) - $7,200 (tax liability in 2040) = $2800
  - **Tax avoided = tax savings – tax liability**

- **Note:** if the tax rate is low and expected to go up, the wait and see strategy will not be a good strategy; if you defer your taxes the highest marginal rate may increase and you will end up paying more tax than you would have
  - If your income levels are expected to go down or marginal rates are expected to go down, you can benefit from deferring your tax liability

PROFESSIONAL CORPORATION EXAMPLE

- Remember: if you are just an employee, incorporating does not help avoid taxes because you will be considered a personal services business and not benefit from small business deductions – will not benefit from corporate tax rates (remember s. 125(7) definition of a personal services business)

Assumptions:

- A lawyer generates $600,000 of net pre-tax professional income from her legal practice as a sole proprietor or as a partner in a law firm
- The lawyer can (and is willing to) live off $100,000 pre-tax per year and wants to invest the remaining $500,000 in an income-producing investment (perhaps her legal practice, perhaps another business, perhaps some passive investment(s))
- For ease of calculations, her marginal tax rate on all of her income is 50% (federal and provincial combined)
  - Of course, in reality, the 1st $45,000 (or so) would be taxed at 25% (if in Alberta), etc.
- Also for ease of calculations, the combined federal and provincial corporate tax rate on the 1st $500,000 of "active business income", after taking into account the small business deduction in **section 125** is 15%
  - Remember, a CCPC (Canadian Controlled Professional Corporation) will pay reduced rate on first $500,000 of active business income
- No tax credits, income splitting, other sources of income, etc.

Option #1 – the lawyer earns all of her professional income personally:

- Personal pre-tax income = $100,000
  - Taxed at 50% rate: after tax income = $50,000
- Business/investment income = $500,000
  - Taxed at 50% rate: after tax income = $250,000 for investments

Option #2 – the lawyer incorporates as a PC and decides to retain the surplus income in the PC for reinvestment

- Under this option, the woman is incorporated as a professional corporation
  - KEEP in mind: the income is being retained in the professional corporation
- Professional Corporation: lawyer both sole shareholder and employee of the corporation (commonly referred to as an active shareholder-manager)
  - Business income = $600,000
  - Salary expense = $100,000
    - So, she as a CCPC, pays herself as an employee $100,000
    - The income is charged at the marginal rate of 50%
  - Taxable income after paying employment income = $500,000
    - Corporate Tax rate for a small business carrying out active business (15%) means tax liability is $75,000 ($500,000 x 0.15)
    - After tax corporate income = $425,000

Compare option 1 to option 2

- Result is same in both options for the individual
- The difference is in respect of the investment money
- In the second option as a CCPC, she has more after tax income to invest ($425,000 - $250,000 = $175,000)
- In Option 1 she had $250,000 of after-tax personal income to invest
- In Option 2 her corporation has $425,000 after-tax corporate income to invest

Note: The second option is tax deferral not tax avoidance!

- Eventually if want to use that money, you will have to pay it out to yourself in which case will be taxed at that point
- Two main ways that a corporation can distribute its income to someone who is a shareholder/employee
    1. By paying a salary (employee) or bonus
        a. This is deductible as a business expense, and is reasonable as per s. 67 of the ITA for any persons who are "key" to the corporation's success
    2. Dividends (paid out of after tax income meaning that the corporation does not get a deduction and when the dividend is paid to the shareholder, as a general rule they are included in the shareholder's income (source = property income))
        a. This is specified investment income, not eligible for small business deduction
        b. there is a special provision for taxing dividends for actual shareholders which tries to take into account the tax already paid by the corporation (Gross Up + Dividend Tax Credit Mechanism) (tangent): in Canada the philosophy is that option #1 should end up equaling option #2 (principle of integration); aim is to maintain neutrality (ie so that legislation doesn't affect how a taxpayer behaves)
- Therefore, ultimately the final amount of tax paid should be the same – ie deferral of income
    - In order for this tax deferral strategy to work – only works or exists if the lawyer or the business person is able to keep pre-tax income in the corporation
- This begins as tax deferral but can become tax avoidance; paying at lower rates in the future, income splitting to pay money to lower income family members

Option 2 A: Money earned in PC but entirely paid out to the lawyer in that year for personal use (in-year earnings)

- Net professional income: $600,000
- Salary expense: $600,000
- Taxed at 50% because all money is paid out as salary, so after tax income in the year is $300,000
- There is no legal or tax benefit if no money is being retained in the corporation to get the tax benefit
    - Professional corporation does not protect you from liability
    - No tax benefit because you are not retaining the money in the company as a tax deferral strategy (so being taxed at a lower rate of 15% and being invested or used to split income)

Notes about Professional Corporations

- Very generally speaking, a PC is a corporation that is approved by the Law Society (or other relevant professional body)
- With respect to Alberta legal PCs, approval from the Law Society has effectively 5 components/requirements (there are other requirements but they are not important for our purposes now), **as per Legal Profession Act, RSA 2000, c L-8:**
    - 1st – the name of the corporation must include the words "Professional Corporation" (**paragraph 131(3)(d)**)[12];
    - 2nd – all of the directors and **voting shareholders** of the PC must be active members of the Law Society (in other words, active lawyers in good standing) (**paragraph 131(3)(e)**);
    - 3rd – any non-voting shareholders of the PC must fall within one of the groups listed in **paragraph 131(3)(f)**, namely: active members who are also voting shareholders, a spouse or common law partner of an active member, a child of the active member, or a trust, all the beneficiaries of which are minor children of the active member;
        - Recent development to allow children and spouse to be non-voting shareholders
        - Old rule was that only an active member could be a non-voting shareholder; so it was harder to bring in non-professional family members to allow for income splitting
    - 4th – the persons who will carry on the legal practice on behalf of the PC are active members (**paragraph 131(3)(g)**); and

[12] All statutory references are to the *Legal Profession Act*, RSA 2000, c L-8

- 5th – the PC's articles must contain a schedule which essentially reiterates **subsection 133(1)**, which provides that the voting shareholders (who are active members) have the same unlimited personal liabilities for the PC's liabilities as if they were carrying on the legal practice either as a partnership or sole proprietor

UNIT #3 –THE GENERAL ANTI-AVOIDANCE RULE (GAAR)

UNACCEPTABLE TO ACCEPTABLE TAX PLANNING FROM WORST TO BEST

1. Unacceptable
    a. Criminal offence (s. 239 – Tax Evasion)
    b. Civil offences (s. 163(2) gross negligence and s. 163.2 third party penalties)
2. Acceptable planning
    a. Technical compliance – made unacceptable through the General Anti Avoidance Rule
        i. But this is not a penalty on the tax payer; it just gives the court the ability to recharacterize and re-tax in a way that is "reasonable in the circumstances" in order to deny the tax benefits that were to be received
    b. Tax deferral
    c. Tax avoidance

- Problem was that tax planners were often finding loopholes and staying ahead of legislation
- Response: introducing the GAAR to catch behaviour that may be in technical compliance with the letter of the law but the tax planning is an abuse of a particular provision or the act as a whole
    - Enacted in the late 1980s
    - Tax planners were initially very wary of the GAAR, but then became more aggressive when the CRA was not assessing on the basis of the GAAR and were not enforcing it
    - Thought was that the provision would be struck down for vagueness and overbreadth, but it was upheld when it finally came before the SCC

GENERAL ANTI AVOIDANCE RULE

- **Question:** what about cases where the taxpayer's tax planning activities/position may be (objectively) said to **technically comply with the letter of the law, but (arguably) not its spirit**? Is this acceptable or unacceptable tax planning?
    - **Answer:** this is the purpose/domain of the general anti-avoidance rule (GAAR) set out in **section 245 –** which catches tax planning that technically complies with the Act but ultimately is found to constitute an "**abuse or misuse of the Act**".
- GAAR in **section 245** of the Act catches situations where:
    - the reporting position may **technically comply** but where the tax planning is found to constitute an "**abuse of misuse of the Act**".
- In *R. v Lipson,* [2009] 1 S.C.R. 3 at para 52, Justice LeBel, writing for the majority, described the GAAR in this manner,
    - The GAAR is neither a penal provision nor a hammer to pound taxpayers into submission. It is designed, in the complex context of the ITA, to restrain abusive tax avoidance and to make sure that the fairness of the tax system is preserved.
- Instead, if triggered, the GAAR allows the CRA (or the court) to deny any inappropriate "tax benefits" otherwise realized by the taxpayer and instead provide tax consequences that are considered "reasonable in the circumstances" – **subsection 245(2).**

KEY PROVISIONS

ITA s 245

(2) General anti-avoidance provision – Where a transaction is an avoidance transaction, the tax consequence to a person shall be determined as is reasonable in the circumstance in order to deny a tax benefit that, but for this section, would result, directly or indirectly, from that transaction or from a series of transactions that includes that transaction

(4) Applies to a transaction only if it may reasonably be considered that the transaction (a) would, if this Act were read without reference to this section, result directly or indirectly in a misuse of the provisions of the Act, Regulation, Rules, tax treaty, or other relevant enactment; or
(b) would result directly or indirectly in an abuse having regard to those provisions, other than this section, read as a whole.

ITA 248(10): Series of transactions

for the purposed of this Act, where there is a reference to a series of transactions or events, the series shall be deemed to include any related transactions or events completed in contemplation of the series

THE PURPOSE OF THE GAAR

- As set out in the Technical Note to this section (dated June 30, 1988), **section 245** of the Act is a general anti-avoidance rule which is intended to **prevent abusive tax avoidance** transactions or arrangements, but at the same time, is **not intended to interfere with legitimate commercial and family transactions**.
    - This is <u>not intended as a punitive rule</u>
    - <u>Purpose of GAAR:</u> expedient way of dealing with inappropriate tax planning that constituted misuse or abuse of the law; GAAR allows for fast response to new ways developed to exploit loop holes and avoid taxes without creating specific provisions that address that kind of undesirable tax planning
- Like the process for assessing a civil advisor penalty, before the GAAR can be applied/assessed (unless GAAR has previously been approved for assessment in the same type of transaction/planning), the auditor must first get approval from the GAAR Committee (an ad hoc committee comprised solely of government officers – primarily from the CRA but also from Finance and Justice)
    - Most files submitted have been approved; likely because the file is not submitted unless it is probably in breach of the GAAR

FOUR STEP APPLICATION OF THE GAAR (CANADA TRUSTCO AND COPTHORNE HOLDINGS LTD.)

STEP #1 – TAX BENEFIT

- the starting point for the application of the GAAR is **subsection 245(1),** which requires that the taxpayer have received a "tax benefit" as a result of the transaction(s)
    - Benefit – a reduction, deferral, or avoidance of tax liability or increase of tax refund (e.g. claiming an RRSP reduction or a tuition credit)
    - Per SCC in *Canada Trustco*, magnitude of the tax benefit is not relevant in this test.
- **Burden of Proof**: Taxpayer must show on a balance of probability that s/he did not receive/enjoy a tax benefit
- **Type of Finding (Factual, Legal, Mixed Fact and Law):** this is a **finding of fact** based on an **objective** review of the evidence by the trial judge.
    - Because it is a finding of fact, where the Tax Court concludes that the taxpayer enjoyed a tax benefit, this finding will only be overturned in cases where the Tax Court Justice made a "palpable and overriding error" (*Copthorne Holdings Ltd. v R*)
        - Palpable – blatant and obvious
        - Overriding – significant (material)
    - **Practical Point:** tax payer is nearly never successful in showing that there was no benefit because they face the burden of proof and the standard is a high one to meet
        - It is usually conceded that there was a benefit
- The existence of a tax benefit can be identified in isolation or established by comparing the taxpayer's situation with an alternative arrangement
    - alternative arrangement must be one that might reasonably have been carried out but for the existence of the tax benefit.

STEP #2 - AVOIDANCE TRANSACTION.[13]

[13] If an "avoidance transaction" exists, either on its own or as part of a "series of transactions", then this fact, if co-existing with certain other named facts, may result in the avoidance transaction also being characterized as a "reportable

- The second step in the GAAR analysis is to consider whether the "tax benefit" determined in Step #1 resulted from an "avoidance transaction" or a series of transactions that includes one or more "avoidance transactions" **- subsection 245(3)**

Mechanics:

- an avoidance transaction is:
  - (a) a transaction that results in a "tax benefit", that
  - (b) was undertaken for the primary purpose of obtaining that tax benefit.
- The key questions in determining whether one transaction constitutes an "avoidance transaction" under **section 245** are:
  - 1 – did the transaction in question result in the tax benefit identified in Step #1
  - 2 – was the primary purpose of that transaction to obtain that tax benefit or was the primary purpose to accomplish something else?
    - Have to be able to adduce objective evidence that you primarily (not exclusively) engaged in the action for something other than to derive the tax benefit
      - Explanatory Notes to **paragraph 245(3)** (as highlighted by the SCC in *Canada Trustco*):
        - fact that the transactions could have occurred in an alternative way which would have resulted in more tax *does not necessarily* make the taxpayer's particular plan which has a better tax result a transaction primarily designed to obtain a tax benefit and hence an avoidance transaction.
      - Alternative non-tax purposes: succession planning (passing money on to children), family planning, business purposes, etc.
- an avoidance transaction can be a single transaction (paragraph 245(3)(a)) or part of a "series of transactions" (paragraph 245(3)(b)).
  - **whether a series of transactions includes one or more avoidance transactions, the analysis generally proceeds as follows:**
    - 1st – does a "series of transactions" exist?
    - 2nd – what transactions are included in the series?
    - 3rd – Result/Connection: whether the tax benefit identified in Step #1 resulted from any transaction contained in that series?
    - 4th – Purpose: whether any transactions within the series were done primarily for the purpose of obtaining the tax benefit (in other words, was an avoidance transaction)
    - Very important to note that the courts will look at the overall purpose of the series (as a whole) as well as the particular purpose of each transaction that comprises the series to see if it was done primarily to obtain a tax benefit.
- **Series of transactions:**
  - Common law definition - a number of transactions that are pre-ordained in order to produce a given result
    - Pre-ordination requires that "when the first transaction of the series is implemented, all essential features of the subsequent transaction or transactions are determined by persons who have the firm intention and the ability to implement them. That is, there must be no practical likelihood that the subsequent transaction or transactions will not take place."
  - "series of transactions" has been extended by subsection 248(10) to "include any related transactions or events completed in contemplation of the series"
    - SCC in *Copthorne:* **subsection 248(10)** means that if one transaction was implemented "because of" or "in relation to" another transaction (or that a transaction was taken into account when the decision was made to undertake another transaction), then those transactions would be part of the same series.

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transaction" pursuant to section 237.3. The determination of and associated consequences of "reportable transactions" are beyond the scope of this course.

        - SCC rejected that there must be a "strong nexus" between the transactions for them to be considered part of the same series
            - but also stated that more than "mere possibility" or "an extreme degree of remoteness" would be sufficient to link transactions together (Cop para 47)
    - in grouping together transactions into a "series", the CRA and courts could look both forwards and backwards.

Type of Finding (Factual, Legal, Mixed Fact and Law): As noted in both *Canada Trustco* and *Copthorne*, this is **finding of fact** made by the trial judge

- Like in Step #1, where the Tax Court finds the existence of an "avoidance transaction", appellate courts will give it deference (i.e. reasonableness standard of review).

Burden of Proof: as in Step #1, the burden is on the **taxpayer**, to show that either:

- There was no connection between the transaction and the benefit
- The primary purpose of the transaction was not to garner a tax benefit

Question: how does the taxpayer (typically with assistance from his/her advisor) discharge this burden and prove that the transaction did not occur primarily to obtain a tax benefit?

- **Answer:** at the initial stage of information gathering, document what the client was requesting and what their intentions were
    - Ask and document what the primary purposes (and secondary purposes) of the client's actions are

STEP #3 - MISUSE OF THE PROVISION OR ABUSE OF THE ACT AS A WHOLE

- The next step (and really the key step) is to look at **subsection 245(4)** – which provides that the GAAR will not apply in situations where the transaction/plan does not misuse any of the provisions of the Act or abuse the Act as a whole.
- **Interpretation Point:** The SCC rejects that there is actually a 2-part test
    - Rather creates a single test that requires a court to do a **textual, contextual and purposive analysis** of the Act as a whole to determine whether the transaction(s) in question meet the definition/requirement.
        - Put another way, the SCC finds it difficult to envision a situation where a transaction would constitute a misuse of a particular provision and not an abuse of the Act as a whole.

Burden of proof: Burden shifts to the Minister on a BOP

THREE STEP ANALYSIS

Step 1: interpret the provisions giving rise to the tax benefit to **determine** their **object, spirit and purpose**, having regard to the scheme of the Act, the relevant provisions and permissible extrinsic aids.

- The Supreme Court explains that "[t]he object, spirit or purpose of the provisions has been referred to as the 'legislative rationale that underlies specific or interrelated provisions of the Act'"[18]
- Further, "in a GAAR analysis, the **textual**, **contextual**, and **purposive** analysis is employed to determine the object, spirit or purpose of a provision.
    - The search is for the rationale that underlies the words that may not be captured by the bare meaning of the words themselves.
    - **However, determining the rationale of the relevant provisions of the Act should not be conflated with a value judgment of what is right or wrong nor with theories about what tax law ought to be or ought to do.**"[19]
    - Not simply an opportunity for the Minister to try and fill in the gaps in the legislation or to prevent something that really is permissible under the current law
- Must look at the true intention and meaning of the provisions and the legislation
    - Where Parliament has specified precisely what conditions must be satisfied to achieve a particular result, it is reasonable to assume that tax payers would rely on such provisions to achieve the result that was prescribed (Canada Trust Co)
    - GAAR is not to correct or fill loop holes in the existing legislation properly interpreted or unintended but allowable consequences
        - In recent case, *Birch Cliff Energy* the TCC said that the Minister must set out in its notice of assessment what the object spirit and purpose of the tax provision is that it is relying upon

Step 2; determine whether the **transaction falls within or frustrates that purpose** through an examination of the factual context of the case.

- Overall inquiry - mixed question of fact and law (palpable and overriding error)
    - The central inquiry is focused on whether the transaction was consistent with the purpose of the provisions of the Act that are relied upon by the taxpayer, when those provisions are properly interpreted in light of their context.
    - Abusive tax avoidance will be established if the transactions frustrate or defeat those purposes.
- *Trustco* give 3 examples of abusive transactions (para 57):
    1. Taxpayer relies on specific provisions of the Act in order to achieve an outcome that those provisions seek to prevent
    2. A transaction defeats the underlying rationale of the provisions that are relied upon; or
    3. An arrangement that circumvents the application of certain provisions such as specific anti-avoidance rules in a manner that frustrates or defeats the object, spirit, or purpose of those provisions
- Minister must clearly demonstrate that the transaction is an abuse of the Act, and the **benefit of the doubt is given to the taxpayer** if the Minister cannot (*Copthorne*)

Step 3: the Trial Judge, as a finding of fact, determines whether there has been an abusive tax transaction.

- Because the judge is answering a question of fact, the decision should not be overturned by an appellate court absent a palpable or overriding error.
- Where there is any doubt after the analysis is performed, the doubt is to be resolved in favour of the taxpayer.

STEP #4 – CONSEQUENCES

- If the first three steps are satisfied, then you proceed to **subsection 245(2)** which gives the CRA (and the courts) the ability to deny the tax benefit and provide other tax consequences that are "reasonable in the circumstances".
- Note: this is a case where a taxpayer has technically complied but is still found to be an illegal application
    - Meant to provide the appropriate tax result as oppose to penalizing a tax payer
- S. 245(5) provides examples of reasonable consequences for violation of the GAAR

ADVISORS AND THE GAAR: PROTECTING YOURSELF FROM YOUR CLIENTS

- all good tax planners should consider whether the GAAR could potentially apply to any transaction(s)/plans that are being proposed to and implemented by their clients and, if successfully applied, what the effects could be – this should be a standard section of any planning letter.
    - This is not only important to the client – who needs this information/analysis to assess whether to proceed with the transaction(s)/plan
        - it is also important for the advisor, should the GAAR be successfully applied (or at least assessed) and the client then turn to the advisor for compensation (on the basis that the advice was negligent or generally not satisfactory).

TAIGA BUILDING PRODUCTS LTD. V. DELOITTE & TOUCHE, LLP (2014 BCSC) – TAX PLAN ASSESSED AS VIOLATING GAAR IN ONTARIO – TAIGA DID NOT CHALLENGE – TAIGA SUES THEIR ADVISORS

Facts: the Defendant accounting firm was the long-time auditor and (tax) advisor for the Appellant. In 2001, the Defendant recommended that the Plaintiff implement a corporate reorganization called the Finco Plan to reduce its future provincial tax liabilities. The Plaintiff accepted this advice and signed an engagement letter to implement it, which entitled the Defendant to a one-time fixed fee ($50,000) and an annual 20% contingent fee based on future provincial taxes saved (over a certain threshold) by the Plaintiff implanting the Finco Plan.

- While the application of the Ontario GAAR was acknowledged as a possible risk, the conclusion was that it was not significant enough to warrant not implementing the plan – 3.75 million $ saved
- When the plan was presented to the Plaintiff's representatives (including the company's founder and member of the Board), the Defendant discussed the risks of the plan including it being challenged as violating the (provincial) GAAR.
    - The engagement letter to implement the Finco Plan referred to the potential provincial GAAR risk (which the Defendant effectively assessed as "unlikely" or "difficult to succeed") and the effects if the GAAR

was successfully applied (repayment of outstanding provincial taxes plus interest and the costs to unwind the plan)

- After the Finco plan was implemented, it was challenged by the CRA on the basis that it violated Ontario's GAAR.
    - Rather than challenge the reassessments (which according to its legal counsel, was a "viable option"), the Plaintiff opted to settle with the CRA.

- The Plaintiff then sued the Defendant on a variety of grounds – asking for approximately $750,000 of contingent fees paid to the Defendant (and perhaps other damages).
    - The complaint, apart from the conflict of interest, is that the Plan was understood by the defendant, to be an "aggressive" tax avoidance scheme with a "high risk" of provoking a vigorous challenge by the CRA, of which risk the defendant failed to advise the plaintiffs.
- Note: If a tax accountant writes a letter, it is not protected by solicitor-client privilege; a lawyer's letter would be protected under the privilege
    - Why keep the privilege with respect to tax planning documents?
        - Solicitor client privilege is a fundamental value of the legal system; exceptions would violate that value
        - Having to release plans and their risks would be doing the CRA's job and that is not the job of lawyers; the lawyer's role is to provide clients with options and the potential pros and cons of the different options
        - Protecting planning tools that could be spread and then disallowed
        - Allow people to engage in aggressive tax planning without fear
    - Why diminish the privilege?
        - Openness and transparency
        - Dis-incentivizing planning that is borderline tax avoidance

Decision: Application dismissed in favour of the Defendant

Reasons:

- **Was the Defendant in a Conflict of Interest in Entering into a Contingency Fee Contract in Regard to the Finco Plan while Acting as TBPL's Exterior Auditor** (which creates a duty for the Defendant to act objectively and impartially in the Plaintiff's best interests)?
    - Justice Affleck found that:
        - The Defendant had a fiduciary duty to the Plaintiff, which imposed upon the Defendant a duty of full disclosure of any potential conflict of interest and a duty to not prefer its own interests over the Plaintiff's;
        - The Defendant did not violate those duties (it was not "acting for two masters"); and
        - The Defendant did not violate any existing ethical rules in entering into the contingency fee agreement.
- **Did the Defendant fail to properly advise the Plaintiff about the risks of implementing the Finco Plan?**
    - Justice Affleck found that the Defendant's advice met the standard (but did not go into much detail as to why/how).
- **Did the Defendant Breach the Engagement Letter?**
    - plain reading of the phrase "successfully challenges" led to conclusion that it means a notice of reassessment was not only delivered, it was also either unsuccessfully resisted in the courts or, at the least, the plaintiffs were professionally advised there was no reasonable prospect of successful resistance in the courts.
    - Neither happened in this instance.
- **Whether the Defendant owed the Plaintiff anything since the Finco Plan was reassessed under the Ontario GAAR (which the Plaintiff did not dispute), Justice Affleck found that:**
    - Settling the reassessments with the CRA did not constitute a "successful challenge" as referred to in the engagement letter.
        - To constitute a "successful challenge", the Plaintiff first had to resist the reassessments in court;
    - Indeed, Justice Affleck noted that 2 years after the Plaintiff settled its case with the CRA, 2 other taxpayers with the same/similar plans challenged their reassessments in court and won.

CASELAW – NOT COVERED IN DETAIL IN CLASS

CANADA TRUSTCO MORTGAGE CO. V. R., [2005] 2 S.C.R. 601 – 3 STEP TEST FOR GENERAL ANTI-AVOIDANCE RULE – BURDEN OF PROOF AT EACH STEP – SALE-LEASEBACK WITHIN THE SPIRIT OF THE ITA

Ratio: The application of the GAAR involves three steps:

(1) whether there is a tax benefit arising from a transaction or series of transactions within the meaning of s. 245(1) and (2) of the Income Tax Act;
(2) whether the transaction is an avoidance transaction under s. 245(3), in the sense of not being "arranged primarily for bona fide purposes other than to obtain the tax benefit"; and
(3) whether there was abusive tax avoidance under s. 245(4), in the sense that it cannot be reasonably concluded that a tax benefit would be consistent with the object, spirit or purpose of the provisions relied upon by the taxpayer.

- The burden is on the taxpayer to refute points (1) and (2), and on the Minister to establish point (3).

Facts: CTMC carries on business as a mortgage lender, and as part of its business operations, it obtains large revenues from leased assets.

- CTMC purchased a number of trailers which it then circuitously leased back to the vendor in order to offset revenue from its leased assets by claiming a substantial capital cost allowance ("CCA" – for depreciation – a cost on capital property) on the trailers for the 1997 taxation year.
- This arrangement allowed CTMC to defer paying taxes on the amount of profits reduced by the CCA deductions, which would be subject to recapture into income when the trailers were disposed of at a future date.
- The Minister of National Revenue reassessed CTMC and disallowed the CCA claim.
- On appeal, the Tax Court of Canada set aside the Minister's decision; the transaction fell within the spirit and purpose of the CCA provisions of the Income Tax Act, and the general anti‑avoidance rule ("GAAR") in s. 245 of the Act did not apply to deny the tax benefit.
- The Federal Court of Appeal affirmed the Tax Court's decision.

Issue: Whether there was abusive tax avoidance under s. 245(4)?

Decision: Appeal dismissed; transaction at issue was not so dissimilar from an ordinary sale‑leaseback as to take it outside the object, spirit or purpose of the relevant CCA provisions of the Act

Reason:

- Duke of Westminster principle (Commissioners of Inland Revenue v. Duke of Westminster, [1936] A.C. 1 (H.L.)):
  - that taxpayers are entitled to arrange their affairs to minimize the amount of tax payable; Canadian tax legislation received a strict interpretation in an era of more literal statutory interpretation than the present.
- Application of the GAAR involves three steps.
  - The first step is to determine whether there is a "tax benefit" arising from a "transaction" under s. 245(1) and (2).
  - The second step is to determine whether the transaction is an avoidance transaction under s. 245(3), in the sense of not being "arranged primarily for bona fide purposes other than to obtain the tax benefit".
  - The third step is to determine whether the avoidance transaction is abusive under s. 245(4).
  - All three requirements must be fulfilled before the GAAR can be applied to deny a tax benefit.
- **Step 1: whether there was a tax benefit**
  - "Tax benefit" is defined in s. 245(1) as "a reduction, avoidance or deferral of tax" or "an increase in a refund of tax or other amount" paid under the Act.
  - Whether a tax benefit exists is a factual determination, initially by the Minister and on review by the courts, usually the Tax Court.
- **Step 2: avoidance transaction**
  - Section 245(3) specifically defines "avoidance transaction" as a transaction that results in a tax benefit, either by itself or as part of a series of transactions, "unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit".
    - Section 248(10) extends the meaning of "series of transactions" to include "related transactions or events completed in contemplation of the series"
    - If there are both tax and non-tax purposes to a transaction, it must be determined whether it was reasonable to conclude that the non-tax purpose was primary.

- Tax Court judge must weigh the evidence to determine whether it is reasonable to conclude that the transaction was not undertaken or arranged primarily for a non-tax purpose.
- The determination invokes reasonableness

- If at least one transaction in a series of transactions is an "avoidance transaction", then the tax benefit that results from the series may be denied under the GAAR.

- **Step 3: Abusive Tax Avoidance**
  - GAAR does "not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a misuse . . . or an abuse".
  - s. 245(4) imposes a two-part inquiry.
    - The first step is to determine the object, spirit or purpose of the provisions of the Income Tax Act that are relied on for the tax benefit, having regard to the scheme of the Act, the relevant provisions and permissible extrinsic aids.
    - The second step is to examine the factual context of a case in order to determine whether the avoidance transaction defeated or frustrated the object, spirit or purpose of the provisions in issue.
- **Application of facts to the law in Step 3: whether there was abusive tax avoidance under s. 245(4).**
  - practical burden of showing that there was abusive tax avoidance lies on the Minister
  - Textually, the CCA provisions use "cost" in the well-established sense of the amount paid to acquire the assets.
    - Contextually, other provisions of the Act support this interpretation.
  - the purpose of the CCA provisions of the Act, as applied to sale-leaseback transactions, was, as found by the Tax Court judge, to permit deduction of CCA based on the cost of the assets acquired.
  - Construing the CCA provisions as a whole, rejected the submission that "cost" in the relevant provisions of the Act should be reread as "money at risk", and also rejected the argument that the "economic substance" of the transaction determined that there was abusive tax avoidance.

COPTHORNE HOLDINGS LTD. V. CANADA, 2011 SCC 63 – HORIZONTAL AMALGAMATION TO INFLATE PUC UPON SUBSEQUENT REDEMPTION OF SHARES, GIVING SHAREHOLDERS TAX FREE INCOME – VIOLATES GAAR

Ratio: Even if a transaction within a series of transactions is not contrary to the text of the ITA, if it frustrates and defeat its purpose, it can be in violation of the GAAR (s. 245)

Facts: By a series of transactions, two Canadian corporations that had been parent and subsidiary became "sister" corporations — that is, corporations owned directly by the same non-resident shareholder, Big City Project Corporation B.V.

- The sister corporations were then amalgamated — a "horizontal" amalgamation — and the **paid-up capital** ("PUC") of their respective shares was aggregated to form the PUC of the shares of the amalgamated corporation.
  - Had they remained as parent and subsidiary, the PUC of the shares of the subsidiary would have been cancelled on amalgamation.
- The amalgamated corporation then redeemed a large portion of its shares and paid out the aggregate PUC attributable to the redeemed shares to its non-resident shareholder.
  - That payment was not treated as taxable income to the shareholder but instead as a return of capital.
- The Minister of National Revenue considered the transactions by which the parent and subsidiary became sister corporations to have circumvented certain provisions of the Act in an abusive manner and thus to have contravened the general anti-avoidance rule (ITA s. 245)
  - Applying the GAAR, the Minister concluded that the PUC of the shares of the former subsidiary should have been cancelled upon amalgamation with its former parent corporation, as required by s. 87(3).
  - If the PUC of the shares of the amalgamated corporation was reduced, the amount paid to the shareholder in excess of the reduced PUC would have constituted a deemed dividend subject to tax.
  - The Minister reassessed the amalgamated corporation for unpaid withholding tax on the deemed dividend portion of the amount paid to the non-resident shareholder
- The Tax Court of Canada and Federal Court of Appeal upheld the reassessments.

Decision: appeal dismissed; appellant was guilty of violating the GAAR

Reason:

- **the GAAR can only be applied to deny a tax benefit when the abusive nature of the transaction is clear" (Trustco, at para. 50).**
    - The court's role must therefore be to conduct an objective, thorough and step-by-step analysis and explain the reasons for its conclusion.
- When the Minister invokes the GAAR, he is conceding that the words of the statute do not cover the series of transactions at issue.
    - Rather, he argues that although he cannot rely on the text of the statute, he may rely on the underlying rationale or object, spirit and purpose of the legislation to support his position.
- **GAAR Analysis:**
- **(1) was there a tax benefit;**
    - The burden is on the taxpayer to refute the Minister's assumption of the existence of a tax benefit.
    - The existence of a tax benefit can be established by comparing the taxpayer's situation with an alternative arrangement that could reasonably have been carried out but for the existence of the tax benefit.
        - In this case, the vertical amalgamation comparison used by the Minister was appropriate, and the finding of the Tax Court that there was a tax benefit should be affirmed.
        - vertical amalgamation would have been the simpler course of action
- **(2) was the transaction giving rise to the tax benefit an avoidance transaction; and**
    - Under s. 245(3) of the Act, a transaction will be an avoidance transaction if it results in a tax benefit, and is not undertaken primarily for a bona fide non‑tax purpose.
    - The starting point is the common law test for a series upon which "each transaction in the series is pre‑ordained to produce a final result".
    - Section 248(10) of the Act extends the meaning of "series of transactions" to include any related transactions or events completed "in contemplation of" the series.
        - the redemption transaction here was part of the same series as the prior sale and amalgamation, and the series, including the redemption transaction, resulted in the tax benefit.
    - If there is a series that results, directly or indirectly, in a tax benefit, it will be caught by s. 245(3) as an avoidance transaction unless each transaction within the series could reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain a tax benefit.
        - This determination is to be objectively considered, and must be based on all of the evidence available to the court.
        - Here, the Tax Court judge was correct to find that the sale of the VHHC Holdings shares to the non‑resident parent corporation was not primarily undertaken for a bona fide non‑tax purpose
    - The burden was upon Copthorne to prove the existence of a bona fide non-tax purpose (Trustco, at para. 66), which it failed to do.
- **(3) was the avoidance transaction giving rise to the tax benefit abusive.**
    - **court must first determine the "object, spirit or purpose of the provisions . . . that are relied on for the tax benefit, having regard to the scheme of the Act, the relevant provisions and permissible extrinsic aids" (Trustco, at para. 55).**
        - text of s. 87(3) ensures that in a horizontal amalgamation the PUC of the shares of the amalgamated corporation does not exceed the total of the PUC of the shares of the amalgamating corporations.
        - The question is why s. 87(3) is concerned with limiting PUC in this way.
        - object, spirit and purpose of s. 87(3) is to preclude the preservation of PUC, upon amalgamation, where such preservation would allow a shareholder, on a redemption of shares by the amalgamated corporation, to be paid amounts without liability for tax in excess of the investment of tax-paid funds
    - **Second, a court must consider whether the transaction falls within or frustrates the identified purpose (Trustco, at para. 44).**
        - while not contrary to the text of s. 87(3), does frustrate and defeat its purpose.
        - found that the avoidance transaction had misused the provisions "to artificially increase the PUC on amalgamation with the subsequent return of [the] artificial increase to shareholders on a tax-free basis, the very result that these provisions were intended to prevent"
    - **analysis will then lead to a finding of abusive tax avoidance:**
        - (1) where the transaction achieves an outcome the statutory provision was intended to prevent;

        - (2) where the transaction defeats the underlying rationale of the provision; or
        - (3) where the transaction circumvents the provision in a manner that frustrates or defeats its object, spirit or purpose.
- **Note on Paid Up Capital (PUC):**
    - PUC represents capital invested in a class of shares of the corporation by its shareholders.
    - When that class of shares is redeemed by the corporation in whole or in part, the amount paid by the corporation to the shareholders in excess of the PUC attributable to the redeemed shares is deemed to have been paid as a dividend that must be included in the income of the recipient shareholder.
    - However, the PUC portion need not be included in the income of the recipient shareholder because it is viewed as a return of capital to shareholders.
    - While PUC relates to shares, Adjusted Cost Base relates to a specific taxpayer.
        - PUC depends on the amount initially invested as capital, whereas the ACB reflects the amount the current shareholder paid for the shares.
        - In some cases the ACB and PUC may be the same, but in others they may not be.
        - In the case of shares acquired from a prior shareholder it will be unlikely that the ACB will be equal to the PUC.

UNIT #4 – TAX IMPLICATIONS OF OWNING YOUR OWN HOME

Principal Residence Exemption

- An income tax benefit that generally provides you an exemption from tax on the capital gain realized when you sell the property that is your principal residence.
- Generally, the exemption applies for each year the property is designated as your principal residence.

Advantages and Disadvantages of Renting vs Home Owning

- **Advantages of renting:** ability to relocate; don't need down payment; financial investment is lower; fixed costs/certain; no maintenance costs
- **Disadvantages of renting:** Less control, rent paid is not an investment (whereas house cost is an investment)
- **Advantages of Ownership:** security; building equity; freedom to customize; good investment;
- **Disadvantages of Home Ownership**: Can be onerous financial commitment; location may not be suitable

From a tax perspective, regardless of which option we choose, the cost of shelter will have to be paid with after tax dollars. Why?:

- **paragraph 18(1)(h)** prohibits the deduction of personal or living expenses, and the lack of a general deduction of housing expenses against employment income in **section 8**.
- **paragraph 20(1)(c)** also prohibits the deduction of interest unless the borrowed monies are used for the purpose of earning income from business or property (which is not satisfied when you take out a mortgage to purchase a home to live in)
    - In the United States, the interest on mortgage payments is tax deductible
    - This creates a disincentive to pay off your mortgage
    - SO, you pay the minimum amount of your mortgage due and keep deducting the interest from your tax liability

Primary tax benefit of **owning** rather than **renting**:

- any gains arising from the sale of a principal residence are potentially tax free due to the principal residence exemption (PRE).

BENEFITS OF OWNING YOUR OWN HOME:

- **Benefit #1: Imputed Income**
    - Imputed definition: deeming or attributing something to something else without it actually being there
        - Therefore imputed income is calling something income when it doesn't have all the characteristics of income – primarily intangible, but could still measure
        - Generally refers to the benefit and savings that is derived from the personal use of one's own assets and from the performance of services for one's own benefit. It is the value of enjoying the assets and the things you do for yourself

- **Another definition** – it is the money that you save by enjoying your own property and services rather than earning income, paying taxes and then using the after-tax income to purchase the goods and services from someone else.
- In the case of home ownership the benefit can be defined as living in your home for free; Imputed income is effectively the rent you are forgoing by deciding to live in it yourself

- **Benefit #2: Appreciation in Property Value**
  - Benefit in investing in a house that appreciates as opposed to stocks, bonds, or commodities, is that generally speaking the latter categories are subject to tax possibly as a capital gain or as a business gain
    - Therefore benefit of home is that if it is a principal residence there is the potential for it to be tax free

CHARACTERIZATION OF THE PROPERTY

- In order for the gain on the sale of a property to be potentially eligible for the principal residence exemption (**PRE**), which is set out in **paragraph 40(2)(b)**, the property must constitute a principal residence as (extensively) defined in **section 54.**

Step #1: the property must constitute a "capital property" as opposed to non-capital property (i.e. "business property" or "inventory")

- This is because both the definition of a principal residence (**section 54)** and the PRE (**paragraph 40(2)(b))** are both found in the **Capital Gains and Losses Subdivision C** of the Act.
  - If the property does not constitute capital property but business property (inventory), then the PRE will not apply and your gain will then be 100% taxable
    - Remember that business includes an adventure in the nature of trade (one time transaction carried out with intention to profit)
- **How do we determine whether property is capital property or business property?**
  - Look to definition of "capital property" in **section 54**
  - Application of the primary and secondary intention tests (preferred method)
- **List of factors the courts have used to determine whether a particular sale is on account of capital or income, namely (*Happy Valley Farms Ltd. v. Minister of National Revenue*):**
  - **Primary & Secondary Intention Test**
    - 1) Primary intention to sell for profit or to use the property? If the primary intention was to use the property (constitutes capital property and gain on disposition is capital gain), subject to courts finding motivating secondary intention
    - 2) Secondary intention test - taxpayer motivated to purchase the property on basis that could sell it for a profit if primary intention was frustrated or if the taxpayer changes their mind – a "can't lose" situation (business property and the gain will be a business gain)
      - Very rare that the courts will apply the secondary intention test
  - **The feasibility of the taxpayer's intention;**
  - **The extent to which the taxpayer's intention was implemented;**
  - **Evidence that the taxpayer's intention changed after the purchase of the real estate;**
  - **The geographical location and zoned use of the real estate acquired;**
  - **Frequency of similar transactions**
  - **Connection between the taxpayer's regular business and the transaction**
    - Closer your profession is to flipping houses, the more likely your transaction will be viewed as part of your normal business, and that the intention was to buy and sell the property for profit (business asset)
  - **The extent to which borrowed money was used to finance the real estate acquisition and the terms of the financing;**
    - Generally, the Courts have taken the view that if you are buying something for a business purpose, you will take out a loan and go into debt
    - You get to deduct interest on a loan when the loan is for business purposes
    - Financing with borrowed funds = business asset
    - If you do not borrow money for your home purchase, it is more likely to be classified as a capital asset

        - Weak indicia though because young people often need a loan to finance their purchase
    - **The length of time the asset was held**
        - Shorter time tends to indicate an intention to flip a home (business asset)
        - But holding on for a longer time does not, in and of itself, indicate a capital asset;
        - Court looks at whether the return on investment was reasonable (as to how the land was used) and whether there was a legitimate use of the land
    - **The factors which motivated the sale of the real estate;**
        - Factors that objectively verify the stated intention of the tax payer
        - E.g. taxpayer claiming that intention was to use the property would be supported by factors such as: divorce, being laid off, getting a new job, neighbourhood is altered (e.g. new gas station)
    - **Reasonable return on investment**
        - How could reasonable person have expected to make money through the acquisition and ownership of property?
    - **The existence of other persons who share interests in the real estate;**
    - **The nature of the occupation of the other persons referred to above as well as their stated intentions and courses of conduct;**
        - Evidence that the taxpayer and/or associates had dealt extensively in real estate.

Step #2: to potentially qualify for the PRE, the property will also have to constitute personal use capital property

- **Personal use property** is defined in **section 54** as capital property used "primarily for the personal use and enjoyment of the taxpayer and anyone related to the taxpayer"
    - This is important for another reason (other than the potential eligibility of the PRE):
        - **stop loss rule** in **subparagraph 40(2)(g)(iii):** any losses on the disposition of personal use capital property are deemed to be **nil**.
            - You cannot claim the loss to offset other gains
            - Reason for rule: The tax payer already benefits from the property by using it, so they should not also benefit by using the loss on the property, caused by their usage of the property, to offset other losses (double dipping)
- **Types of capital property:**
    - Personal use capital property – intention to use the property for your personal use
    - Income earing capital property – property on which you earn income e.g. rents; so if you buy property with the intention of renting it out, it will not be eligible for the personal residence exemption
    - Depreciable capital property – property that declines in value solely because of time passed or because it is being used
        - E.g. vehicle
    - Non-depreciable capital property – does not decline in value solely due to time or usage
        - E.g. land and shares

PRINCIPAL RESIDENCE DEFINITION

Once found to be (i) capital property, and (ii) personal use capital property, the property must also comply with definition of "**principal residence**" in **section 54** to be eligible for the PRE

- **Note:** you can have more than one principal residence – can only claim the exemption for one though
- **Note:** no requirement that the property be located in Canada

1st Requirement: it must constitute a **"housing unit"**, which according to the Folio (para 2.7), generally includes: a house, apartment, duplex, cottage, mobile home, trailer, and a houseboat.

2nd Requirement: the taxpayer must **own the property,** either solely or jointly with another person (preamble).

- There are **two main types of shared ownership**, namely, **joint tenancy** and **tenancy in common**.
    1. **Joint Ownership–** technically, each owner owns the entire property and has a right of survivorship (on the death of one owner, their interest disappears, making the surviving owner's interest greater by a corresponding amount)

- Important Tax Point: for tax purposes, to calculate a gain, you effectively divide the ownership interest between the joint owners
- Joint tenants are faced with proportionate tax burden (e.g. two joint tenants, then each tenant pays 50% of the total tax owing on the property)

2. **Tenancy in Common –** each owner has a specified interest in the property with no survivorship rights.
   - In this case, the tenancy will specify the exact ownership percentage of each taxpayer
   - The owners are taxed based on percentage of ownership
   - When an owner dies, they are deemed to have disposed of their interest

- In addition to the types of shared ownership, there are also **two types of ownership interests**, namely, **legal** and **beneficial/equitable interests**. As set out in **paras 2.79 – 2.80 of the Folio:**
  - **Legal ownership** "exists when title is transferred to, recorded in, registered in or otherwise carried in the name of a person. Legal owners are generally entitled to enforce their ownership rights against all other persons".
  - **Beneficial ownership** is "the type of ownership of a person who is entitled to the use and benefit of the property whether or not that person has concurrent legal ownership. A person who has beneficial ownership rights but not legal ownership can enforce those rights against the holder of the legal title"
    - If there is a separation of title ownership, it is the beneficial owner who is taxed
  - Where there is a separation of legal and beneficial ownership, generally speaking, beneficial ownership will generally be more important
    - You must have beneficial interest in the property for it to qualify for the PRE
  - Beneficial ownership "is a mixed question of fact and law that can only be determined after a complete review of all the facts and circumstances applicable to a particular situation"
    - So look to the circumstances of the case even where there is no beneficiary interest on title

3rd Requirement: the beneficial owner must be an individual; it cannot be a corporation.

- This is required by **paragraph 40(2)(b),** which provides that only an individual can claim the PRE.
  - But if a corporation holds only the legal interest in the property, there is still potential for applying the personal residence exemption, if the residents hold the beneficiary interest
- Note: the general rule is that you don't want a corporation to hold a property for personal use

4th Requirement: the property must be **"ordinarily inhabited"** by the taxpayer, the **taxpayer's spouse or common law partner** (or former spouse or common law partner) or by a **child** of the taxpayer (**paragraph 54(a)**).

The "Ordinarily Inhabited" Requirement

- Not defined in Act; must rely on case law (ordinary meaning of the phrase is usually used – ie. to live in on a regular basis)
  - Some common definitions that have been employed by the courts include: "usually or commonly occupied as an abode, more than a place where one would visit occasionally or use for certain purposes other than ordinary habitation, and to normally occupy as a home"
- Typically, this is not a significant barrier to claiming the PRE. More specifically, the CRA has stated in a variety of publications, including **paras 2.10 – 2.12 of the Folio** that:
  - The property does not have to be continuously inhabited for a long period of time during the year to qualify;
  - It can be occupied seasonally (i.e. cottage at lake) and will typically be considered by CRA to be "ordinarily inhabited"
- Requirement is an issue only in two situations, namely:
  - **Issue #1** – where it is not physically possible to "ordinarily inhabit" a property as a principal residence
    - E.g. buying a house or a condominium before it's built
    - In that case, you cannot fulfill the requirement for "ordinarily inhabit"
  - **Issue #2:** CRA will not consider a property to be ordinarily inhabited if the main purpose of the property is to gain or produce income
    - "main" or "primary" purpose means that the property is making income 50% of the time

- So if you rent it out for a few months each year, it can still be ordinarily inhabited (but if it is always available for rent, this could be problematic)
- Note: if you buy a property primarily to rent it out, it technically won't even be personal use capital property (it would be income earning capital property)

▪ **Note**: if the housing unit is rented to the taxpayer's child, who also ordinarily inhabits the housing unit in the year, then this rental arrangement alone will not disqualify this property from being eligible for the PRE
- But if the majority of the house is being rented out to others, this will also be problematic

CLAIMING THE PRINCIPAL RESIDENCE EXEMPTION – LAST TWO REQUIREMENTS

- In addition to the **four requirements** for a property to constitute a principal residence already discussed, there are **two additional requirements** that are engaged when the taxpayer wishes to claim the PRE:

5th Requirement: the taxpayer must designate the property as his/her principal residence for each desired year

- neither the taxpayer nor his/her spouse or common law partner (if any) or minor, unmarried children may have designated any other otherwise qualifying properties as his/her principal residence for that year (subject to an exception in respect of qualifying properties and designations made in respect of years before 1982) (**paragraph 54(c)** "no other property can already have been designated")
  - So per family unit, you can only have one designated property as a principal residence (this was not the case prior to 1982)
- Note: there are some exceptions for minor dependent children

6th Requirement: in order to be able to make a principal residence designation for a particular year, the taxpayer must be a **Canadian resident** for that year (by virtue of the definition of "B" in the calculation of the principal residence exemption in**)** Canadian resident (**paragraph 40(2)(b)**)

- Canadian resident either by way of the common law or a statutory deeming rule (e.g. sojourner rule)
- Note: This requirement does not mean that in the year that you claim the PRE you must be a Canadian resident.
  - What is says is that to be able to validly designate what would otherwise be a PR as being your designated PR for that year, in the year that you are seeking to make that designation, you must be a resident (so possible for a non-resident to make a claim for PRE if, for at least part of the period of ownership, they were a resident)

What can be sheltered? (Basically 7th Requirement: 0.5ha limits for PRE):

- **Paragraph 54(e)** of the definition of a "principal residence" provides that generally speaking, in addition to the house itself, the taxpayer can claim up to ½ hectares of land as part of his principal residence
  - Home as well as any property that the home is attached/affixed to, up to ½ hectare of land (definition in **section 54**)
- If property property is over ½ hectare in size, then **use and enjoyment test** must be satisfied to include the whole property as PRE:
  - **The excess land must be necessary to the use and enjoyment of the principal residence in order to qualify for the exemption, and not simply desirable**
    - The most common example of this is where, by law, the property cannot be subdivided into a smaller parcel (***Cassidy v. R)***

CASSIDY V. R., [2012] 1 C.T.C. 105 (FCA) -EXCEPTION TO 0.5HA LIMIT ON PRE – UNABLE TO LEGALLY SUBDIVIDE

Facts: Cassidy and his then common law spouse acquired a house on a 2.43 hectare parcel of land in 1994; He sold the land and home in 2003; Cassidy could not have acquired less than the 2.43 hectare parcel because of the zoning laws then applicable to the area; Cassidy realized a capital gain on the sale but he did not report the gain when filing his 2003 income tax return because he believed that the entire gain fell within the principal residence exemption; The Minister disagreed; Mr. Cassidy appealed the assessment to the Tax Court without success, and then appealed to the FCA

- principal residence provides that generally speaking, in addition to the house itself, the taxpayer can claim up to ½ hectares of land as part of his principal residence

Issue: whether Mr. Cassidy is entitled to the benefit of the principal residence exemption in relation to the capital gain he realized on the sale of his home and the 2.43 hectares of land on which it was located?

Decision: Appeal allowed; Mr. Cassidy is entitled to the benefit of the principal residence exemption for the full amount of his capital gain realized on the sale of his house and the 2.43 hectares of land

Reason:

- Crown argued that Mr. Cassidy was not entitled to the principal residence exemption for 1.93 hectares of the property because when he sold his property in November of 2003, he was no longer barred by local laws from subdividing the property.
    - Crown argues that the determination of principal residence exemption is required only for the date on which the property is disposed of.
- When taxpayer acquired property, local zoning by-laws precluded him from acquiring less than entire 2.43 hectares of land
    - Therefore, as long as zoning remained what it was in 1994 and there were no other relevant facts, entire 2.43 hectares of land would have been taxpayer's PR until May 2003, when zoning changed
- **Regarding calculation:**
    - Application of formula in s. 40(2)(b) of Act resulted in gain allocable to house and half hectare of land being entirely exempt; for remaining 1.93 hectares of land, formula yielded same result
    - Tax Court failed to give effect to language of s. 40(2)(b) that defines variable B — Determination of variable B requires determination, **for each taxation year** in which taxpayer owned property in issue, as to whether property met definition of PR for that taxation year.

THE BASIC MECHANICS OF THE PRINCIPAL RESIDENCE EXEMPTION – 3 STEPS

Step #1: calculate the taxable capital gain pursuant to subsection 40(1)

- **Capital Gain/Loss** = Proceeds of Disposition (actual or deemed) – Adjusted Cost Base – Selling Expenses
    - Note for ACB: ITAR Rules for determining ACB if asset was purchased prior to Jan 1, 1972
- **Taxable Gain/Loss** = Capital Gain/Loss X Inclusion Rate
- One of the implications of personal use capital property is that any loss from the disposition of the property is deemed nil (so you cannot claim capital loss)
    - Rationale: you get the benefit in having personally enjoyed and used it therefore you have benefit relative to depreciation in value (analogous to loss in value of a car)

Step #2: calculate the PRE as set out in paragraph 40(2)(b)

- **PRE** = ((# years property is designated as PR + 1)/(Total # of Years Property was Owned)) X taxable capital gain
    - Note – if you were not a Canadian resident at the time of purchase, you do not get the + 1

Step #3: subtract the PRE as calculated in Step #2 from the capital gain calculated in Step #1.

- **Net taxable gain** = taxable capital gain – PRE
- **Note**: if the result of the formula is a negative amount, **section 257** deems it to be nil.
- Technically speaking, to claim the principal residence exemption, **Form T2091** *Designation of a Property as a Principal Residence by an Individual* must be completed and included with the taxpayer's return in the year of sale.
    - The October 2016 amendments now require disclosure in all cases, and penalties if not properly

PRACTICE EXAMPLES

SCENARIO #1

- **Assumptions:**
    - The Taxpayer is a single adult female with no dependent children.
    - She bought a house (House #1) in 2006 for $250,000.
    - On April 2, 2015, she bought another (bigger/fancier) house (House #2) for $500,000.
    - On June 29, 2015, she sold House #1 for $410,000 and incurred selling expenses of $10,000.
    - In all relevant taxation years, the Taxpayer's employment income puts her into the highest marginal bracket (excluding the effect, if any, of any housing transactions), which we will assume to be 40% (federal and provincial combined)
    - In all relevant taxation years, the Taxpayer was a Canadian/Alberta resident

- Other than these two houses, the Taxpayer has never owned nor designated any other properties that could potentially qualify as her "principal residence" for income tax purposes.

- **Question:** what are her tax implications arising from her housing transactions?
- Answer: She has a tax liability of $0 for the capital gain in her House 1
  - Note: years is on a calendar year basis, not on number of days. Best idea here is not to designate the year she sold it to maximize the years of designating a home as a principal residence by designating it to her new house.
- **Process Followed:**
  - 1) Capital Property? First, carry out a primary/secondary intention test to determine if the property is a capital asset (why was the home purchased in 2006?). If for use, then it is a capital asset.
  - 2) Personal Use Capital Property? Was the Capital asset intended to be used for income, or was it for personal use? (if it was intended as a rental property, it is not eligible for a PRE)
  - 3) Step 1: Calculate Taxable Capital Gain:
    - 410,000 (proceeds on disposition) - 250,000 (ACB) – 10,000 (selling expenses) = $150,000
    - Taxable capital = $150,000 x 50% inclusion rate = $75,000
  - 4) Step 2: Make sure all requirements for PRE are met and calculate PRE:
    - is it a housing unit? Is she the legal and beneficial owner? Does she own it as an individual and not as a corporation? Was it ordinarily inhabited by her? (as long as she doesn't occupy it less than 50% of the time and it is physically possible for her to inhabit)? Designated as principal residence each year? Canadian resident every year? Does it sit on land less than ½ hectare in size?
    - PRE = (# designated as PR + 1)/(Total # of years owned) x Total Capital gain
      - (note: why is there the + 1 in the equation; because that allows for the homeowner to save the last year – the sale year – to designate your new home as the principal residence)
      - Total calendar years: 10 years (2006 – 2015) (if 1 year was saved for designating your new home as your principal residence, you could have said 9 – saving the year of transition for the new property)
      - PRE = 10+1/10 x $75,000 = $82,500
    - Step 3: net taxable gain = taxable capital gain - PRE
      - $75,000 – 82,500 = -7,500 (deemed zero by the stop loss rule)
    - **Tax liability = $0**

SCENARIO #1A

- Assume everything in Scenario #1, except that:
  - The Taxpayer bought vacant land in 2006 for $50,000
  - The Taxpayer hired a builder in 2007 to build House #1 on the vacant land for an agreed purchase price of $200,000
  - On January 2, 2008, she took possession of the (finally) completed home and moved in.
- **Question:** what are her tax implications arising from her housing transactions?
- **Process:**
  - **First, check that all requirements are met:**
    - capital asset?
    - Personal Use capital?
    - Principle Residence Requirements all met?:
      - Housing unit?
      - She owns it?
        - She has beneficial and legal title?
      - She is an individual, not a corporation?
      - Ordinarily inhabited?
      - Canadian resident each year?
      - She declared it as a principal residence each year?
        - Does the land sit on less than ½ ha?
  - Step 1: Capital gains = net proceeds – costs of sale – ACB
    - $410,000 - $10,000 - $250,000 = $150,000

        - There is no change from situation 1 even though the land and the house were purchased a year apart.
    - **Taxable capital** = $150,000 x 50% inclusion rate = **$75,000**

- Step 2: PRE = ((# years designated Property as PR + 1)/(Total # of Years Property was Owned)) X taxable capital gain
    - **PRE** = (7 + 1)/10 X $75,000 = **$60,000**
        - Just designating for 7 years (2008-2014), to save one year for the new house she bought in 2015
- Step 3: Net taxable gain = taxable capital gain – PRE
    - $75,000 - $60,000 = $15,000
- Tax liability = Net taxable gain x marginal tax rate
    - **Tax liability = $15,000 x 0.40 = $6,000**

- **Observations:**
    - If a person only has one PR at a time, then this mechanism will effectively shelter the gains for the Canadian resident household for their entire life

SCENARIO #2

- Husband and Wife currently own two properties. Their house was purchased by (and is solely owned by) Husband in 1995 for $100,000. Their cottage was purchased by (and is solely owned by) Wife in 2005 for $25,000. The couple, both elementary school teachers, live in their house from September to June and spend July and August in their cottage at the lake. In 2014, Wife is offered a fantastic job in Ontario and, as a result, the couple decides to sell both Alberta properties in that year and move to Ontario.
- It is now February 2015, and the couple comes to your office for some tax advice. In particular, they want to know how best to utilize their principal residence exemption and what, if any, amount each will have to pay on their tax return for 2014 as taxes from the sale of their Alberta properties. They inform you that they sold their Edmonton house for $610,000 (with selling expenses of $10,000) and their cottage for $425,000 (with no selling expenses). They also inform you that they haven't made any principal residence designations for 1995 to 2015, do not own any other housing units, and have no children.
- Please assume the marginal tax rate for each individual to be 40% and that the couple have decided not to designate either property as their principal residence for 2014 (they wish to save this year's designation for the Ontario home they will buy).

Answer:

- **First: ensure that all requirements are met (**capital property?, personal use capital property? Ownership (both beneficiary and legal title), Housing unit?, Ordinarily occupied (two summer months being spent at the cottage is fine as long as the couple was not renting it for the other ten months of the year)?, Canadian resident each year (must have been resident at least for portion of year to declare PRE)? Principal residence declared each year? Property is less than ½ ha in size?
- **Note: How to determine which home to delegate as your principal residence:**
    - Find out the amount that the house value increased per year and allocate the maximum number of years to the house that increased the most in value (your principal residence should be the property that increased the most $/calendar year)
- **Step 1 Capital gains = net proceeds – costs of sale – ACB**
    - House: 610,000 – 10,000 – 100,000 = $500,000
    - Cottage: 425,000 – 25,000 = $400,000
    - **Value increase/year:**
        - House: $500,000/20 = $25,000/year
        - Cottage: $400,000/10 = $40,000/year
        - So you want to designate the maximum number of years possible to the cottage as your principal residence to maximize your tax savings!
- **Step 2:** PRE = ((# years designated Property as PR + 1)/(Total # of Years Property was Owned)) X taxable capital gain
    - Cottage (2005-2013): PRE = 9+1/10 = 1 X $400,000 = $400,000

- House (1995-2004): PRE = (10+1)/20 X $500,000 = $275,000
  - Note: 2014 was used to designate their new house as the principal residence
- **Step 3:** Net taxable gain = taxable capital gain – PRE
  - Cottage: 400,000 – 400,000 = 0
  - House: 500,000 – 275,000 = 225,000
  - **Net taxable gain:** $225,000 X 0.50 = 112,500
    - 50% inclusion of capital gains in tax liability calculation
- **Final step: Tax liability** = Net taxable gain x marginal tax rate
  - Tax liability = 112,500 x 0.40 = $45,000

If there had been full designation of the Edmonton House every year possible:

- Step 2) PRE = ((# years designated Property as PR + 1)/(Total # of Years Property was Owned)) X taxable capital gain
  - House (1995-2013): PRE = (19 + 1)/20 x 500,000 = 500,000
  - Cottage: PRE = none, because no years were designated to the cottage
    - You don't get the plus one if you don't designate the property as a principal residence for one year
- Step 3) Net taxable gain = taxable capital gain – PRE
  - House: 500,000-500,000 = 0
  - Cottage: taxable capital = 400,000 x 0.50 = 200,000
- **Final step:** Tax liability = Net taxable gain x marginal tax rate
  - Tax liability = 200,000 x 0.40 (marginal rate) = $80,000 (higher tax liability by $35,000)

Further Questions:

- What if both properties were owned jointly (as opposed to the Husband owning one and the Wife the other)?
  - **Answer:** it makes no difference because you are allowed only 1 principal residence per family per year
- Would it make a difference if the increase in value of the House primarily occurred during 2007 – 2009?
  - **Answer:** It does not matter when the actual gain occurred; it is a point in time calculation, so all that matters is the average accumulation per year
- What if the Cottage was located in Florida?
  - **Answer:** Does not matter where the housing unit is located, you can still claim it as your principal residence
- What if instead of taking a job in Ontario, the wife took a job in the US (and the couple severed their Canadian residence and acquired US residence in 2014?
  - **Answer:** does not matter, because for at least part of 2014 they were resident in Canada, so they could designate a property as a principal residence

SCENARIO #3

- Mom and Dad's child (Daughter) has recently graduated from high school and is considering her post-secondary options. While Dad wants her to go to live at home and go to the University of Alberta (his alma matter), Mom is encouraging Daughter to consider other options including attending university away from home. After much research (and lunches with Mom), Daughter decides to enroll at the University of Victoria.
- The "deal" that Mom and Dad make with Daughter is that if she promises to work hard in school (with grades indicative of such effort), then Mom and Dad will pay for all of her expenses (including accommodations).
- After some of his own research on living in Victoria, Dad attends your office to ask for your advice. "The rental market around the University is outrageous. So too is the housing market, but it appears to be solid and appreciating. If my wife and I were to buy an apartment for Daughter to live in while she attends University, then in four years when she is done (please, please let her be done in four years), can I sell it and claim the principal residence exemption to shelter what is hopefully a healthy gain? With any luck, the gain could offset all of the expenses we incur to finance Daughter's education."

Instruct:

- **1) Must go through all of the requirements for principal residence and the principal residence exemption:**

- 1) Is it a capital asset?
  - Primary and Secondary Intention test (if necessary)
    - Was there a secondary intention to flip? – probably not based on the information. Not like there was some great deal they found that would make them think about flipping the house for profit.
- 2) Is it personal use capital?
  - this is where you look at whether the daughter is paying rent and if others are paying rent
  - the CRA's position is that if it is just a child paying rent to the parents, then the property can still be justified as personal use property, but probably not if other renters are paying
    - if more than 50% of the housing unit is being used as non-personal use then it will not qualify
  - Give the owners alternatives and explain those: example maybe more profitable to forgo the PRE and instead try to get more rental income
- 3) Who are the owners? Who's the beneficial owner?
  - maybe parents want to be on title but to give beneficial ownership to the daughter
    - important because it is the beneficial owner who claims the PRE and has to satisfy all the requirements
- 4) Housing unit?
- 5) Own as individual, not a corporation?
- 6) ordinarily inhabit?
- 7) Canadian resident each year
- 8) Claimed as principal residence each year and less than 1/2ha in size?

- From tax perspective one of the key issues here is whether the ordinarily inhabited requirement will be met
  - the property must be **"ordinarily inhabited"** by the taxpayer, the **taxpayer's spouse or common law partner** (or former spouse or common law partner) or by a **child** of the taxpayer (**paragraph 54(a)**).
  - **S. 54 definition of principal residence**
    - para (a) – doesn't specify if this only applies to adult child -- look to see if "child" is defined. It is not for the purposes of section 54 but under s. 252 of the Act there is a definition
    - **S. 252.** No reference to age of majority or minority, therefore some authority that adult would still be considered a "child".
  - For this requirement, an adult child can be the ordinary inhabitant rather than the parents
    - This is because under s 54(a), it is stated that principle residence can be ordinarily inhabited by a child of the taxpayer (any biological child, no limit on age)
  - You can only make one designation of a housing unit per family unit – s. 54(c)
    - If you are a child who is 18 years of age or older, married, or has a common-law spouse for a portion of the year, then your parent's designation of a principal residence will not affect your designation
    - So… a parent can designate a principal residence as a housing unit occupied by their child, and the child could still designate another housing unit as their principal residence (as long as they are over 18, married, or have a common-law spouse)
  - If you are under 18, not married, and not in a common-law relationship, you cannot designate your own principal residence

- **2) Examine - Should the parents claim the Victoria house as a principal residence?**
  - **Advantages of doing so**: extra + 1 in years if you claim at least 1 year for both houses, parents can have some control over where the child is living (safety, etc.)
  - **Disadvantage:** if you claim the Victoria home, you can't claim your primary home as the principal residence for those years, potential for losing value of the home (if daughter mistreats the home), have to finance a second home, not giving the child the life experience of planning their own living and expenses
- Assuming all requirements are at this point satisfied and the intention is to buy and own but the daughter is going to live in it:
  - **Parents will have to be the ones who determine the gains on the property, report them, and determine whether or not designate the property as their principal residence**

- look at predicted average annual gain – larger annual average gain will be the one you want to shelter from gains for those years of ownership
- Calculate capital gains, PRE, and tax liability
- **Considerations for principal residence:** length of ownership of the parents' home (longer ownership will mean that a few years of not claiming will have less impact), expected gain in house value over the four year period, you don't have to decide which house you designate until you sell the property (at the time of disposal of the property), ability to finance the home (if they have to borrow, this is a disadvantage because interest on the loan is not deductible if it is for personal use property)

- **3) GARR Analysis of the potential tax planning approach and give feedback to the clients:**
  - Must be a benefit
    - Potential for a tax-free capital gains
  - Benefit was a result of an avoidance transaction
    - Avoidance transaction – any transaction undertaken primarily to avoid tax
      - Is there an avoidance transaction – bought the home primarily to provide daughter with a safe place to live and enable her to go to school, and help finance the schooling, and now the transaction (disposition and designation as principal residence) is being carried out because the daughter no longer needs to live there
      - But could argue: Victoria housing market is strong, parents are primarily trying to avoid the paying of tax (weaker argument)
  - Must constitute a misuse or abuse of the Act (onus on the Minister)
    - This is a portion of the Act intended to help people receive some tax relief
    - Intended for taxpayers to utilize this provision in this manner
- **4) Alternative routes for the parents:**
  - Help the daughter with renting, and use the money that otherwise would have been invested in a home to invest in stocks
    - Advantages and disadvantages: stocks more speculative, gains on house would be potentially tax free (this advantage is not present for stocks, which will potentially be fully taxable)
  - Scholarships
  - Buy and charge rent to the daughter (but this may trigger the GAAR analysis more negatively if the daughter has no money of her own)
    - If the daughter is paying rent, the housing unit can still be designated as a principal residence
    - But if other rooms are rented out to non-children, primary purpose is no longer personal use property, and cannot be used as a principal residence
    - Parents will also have to report rent income for tax purposes
  - Gift of cash to the daughter and allow the daughter to purchase a home
    - An outright gift of cash is not taxed and the daughter can designate the house as a principal residence (advantages)
    - If the daughter then pays the money back as a gift upon selling the house (begins to look counter to the GAAR)
  - Or set up the house as a trust – beneficial ownership held by the daughter
  - Or daughter could take a loan, a mortgage on the house and the parents could co-sign as guarantors
  - Or make a loan to the daughter on commercial terms (basically a mortgage from the parents), and the parents can place a security interest on the property (priority over the proceeds from the house's disposition)

DEATH AND THE PRINCIPAL RESIDENCE EXEMPTION

Question: What happens when someone with a principal residence dies?

Answer: Generally speaking, when a person dies, s/he is deemed to dispose of his/her capital property immediately before death at FMV - **paragraph 70(5)(a).**

- This requires the executor of the deceased's estate to calculate the capital gain and PRE with respect to the principal residence, which is then reported on the deceased's terminal return
- the beneficiary of the house will take the house with an ACB equal to its FMV at the testator's death

Spousal Rollover:

- If the beneficiary of the estate is a Canadian resident[14] and is a surviving spouse or common law partner, **subsection 70(6)** provides:
    - when capital property is transferred to a spouse or common-law partner as a consequence of death, the capital property will be deemed to be disposed at the testator's "cost" and acquired by the Widow at such cost (so the ACB is adjusted to be equal to the ACB that was held by the spouse)
        - Effect is a tax deferral.
        - **Note:** can also have spousal rollover when both still alive (ie *inter vivos*) through **s. 73**; will also transfer at ACB
        - **Why is this done?:** often old couple may not have assets; don't want to have a situation where the spouse receiving the house has to sell the house or take out a loan to pay for the taxes due on the disposition gains that arise upon the deceased's death
    - With the transfer occurring at the deceased owner's cost, no capital gain is triggered by the disposition (and hence no need to make use of the PRE).
- **Subsection 40(4)** compliments **subsection 70(6):**
    - in such instances (i.e. transfer of capital property between spouses as a consequence of death), the Widow will be deemed to have owned the capital property during the time that the testator owned the property
    - The widow will be able to designate the capital property as her principal residence during that time (unless the testator designated another property as his/her principal residence during that time)
- **As a result of these two provisions:**
    - when the Owner of the property dies, there are no tax implications in respect of the principal residence property and the tax attributes flows to the Widow.
    - When the Widow dies, he/she can potentially shelter the entire gain on the PR using the PRE (or the estate, or kids, whoever is left to pay)

EXAMPLE #1: GENERAL RULE FOR DEEMED DISPOSITION UPON DEATH

- Assume: mom purchased house in 2000 for $250,000
- Mom dies in 2017, house's FMV = $600,000
- Daughter inherits house in Mom's will
- Mom (2017):
    - Calculate Taxable Capital Gains
        - Deemed proceeds – ACB = capital gain
        - Capital gain = 600,000 – 250,000 = 350,000
        - Inclusion rate: 50%
        - Taxable capital gain = 250,000 x 50% = 125,000
    - Calculate PRE
    - Calculate Net Gain
- Estate (2017)
    - House ACB = $600,000
    - If the beneficiary wants to actually sell so she will have the proceeds, rather than the house:
        - Capital Gain = proceeds – ACB = $600,000 - $600,000 = $0
            - Taxable Capital Gain therefore equals 0, and there is no tax liability
    - So, the disposition of the home is really only taxed once, and the tax liability falls upon the donor, not the donee
- **As per s. 70(6): (if the property is transferred to a spouse, by will)**
    - Dad (2017)
        - Dad's ACB: $250,000 (his wife's original purchasing price)

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[14] If the surviving spouse or common law partner is not a Canadian resident immediately prior to the deceased's death (who also had to have been a Canadian resident immediately prior to his/her death), then **subsection 70(6)** does not apply, meaning the default rule in **subsection 70(5)** applies (i.e. deemed disposition at FMV).

- Taxes on the estate: Capital Gain = Proceeds – ACB = $250,000 - $250,000 = 0 (so there is no capital gain and no taxable gains)
    - so dad doesn't need to sell the house to pay the taxes owing on the deemed disposition of the capital property
    - So principal residence exemption need not be designated to the property at the time of mom's death, and the dad can designate that home as principal residence upon his disposition or deemed disposition (in which case he will have to pay taxes on the capital gain)

SCENARIO #4

- Assumptions:
    - Mom purchased the couple's current house in 2000 for $250,000 and they have lived in it ever since.
    - In 2009, Mom died. At this time, the house was appraised at $450,000. Pursuant to Mom's will, Dad took full legal and beneficial ownership of the house.
    - Dad died in 2015. Due to a decline in the housing market (due to the financial recession), the house was appraised at this time at $400,000.
    - Neither Mom nor Dad had any other principal residences nor did either of them make any designations during this time period.
    - Any income/gains realized by Mom or Dad are taxable at 40%
    - Mom, Dad and the house satisfy all requirements (as applicable) to be eligible for the PRE
    - In Dad's will, the house goes to Son.

Question: what are the tax implications to Mom and Dad?

Answer:

- **2000:** ACB of 250K
- **2009:** Deemed disposition, but because it is going to Dad, as per s. 70(6) and steps into mom's shoes as per s. 40(4), it can be fully sheltered (the gains aren't taxed to Mom)
    - So Mom has a deemed disposition of $250,000
    - Her ACB = $250,000
    - Capital Gain = 0
    - Dad gains the house at an ACB at $250,000 (FMV was $450,000)
        - **Note:** you can elect out of 70(6), so there would be a deemed disposition and Mom has to pay the taxes on the gain
            - **Why you would do this?:** if Mom had other capital losses (from stocks, etc.) to offset the capital gains (net capital losses can be carried backwards 3 years and forward until death to offset capital gains)
            - Therefore, capital losses can be used to eliminate the taxes owing to Mom, and Dad can benefit because his ACB will be equal to the FMV of the home upon the date of Mom's death
- **2015:**
    - (1) Taxable Capital Gains
        - Dad's deemed proceeds = $400,000
        - Dad's ACB = $250,000
        - Capital Gain = $150,000
        - Taxable Capital gain = $150,000 x 50% = $75,000
    - 2) PRE: 2000-2015
        - PRE = (16 + 1)/16 x $150,000 = $159,375
        - Note: we include the full 16 years rather than save 1 year to cover a new house because there is no new house in this scenario
    - 3) capital gains – PRE = -9,375
        - 150,000 – 159,375 = -9,375
        - Taxable capital gains = -9,375 x 40%
        - This is deemed 0 as per the stop loss rule
    - The son takes the house at the ACB = $400,000 (FMV in 2015)
- **Note:** idea that you never want to let your estate go through probate

- Money charged to courts to release property as per dictated in the will
- To avoid this issue, you can make your son, whom you want to give the house to after your death, joint ownership prior to death
  - In such a case, since the son is a joint tenant, upon death, Dad's 50% interest disappears and the son becomes the sole owner as per the right of survivorship
  - There is no deemed disposition at that point of time so there are no tax implications for the son (however, there is a deemed disposition of 50% of the estate upon the gifting of the joint ownership)

SCENARIO #4A

- Assume that after Mom's death in 2009, Dad decides to put Son's name on title as a joint interest holder (i.e. he creates a joint tenancy) as a proactive step to reduce his estate and the probate fees on his death.
  - Dad's disposition (2009):
    - Deemed proceeds (upon a gifting of 50% joint interest to the son in 2009) = $225,000 (because 50% x $450,000, which was the FMV in 2009)
    - Dad's ACB = 125,000 (half of the ACB that Dad received upon mom's death, as per s. 70(6), at $250,000)
    - Capital Gain = Proceeds from disposition - ACB
      - $225,000 – 125,000 = 100,000
    - PRE (2000-2008): 9+1/10 x 100,000 = 100,000
    - Tax liability: Capital Gain – PRE = 100,000 – 100,000 = 0
  - Son's 50% joint interest after dad's death (once he has become sole owner):
    - ACB = $225,000 (50% of FMV when son acquires half interest) + FMV of dad's 50% when dad dies
- Also assume that Dad doesn't die until 2016, at which point the House is valued at $600,000:

2016:

- Dad (deemed disposition upon death):
  - Deemed proceeds = $300,000 (50% joint interest x $600,000 FMV)
  - ACB = $125,000 (50% x $250,000 – which was the ACB of the whole house, based on mom's actual cost to purchase the home)
  - Deemed proceeds – ACB = $175,000
  - PRE (2000-2015): (16 + 1)/17 x $175,000 = $175,000
    - Note: you must designate this house as the principal residence at minimum for the years of 2000-2008 since the house was already designated as a principal residence for those years when the dad disposed half interest to the son in 2009
  - Taxable capital = $175,000 - $175,000 = 0
- Son's ACB (2016) = $300,000 (from the deemed proceeds from dad's death for his %50 interest in the house)
  - (2009) half interest ACB = $225,000 ($225,000 was half the FMV of the house in 2009)
  - Total ACB = $525,000
- If son wants to sell the house in 2016:
  - Actual proceeds: $600,000
  - ACB = $525,000
  - Capital gain = $75,000
  - Inclusion rate = 50%
  - Taxable capital = $37,000
  - Tax liability (at tax rate of 40%) = $15,000
  - The son cannot claim principal residence exemption because even though he owned 50% interest in the home since 2009, he did not ordinarily inhabit the home
- So, in this situation, the gains could have been fully sheltered if the son had not been made a joint owner of the property, since the entire property was owned and inhabited by the dad for the entire time; so, making the son a joint owner creates a tax liability of $15,000 just to avoid paying probate fees of approx. $400 in Alberta
- Alternatives: you can give legal title to the son before the dad's death or give the son power of attorney

CHANGE IN USE OF PROPERTY FROM PERSONAL TO BUSINESS

- generally speaking, we characterize an asset for tax purposes **at the time of acquisition** and that characterization remains for the period of ownership by the taxpayer.
    - Further, the two possible characterizations of an acquired asset are:
        - **Business property/inventory**, where the taxpayer purchased the asset to sell for a profit), or
        - **Capital property**, where the taxpayer purchased the asset to "use it" as opposed to sell it for a profit
            - Of course, there are two main ways to use an asset, namely:
                - To earn income, and
                - To enjoy personally
- Assuming that a taxpayer purchases a housing unit to "use" (as opposed to "sell"), then if there is a **change in use** of the housing unit either from **income producing to personal** or from **personal use to income producing**, then **subsections 45(1)** and **13(7)** will deem there to have been a disposition and acquisition of that property at its FMV.
    - As a result, it will be necessary to calculate the gain/loss on the property.
- **Home "converted" from principal residence to a rental property:**
    - **subsection 45(1)** deems there to be a disposition (and reacquisition) at FMV and the resulting gain (if any) on the deemed disposition will be potentially eligible for the principal residence exemption.
        - From that point forward, the property will be characterized for tax purposes as being a depreciable capital property (as opposed to personal use property), and any gain will not be eligible for the PRE.
    - However, the Taxpayer can make a designation pursuant to **subsection 45(2)** to avoid the change in use rules from applying for a period of time.
        - This defers the deemed disposition and re-acquisition for FMV for up to 4 years
        - If the taxpayer makes this designation and does not claim capital cost allowance (CCA) on the property during this time[15] (but can claim other expenses and, of course, must claim the rental income):
            - then the taxpayer can (by virtue of the principal residence definition in **paragraphs 54(b)** and **(d)**) keep the property eligible for a principal residence exemption for 4 years, even though the taxpayer and his/her family no longer "ordinarily inhabit" there.
            - Set-back: if you exercise this right, then you can't use those years of designation for your new house, so you may have short term tax savings but end up not saving in the long-run (if the new home ends up increasing in value by a significant amount)
        - **This four-year extension rule** can be **extended indefinitely** where the taxpayer's move is employment related (i.e. relocation of employment) - see **section 54.1**
        - This election is made by sending in a letter with the taxpayer's return in the year of the change in use.
- **home being "converted" from a rental property to the taxpayer's principal residence**
    - pursuant to **subsection 45(1),** the general rule is that there is a deemed disposition (and reacquisition) of the property at FMV.
        - Because the deemed disposition occurs when the property was being used as an income-earning property, the PRE is not available to reduce/eliminate the gain.
        - However, it is possible to make an election under **subsection 45(3)** (if no CCA was claimed on the property while it constituted a rental property) to defer the gain until the property is actually sold.[16]
        - Further, by virtue of **subsection 45(3),** when the taxpayer actually disposes of the property (with the use at the time of disposition being the taxpayer's principal residence – assuming all of the requirements are satisfied):

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[15] If CCA is claimed in any taxation year, then by virtue of **subsection 45(4),** the election will be deemed not to have been made (with the associated consequences).

[16] The **subsection 45(3)** election is filed in the year of sale, unless the CRA makes a formal demand for the election earlier.

- then **subsection 45(3)** allows the taxpayer to treat the house as his/her principal residence (and satisfy the "ordinarily inhabited" requirement) up to 4 years prior to the house's use being changed to the taxpayer's principal residence.[17]
- E.g. if you own a rental property for 11 years, 4 of which it was used for capital… can still shelter 8 years (4+4)

- **if a taxpayer changes only a portion of the use of the home (from a principal residence to an income earning purpose):**
  - then there will be a deemed disposition (and reacquisition) of **only that portion** of the property at FMV pursuant to **subsection 45(1).**
    - Given that the property constituted the taxpayer's principal residence, it is possible for the PRE to reduce/eliminate the associated capital gain (which would commit the taxpayer to designate that property as his/her principal residence for those years).
  - However, it is not possible to do a **subsection 45(2)** election (4 year deferral); it is not applicable to partial changes.
  - CRA takes the position that this tax treatment will be applicable where:
    - the **partial change in use is "substantial and of a more permanent nature**" – e.g. **"structural change" of the front half of the house into a store**.
  - After the partial change in use, then the taxpayer (of course) is required to report the net income from the changed portion.
  - The **deemed disposition and reacquisition rule in subsection 45(1) will not apply** (and hence the **home will continue to fully constitute the taxpayer's principal residence**, assuming all of the other requirements are satisfied) where all of the following conditions are met:
    1. The income-producing use is ancillary to the main use of the property as a residence (i.e. not more than 50%);
    2. There is no structural change in the property; and
    3. No CCA is claimed on the property.[18]

TAX PLANNING FOR THE ELDERLY WITH A PRINCIPAL RESIDENCE

- **Assumptions:** older/retired client, house rich, income poor
  - **Client's Needs**: money – for living, investing or giving (to children/grandchildren); security; access to health services
  - **Client's Resources**: very limited liquid assets (or regular income), large amount of equity in principal residence
- **4 potential options:** (i) sell current house (downsize), (ii) stay in house and rent out portion, (iii) home-equity line of credit, and (iv) a reverse mortgage

(i) Sell current house:

- Tax implication: This is a disposition of a capital asset, so will be taxed on capital gains
  - Capital gain will be taxed, so will have to look at the principal residence exemption
    - Important factors: date of purchase (gains after Jan 1st, 1972 are taxed), whether principal residence exemption is available (or if other housing unit has already been designated in some or all years), residency, ownership, etc.
- Big downside: many emotionally/personally don't want to leave the home
- Clean cut: no 3rd party interference from lender

(ii) Stay in house and rent out portion

- Tax implication: could trigger a deemed partial disposition due to change in use

[17] See Folio paras 2.54-2.56 for the CRA's description of this provision (and an example).
[18] In the Folio, the CRA provides the following examples of where these conditions would be satisfied (and the home would continue to be the taxpayer's principal residence): the taxpayer uses a portion of the home to carry on a childcare business, where one or more room is rented, or the taxpayer sets up a home office.

- If more than 50% of home rented out, may lose the "ordinarily inhabited" requirement and lose the ability of claiming a PRE
- May be more help with work around the home
  - If just one room rented out – probably not deemed disposition of portion of home and probably no loss of ability to claim PRE
- Weaknesses: less privacy, extra duties, potential security concerns, maintaining tenants

(iii) Home-equity line of credit:

- A homeowner line of credit secured by the value of the home
- A creditor will give the homeowners a line of credit less than the full value of the house (less than full value so that creditor does not over-expose themselves)
- Tax implication:
  - This does not constitute a disposition under the Income Tax Act (see definition of disposition – 248(1)) – so it is not required for the owners to pay tax on the capital gain of the house
- The couple is able to continue living in their home
- Weaknesses: have to make interest payments on a regular basis (may also have to pay some of the principal), not the whole value of the home (usually at most give 75% of your equity),
  - Interest is charged on the line of credit; the interest cannot be deducted unless it is invested in an income earning purpose
  - The financial institution will usually want the interest paid on a monthly basis (so if they're already lower income, they may have issues with paying the interest)
  - This strategy will reduce the estate left behind in the couple's will
- One point: make sure elderly persons take care of themselves with the equity they built, rather than being overly worried about leaving a house or money in their estate

(iv) Reverse Mortgage:

- Most in Canada supplied by "Canada Home Income Plan" (CHIP)
- What's a conventional mortgage: a way for people to acquire houses.
  - Advance an amount in exchange for a security interest on the house which means they have a first claim to proceeds when sell the house up to the amount that is owing.
- **Reverse mortgage:** mortgager put security interest on title – frees up equity in the house, therefore you own less of the property than you did before the reverse mortgage. Homeowner will typically receive an amount up to 10-40% of equity (will depend on their age)
  - Allows homeowners to transfer equity in house to a more liquid form
- There is typically an age (minimum 55 years old) and use requirement (must agree not to sell the home)
- Strengths
  - compared to HELOC – no requirement to pay any of the monies given back while the homeowners are alive (can if you want to but generally don't have to make the interest payments like with HELOC)
    - If interest not paid monthly, it will just be added to the principal owed, which will be paid upon the death of the surviving spouse or common law partner to the original signatory homeowners
  - Upon the death of the surviving spouse or common law partner, CHIP will only have access to the house that is the security for the loan; the rest of the homeowner's estate is not liable to pay back the mortgage
    - So even if principal grows to exceed the value of the home, CHIP can only collect on value of home
  - No minimum monthly income required to show ability to pay monthly payments, which is the case for HELOCs
  - No restrictions on how the money can be used by the homeowners
  - Allows owners to stay in their home
- Weakness:
  - higher interest rate than HELOC
  - Also, interest is compounded so principal increases more rapidly
  - Less money can be received (lower % equity of the home)
- Tax implications: no tax implications
  - GARR risk:
    - 1) is there a tax benefit?

        - Not really because it is just a delay of the triggering of the taxing capital gains
    - 2) primarily for the purpose of a tax benefit?
        - Probably not, as the primary purpose is probably to have liquid assets while living in the long-time home
    - 3) contrary to the spirit of the Act
        - no

UNIT # 5 –NON-REGISTERED FULLY TAXABLE INVESTMENTS

- **Three main goals:** (i) maximize wealth, (ii) meet long-term goals, and (iii) reduce tax liability; not only generate wealth, but also manage – where savings come into play
- From a tax perspective, one relevant question is, what **type of investment (or account)** should I put my savings in?
    - Note – this is a different question than **what should I invest in**? (This is a question better asked to an investment advisor)
- **The 3 types of investments that we are going to look in this Unit are:**
    i. Non-registered fully taxable investments,
    ii. Registered Investments (RRSPs, RPPs, and RESPs), and
    iii. Tax Free Savings
- To assist in determining which type (or combination) of investments a person should (at least from a tax-minimization strategy) have, the **person should ask himself/herself the following questions:**
    - **What is my income and tax situation at time of investing and saving?**
        - Am I in my higher income earning years or lower income earning years relative to where I think I'll be later in my life?
        - Will my income change significantly from the time I make the investment to the time I may need or want to use it?
    - **Do I have a specific use or purpose for the investment?**
        - Is this intended use in the short or the long term?
    - **Do I foresee myself using this investment or will it likely be enjoyed by someone else?**
        - if someone else, what will their likely tax situation be at the time they will likely use the investment of savings
    - **What other investments or access to financing to I currently have?**

Assumptions/Background Information:

- Individual is in the highest tax bracket and resident in Alberta (which is applicable for income in excess of $300,000)
    - This gives us the "worst case" scenario for an Alberta resident – investment income will (generally) be subject to tax at 48 % (or more properly, based upon the 39% bracket)
- The taxpayer wants to use her savings to make passive investments (as opposed to investing in or carrying on an active business) which generate **interest income**, **dividend income**, and/or **capital gains.**

OPTION 1: INTEREST INCOME

- Generally speaking, interest income is the return one receives from loaning money to another.
    - As it is not defined in the Act, "interest" has been generally defined by the courts as "the return or consideration or compensation for the use or retention by one person of a sum of money, belonging to, in a colloquial sense, or owed to another" and "is referable to a principal in money or an obligation to pay money".[19]
    - generally speaking, it does not have any special tax rules/treatment.
        - It is fully taxable under **subsection 9(1),[20] paragraph 12(1)(c),[21] and subsection 12(4).[22]**

[19] *Saskatchewan (Attorney General) v Canada (Attorney General),* [1947] S.C.R. 394 at para 47.
[20] Subsection 9(1) is the starting point for the calculation of business and property income (which would include interest income) and defines income from a business or property as "the taxpayer's profit from that business or property for the year".

- **Interest income** is fully taxable under the current Act and hence is the simplest to determine.
  - Given out assumptions, if an Alberta taxpayer earns $1,000 of interest income in 2016, she will pay $480 of (federal and provincial) tax and will have $520 of after-tax income.
  - This will be our baseline for comparison with other investments and, as we will quickly see, the highest rate of taxation on investment income (at least only considering the individual investor).
    - Note: always look to the after-tax income to compare

OPTION 2: CAPITAL GAINS

- **Capital gains**
  - capital gains arise when capital property is disposed of (or deemed to be disposed of) for an amount in excess of its adjusted cost base (ACB).
  - capital gain is currently only **50% taxable** pursuant to sections 38 and 40
  - Consequently, given our assumptions, if an Alberta taxpayer realizes a $1,000 capital gain, then she will pay $240 of tax and will have $760 of after-tax income.
- Practically speaking, there are 2 ways of handling this special treatment, both of which come to the same answer.
  - First way: take the applicable marginal rate (assumed in this Unit to be 48%), multiply it by 50%, and apply that adjusted rate against the full capital gain (i.e. $1,000*24%)
  - The second (and technically correct) way is to multiply the capital gain by the 50% inclusion rate to get the taxable capital gain and then apply the applicable marginal tax rate (48%) to the taxable capital gain ($500*48%).

Note: where the capital gain arises from the disposition of "**qualified small business corporation shares**" and/or "**qualified farm or fishing property**", the taxpayer may be able to further reduce the associated tax liability through the use of the **capital gains deduction** in **section 110.6**

- This provision provides a cumulative lifetime exemption for gains arising from dispositions of these types of property– and generally speaking, only when realized by individual taxpayers.
  - Two tests built into the definition of a **"qualified small business corporation share"** is defined in **subsection 110.6(1)**:
    - Must be:
      - a share of a Canadian controlled private corporation that uses substantially all of its assets (more than 90%) in carrying on an "active business" in Canada (at the time of disposition) **and**
      - for the 2 years immediately preceding the disposition, more than 50% of the corporation's assets were principally used in carrying on an active business in Canada.
    - Generally speaking, the individual must also have owned the share(s) for more than 2 years to qualify
- **"qualified farm or fishing property"** is defined in **subsection 110.6(1)** as:
  - real or immovable property that was used in the course of carrying on a farming or fishing business in Canada – either by an individual, through a corporation (referred to as a family farm or fishing corporation) or partnership (referred to as a family farm or fishing partnership)

OPTION 3: DIVIDENDS

- Generally speaking:
  - dividends are paid out of **after-tax corporate income** (generally, there is no deduction for a corporation for paying dividends to a SH)
- The taxation of **dividends** (pursuant to **subsection 82(1)** and the associated sections) is the most complicated of the 3 types of investment income that we are discussing.

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[21] Paragraph 12(1)(c) provides that "any amount received or receivable by the taxpayer in the year… as… interest" must be included in the taxpayer's income for the year, unless it was included in the taxpayer's income in a preceding year.
[22] Subsection 12(4) – which applies to individual taxpayers (subsection 12(3) is the analogous provision for corporate taxpayers) – requires taxpayers to report on their tax return the interest income from investment contracts that accrued in that taxation year.

- **One reason for the added complexity is due to the fact that dividends are not deductible to the payor corporation.**
  - So corporations have to pay dividends out of their after tax income (so these expenses are not deducted from their tax liability)
  - **Compared to Interest Paid out by a Corporation on Loans it Receives:**
    - Interest expenses paid by a corporation on its loans are a deductible expense (when the loans are used for business activities), so it reduces taxable income and tax liability, as per s 20(1)(c)
      - Therefore, the government is contributing to the expense of a corporation's business activities
    - Interest rate paid to the creditor will therefore usually be higher than the dividend rate offered by a company (you will earn more interest by loaning a company money than by earning dividends by investing in the company in return for dividends, because the company cannot deduct its dividend payments from its income like it can for interest paid on loans it receives)
- **The other reason for the added complexity** is due to Canada's long-standing (and evolving) tax policy decision to generally try to **integrate** the taxation of corporate income and the taxation of dividends to shareholders, such that the total taxes is paid on such income is approximately the same as if it was earned personally **(principle of integration).**
  - Idea is that the overall tax on the income is the same whether an individual carries on its business activities as an individual or as a corporation

- **Note:** the interest is from when you invest in debt whereas the dividends are from investing in equity

Example: assume that an activity generates $1,000 of business income per year

- **If the activity is carried on personally by the taxpayer, then that income will be subject to a personal income tax rate of 40%:**
  - Personal tax liability = $1000 x 40% = $400
  - After tax personal income will be $600
- **If the taxpayer incorporates the company to carry on the activity, then the income will be subject to a corporate tax rate of 30%.:**
  - After tax corporate income will equal $700 ($1000 – 30% x $1000)
  - Corporation then takes that after-tax income and pays it out as a dividend
  - Tax liability for pay-out of dividend to the individual: $700 x 40% (personal income) = $280
  - After tax personal income = $420
  - This is a problem because the income is being taxed twice, so the person would have had a lower tax liability carrying out business as an individual than as a business ($600 after-tax income compared to $420)

- **The Gross Up and Dividend Tax Credit Regime**
  - Fixing this situation to meet the principle of integration:
    - Individual dividend income = $700 (amount corporation has as after-tax income)
    - **"Gross up" (done notionally)** = $300 (gross up to the original pre-tax amount when it was corporate income)
      - So the gross up rate would be: $300/$700 = 42.9%
      - In real life, the gross up rate for dividend is 38% (gross up intended to equal the amount which, added to the dividend would equal the amount of pre-tax income earned by the corporation)
      - So you would have the dividend income ($700) and then you would multiply it by the gross up rate (38%, or in this example, 42.9%) to determine the dividend tax credit
    - Pre-Corporation tax amount = $1,000
    - If personal tax rate was applied (40%) = $1,000 x 40% = $400
      - Grossing up makes it as though it was personal income and taxed at personal rate
      - Problem to resolve: it was earned by the corporation, not an individual
    - **Dividend tax credit** (supposed to reflect what the corporation paid in tax, if this was added to the after-tax corporate income): $300

- **Net personal tax liability** (paid on the $700 dividend): $100
  - This is the difference between what the individual would have paid if they had made $1000 as pre-tax personal income and the tax credit of $300 calculated by multiplying the gross up rate by the dividend income)
  - So, the corporation would be taxed $300 and the individual would be taxed $100 on the $700 dividend they receive
  - The after tax income for the individual is $600 (same as if the individual carried out the business activity as an individual)
- **Tax rate to the individual for the dividend income is therefore: 14.3%** (Net personal tax liability/dividend income = 100/700 = 14.3%)

"Gross up and dividend tax credit regime":

- this regime tries to take into account the corporate tax that has already been paid on corporate income in determining the appropriate amount of further tax to be levied on the shareholders in respect of the dividend.
  - **To accomplish integration**, the net effective personal tax rate on dividend income has to be less than the full bracketed rate (40% in our example).
    - Because you don't want to tax the corporation at the full corporate rate, and then tax that dividend again at the full personal rate
  - Canada has tried to design the regime so that the total tax (both corporate and shareholder) levied on corporate income distributed to its shareholders approximates what a sole proprietor/partnership would pay (in total) on such business income earned personally
  - Consequently, the applicable personal tax rate is effectively adjusted through the "Gross Up" (GU) and "Dividend Tax Credit" (DTC) regime, which is applicable when the dividends are received by individual shareholders (as opposed to corporate shareholders)
  - Compared to interest income, dividends will be taxed to individual shareholders at **lower effective personal rates** (rates on dividends will always be lower than the highest marginal rate)
- The amount of the GU and DTC, and hence the effective personal tax rate for dividends will depend on the amount of tax levied on the corporation's income
- **Eligible Dividends**
  - If the **corporation's income is subject to a higher (or full) corporate tax**, then the corresponding effective personal tax rate will have to be (relatively) low to accomplish integration.
    - **This is accomplished by having the GU set at 38% and the DTC set at 6/11 of the GU**
    - These dividends are referred to in the Act as **eligible dividends** (and are called "eligible" because they are *eligible* for a greater GU and DTC which results in a lower effective personal tax rate) and are defined in **subsection 89(1)**
      - Eligible means subject to full corporate tax rates, so the personal tax rate on those dividends would have to be lower than normal
    - Most common in this category are dividends paid by Canadian public companies and by CCPCs that were not taxed at a reduced corporate tax rate (due to the small business deduction (SBD))
    - **Note:** in order for eligible dividends to be treated as such for tax purposes (i.e. receive the higher GU and DTC to reduce the effective personal rate of tax), the corporation paying the dividend must designate the dividend (in writing) as such at the time the dividend is paid to the (individual) shareholder pursuant to **subsection 89(14)**
- **Non-eligible dividends**
  - Conversely, if the corporation's income is subject to a lower corporate tax rate (i.e. due to the application of the small business deduction), then the corresponding effective personal tax rate can be (relatively) higher to accomplish integration.
    - These dividends are not eligible for the enhanced GU and DTC which reduces the effective personal tax rate
      - So for non-eligible dividends, the personal tax rate on the dividends is higher than for eligible dividends
    - **The GU for these dividends is 17% and the DTC is 21/29 of the GU**
- **Because of the GU and DTC regime**, compared to interest income (which has no special tax treatment):
  - dividends will be taxed to individual shareholders at **lower effective personal rates**

- given the nature of the dividend tax credit, if the individual shareholder has no other sources of income (which might be the case for spouse/child shareholders), it is possible for that shareholder to receive a significant amount of dividends (i.e. up to $50,000) and pay no personal tax on them.
  - Because the dividend tax credit could be added to your other regular tax credits

- **3rd main type of dividends**, namely **capital dividends,** which are dividends that are paid out of the "capital dividend account" as defined in **subsection 89(1)** and which are designated as "capital dividends"
  - If corporation makes capital gains, it pays tax only on 50% of the income
  - That capital income is then entered into a notional capital dividends account
  - If an individual shareholder receives payment from the capital dividends, they are not taxed on that income, to preserve the fact that 50% of capital gains are not taxed (so this is aligned with the concept of integration)

For 2016, Alberta resident individual shareholders are subject to the following effective personal tax rates on dividends (assuming the taxpayer is in the highest marginal tax bracket):

- For **eligible dividends, 31.71%**, and
  - So with respect to **eligible dividends** of $1,000, the amount of tax is $317.10 with $682.90 left over after tax to an individual in Alberta with income in the highest marginal bracket
- For **non-eligible dividends, 40.24%**
  - So with respect to **non-eligible dividends** of $1,000, the amount of tax is $402.40, with $597.60 remaining as after-tax income.

SUMMARY ON THE GENERAL TAX CONSEQUENCES FOR NON-REGISTERED INVESTMENTS

- Non-registered investments are made with after-tax income
  - So there's no tax deduction associated with this type of investment
  - There is no tax benefit or deferral/avoidance for these kinds of investments
- Any income generated from these investments is subject to tax in the year of recognition
  - Recognition event for dividend or interest income is when you have a legal entitlement to the income (**the accrual method)**
    - E.g. when dividend is declared
  - In the case of capital gains: taxed when there is a disposition (actual or deemed disposition)
    - Includes disposition for value, voluntary and involuntary dispositions, deemed disposition, or actual disposition
- **Benefit:** After-tax income from non-registered investments is fully accessible for making other investments
- **When theses kinds of investments are beneficial:**
  - When you are young and want ready access to the income from the investments
  - When your tax rates are low compared to what they will be in the future (e.g. young with a low income), because in that scenario, there is less inventive to engage in tax deferrals
  - When there is a higher risk of tax rate going up, rather than down (e.g. 5 years ago under the Conservative governments) and you will likely continue to be in the upper tax bracket
    - Rationale: pay your taxes now while the highest marginal rate is lower compared to what it will be in the future

Ranking for best pre-tax income investment to give the highest return in 2016:

- 1) Capital Gains: on $1000 pre-tax income, after tax income will be $760 (effective tax rate of 24% on the total – 48% x $500 taxable)
- 2) Eligible Dividends: on $1000 pre-income: after tax income will be $682.90 (taxed at 31.7%)
- 3) Non-eligible dividends: after tax income on $1000 will be 597.60 (40.19% tax rate)
- 4) Interest income: after tax income on $1000 will be $520 (48% tax rate)
- What this means: must take into account the return rates and the risk involved in deciding which investment to make
  - May still want to invest in interest earning bonds as long as pre-tax income return is higher and there is lower risk

- Pre-tax income return is usually better for the interest income from a loan given to the corporation because the corporation can deduct the payment of interest on their loan from their tax rate (as a business expense)
- Note that shares can also give potential for shares to increase in value, in which case you can also have capital gains on the loan investment

Compare to 2014 for tax consequences:

- 1) Eligible dividends ($807.10 return on $1000)
- 2) Capital gains ($805)
- 3) Non-eligible dividends ($706.90)
- 4) Interest income ($610)
- Lessons:
  - Preferred investments for tax purposes will shift from year to year
  - In 2014, eligible dividend and capital gains return was very similar, while capital gains provide a substantially greater after-tax income in 2016
    - This suggests that maybe capital gain inclusion for taxes will increase after 2016 (otherwise the principle of neutrality will be violated – tax payer behaviour will be altered from choosing eligible dividends to switch to capital gains)

UNIT #6 – REGISTERED EDUCATION SAVINGS PLANS

OVERVIEW

- RESP is a special type of investment account under the Act designed/intended to assist individuals in saving for their children's, grandchildren's, etc. post-secondary education.

The three participants in an RESP are:

- The **Subscriber** – the person who opens and contributes to the RESP (usually a parent or primary caregiver),
- The **Promoter** – the person who manages the RESP in accordance with the Act (usually a financial institution), and
- The **Beneficiary(s)** – the person(s) who is intended to use the money from the RESP to finance his/her post-secondary education
  - To be a beneficiary, the individual (typically a minor child) must be a Canadian resident with a SIN at the time the RESP is created.

Generally speaking, there are two main types of RESPs:[23]

- **Individual plans**, and
- **Group plans**

<u>Individual Plan</u>

- **An individual plan is where the promoter sets up a separate trust for that specific plan.**
  - **Individual plans** can be further divided into:
    - **Individual non-family plans** – which can have only one beneficiary
    - **Individual family plans** – which can have more than one beneficiary, but they all must be related by blood or adoption to the subscriber.[24]

[23] There are also "specified plans" for disabled beneficiaries (which we will not generally be discussing in this course)

[24] It is possible to add beneficiaries to a family plan as long as the new beneficiary is under the age of 21 at the time s/he is added (unless s/he was a beneficiary of another family plan)

- **Subsection 251(6)** provides that children and grandchildren of the subscriber will be related by blood to the subscriber, and that "adoption" refers to legal adoption and adoption in fact.[25]
- No such requirement for an individual non-family plan (can set up a plan for your friend's child)

- **In an individual plan, the <u>subscriber usually determines:</u>**
  - **when** s/he will make a contribution **and the amount** (although the promoter often sets out a minimum contribution amount).
  - In the case of an **individual family plan,** when making a contribution, the subscriber must specify for which beneficiary the contribution is being made.[26]
    - You can create an individual family plan for one individual; there is greater flexibility for an individual family plan
    - The plan allows you to add siblings as they are born
- The **subscriber also usually determines**:
  - the **timing and type of payments** out of the plan (once the beneficiary becomes eligible to receive payments under the plan)

<u>Group Plan</u>

- A **group plan** is a collection of individual non-family plans where the promotor sets up a trust for each group plan (puts more control in the hands of the promoter, rather than the subscriber)
  - The **promotor establishes the regular contributions** that each subscriber will make (or the contribution options for all subscribers in that group)
  - the **promotor then invests the contributions** for all of the subscribers in that group.
  - When the plan matures, contributions are returned to the subscribers and the investment earnings are shared amongst the group subscribers in accordance with their contributions and the **terms of the plan** (which often <u>sets out a payment schedule for all qualified beneficiaries</u> in a particular group plan).

Important Point for terms that must be followed by the subscriber:

- Terms created by a specific promoter may be vary and some provisions may be punitive
- E.g. subscriber could be subject to large penalty on their contribution if the beneficiary does not become eligible for at least one year over the duration of the registered plan

CONTRIBUTING TO AN RESP (ASSUMPTION THAT AN INDIVIDUAL PLAN HAS BEEN CREATED, ALLOWING FOR SUBSCRIBER FLEXIBILITY)

Requirement to establish RESP:

- To establish an RESP, the subscriber must decide what plan s/he wishes and after making this selection, must give the promoter the SIN of the Canadian resident beneficiary(s).
- The subscriber can then start making contributions to the RESP in accordance with the plan's terms.

Maximum Contributions

- **For 2007 and subsequent years, there are no restrictions on the annual contribution limits made by a subscriber to an RESP. However:**
  - The maximum lifetime contributions for each beneficiary cannot exceed $50,000 (excluding government grants) in total - <u>excess contributions are subject to a penalty tax (1% per month tax)</u>

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[25] See paragraph 14 of IC93-3R2 for further examples where this requirement will be met (i.e. stepchildren of the subscriber will qualify, whereas nieces, nephews and cousins will not). Subsequent references are to the IC unless otherwise stated.

[26] For individual family plans, contributions are generally only allowed if the beneficiary is under the age of 31 at the time of the contribution – see para 16.

- So, it is important to ensure that there is one plan for one beneficiary and the contributions are all coming from one subscriber (optimally) – this makes it easier to make sure that the maximum contribution is not exceeded

Beneficiary residency:

- The subscriber can only make contributions to an RESP if in the year of the contribution, the beneficiary is a Canadian resident.

Tax deductibility:

- These contributions are **not tax deductible** to the subscriber.
- Put another way, the contributions must be made with after-tax income.

<u>Canadian Education Savings Grant (CESG)</u>

- For every year up to the year that a Canadian resident child turns 17:
  - the **child accumulates $500** of Canadian Education Savings Grant (CESG) room – regardless of whether the child is currently a beneficiary of an RESP, subject to a **maximum lifetime CESG room for a child is $7,200** (entitlement maxes out after 14 years – 500/year)
    - Child may also be eligible Canada legal bonds, which work similarly but are only available for low income families
- **Matching Contributions**
  - To the extent that the subscriber makes contributions to a child's RESP, Employment and Social Development Canada **(ESDC**), who administers the CESG, the Canada Learning Bond (CLB) and related provincial grant programs,[27] makes **"matching contributions"** to the child's RESP.
    - These matching contributions are based upon the amount of the subscriber's contributions for the year, the child's grant room, and the child's family's income.[28] More specifically:
      - For any child beneficiary (regardless of his/her family's income), ESDC will contribute 20% of the subscriber's contributions for the year as a CESG up to a maximum annual amount of $500.[29]
        - So, if the subscriber contributes $2,500, they will max out the CESG contribution of $500 for that year… subject to accumulated CESG room
      - To the extent that the child has additional grant room in a particular year, ESDC will continue to contribute 20% of the subscriber's contributions for the year as a CESG up to a **maximum grant for any particular year of $1,000**.[30]
        - E.g. contributor should not contribute over $2,500 the first year of the RESP when the child is 1 year old to avoid maxing out the annual CESG matching contribution
    - There used to be a provincial program in Alberta, where the government would put $500 in the account to kick things off without any contributions, but that program no longer exists
      - Other provinces still have similar programs
  - As noted above, the maximum lifetime amount that any Canadian resident child can receive in CESGs is $7,200, which requires the subscriber to make contributions of $36,000 - $2,500 for 14 years (subject to the annual limitations and the child's grant room at the time the contributions are made).[31]

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[27] The details of these provincial grant programs are beyond the scope of this course (but see paras 30-34 for further details). Note: the Alberta Centennial Education Savings Grant program was terminated effective April 1, 2015. While in operation, this program provided a $500 grant upon the opening of an RESP for an Alberta resident child, with additional $100 payments when the child (assuming s/he continued to be an Alberta resident) when the child turned 8, 11 and 14 years of age.

[28] For low income families, ESDC will pay CESG at an accelerated rate (in respect of a portion of the subscriber's contributions) and will also make payments under the CLB. The details of these additional grants are beyond the scope of the course (but see paras 24 and 28)

[29] To get this $500 CESG, the subscriber would have to contribute $2,500 in a particular year.

[30] Given the contribution formula, to receive $1,000 of CESG, the subscriber would have contribute $5,000 in a particular year (and the beneficiary would have to have sufficient CESG room to support this additional grant).

RESP Example #1:

- Emma is born on February 28, 2010 in Edmonton. Her sister Amy is born on March 15, 2015 (in Edmonton). They have lived their whole lives in Edmonton with their parents Bert and Ernie and are all Canadian residents at all relevant times. On June 4, 2015, Ernie sets up an individual family plan for Emma and Amy (after obtaining Social Insurance numbers for each daughter and submitting it to TD Canada Trust, the promotor of the RESP).
- **Question #1:** How much CESG room do Emma and Amy have for 2015?
    - **Answer:**
        - Emma: 6 x 500 (2010-2015, including year of birth) = 3,000
        - Amy: $500
        - Note: kids become entitled to CESG from birth, even if the RESP is not created immediately upon birth
- **Question #2:** After setting up the RESP on June 4, 2015, Ernie contributes $10,000 in total to the RESP - $5,000 for Emma and Amy respectively. How much CESG is paid into the RESP for each daughter in respect of Ernie's contributions?
    - **Answer:**
        - Emma: $1,000 (20% of $5000, still has $2,000 of contribution space moving forward)
        - Amy: $500 (max contribution because she has only been alive for one year)
- **Note:** while you can carry forward CESG space for donation, you can't carry forward the fact that you may have paid more than what would entitle you to the maximum CESG contribution
    - This means that there is no point in overcontributing (over $2,500) in the first years of creating the RESP
    - To maximize the government grant, want to be smart about when you are contributing and the amount
    - You must also must have made at least a couple contributions prior to when the child is 14 years of age to benefit from the matching CESG contributions
    - Also note that the maximum of $50,000 does not count for the CESG paid by the ESDC or the current balance of the RESP (including the interest accumulated)

TREATMENT OF CONTRIBUTIONS IN AN RESP

- Once received, the promotor (i.e. the financial institution) will invest the contributions and grants according to the subscriber's instructions and/or the terms of the RESP (which may leave this discretion with the promotor).
    - In all cases however, these **investments must constitute "qualified investments", which include:**
        - cash deposits, guaranteed investment certificates (GICs), government and corporate bonds, and publicly-traded shares and mutual fund units.[32]
    - If at any time, any of the investments do not constitute "qualified investments" as defined in **section 204** (and referred to in **subsection 146.1(1)):**
        - the value of those non-qualified investments will be subject to a penalty tax pursuant to **subsection 207.1(3)** and/or may put the registration of the plan in jeopardy (see **subsection 146.1(2.1))**
- These investments will hopefully generate income/gains to the RESP which **will not be subject to tax while in the RESP** pursuant to **subsection 146.1(5)**.
    - So, the subscriber is choosing the specific investments, and if they choose well, the funds in the account could grow significantly

PAYMENTS OUT OF AN RESP

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[31] CESG amounts are only available up to the end of the year that the beneficiary turns 17, although there are other rules that could effectively limit the ability to receive CESG up to the year the beneficiary turns 15 – see para 24 for further details.

[32] See para 19 for further details, as well as CRA, Income Tax Folio S3-F10-C1, "Qualified Investments – RRSPs, RESPs, RRIFs, and TFSAs" (2 September 2016).

SUBSCRIBER CONTRIBUTIONS

PAYMENT TO THE CONTRIBUTOR – "REFUND OF PAYMENTS"

- **Ownership of the contributions:**
  - Subject to the specific terms of the RESP, the subscriber retains ownership over his/her contributions and, as such, can receive a refund of any of the contributions s/he made into the RESP.
  - These payments (referred to as a **"refund of payments"** under **subsection 146.1(1))** are **not taxable** to the subscriber.
    - As such, such contributions can be subject to a successful action by the subscriber's creditors – see *MacKinnon v Deloitte & Touche*, 2007 CarswellSask 63 (Sask. Q.B.).
    - **So,** if you are more likely to be sued as a contributor (e.g. you are a lawyer), it may be better for your spouse to make the contribution
  - **Important Point:**
    - When you take out your contribution, the matching CESG contribution must also be repaid to the government; you will also not receive the CESG contribution space back

PAYMENT TO THE BENEFICIARY

- Similarly, subject to the terms of the RESP, the RESP may make payments of the subscriber's contributions to the beneficiary at any time (typically upon the subscriber's request).
  - These payments are **not taxable** to the beneficiary.
  - The payments are treated as a cash gift from the subscriber

GOVERNMENT GRANTS (CESGS) AND INCOME PAYMENTS

- **"education assistance payment" (EAP):** Any other payment made out of the RESP to assist a beneficiary to further his/her post-secondary education is referred to (in **subsection 146.1(1))**
  - EAPs are comprised of any government grants (i.e. CESGs) and any income/gains on both the contributions and the government grants paid out to the beneficiary to further his/her post-secondary education.
- **Limitations:**
  - A beneficiary becomes entitled to receive EAPs when s/he is:
    - enrolled in a "qualifying educational program", which is defined in **subsection 146.1(1)** as "a program at a post-secondary school level of not less than three consecutive weeks duration that requires that each student taking the program spend not less than ten hours per week on course or work in the program".[33]
  - **Maximum amounts that can be received:**
    - **for the first 13 consecutive weeks** of enrollment in a qualifying educational program, the maximum amount of EAPs that a beneficiary can receive is: $ 5,000.
    - After the beneficiary has completed 13 consecutive weeks in the previous 12 month period at the qualifying educational program and **as long as the amounts are reasonable**:

[33] Note: for beneficiaries that qualify for the disability tax credit, the educational requirements are set out in the definition of a "specified plan" in **subsection 146.1(1).** These plans are beyond the scope of this course. Also note: "post-secondary school level" and "post-secondary educational institution" are both defined in **subsection 146.1(1)** and are referred to in para 43**.** As noted in para 41, a post-secondary course usually provides credit towards a degree, diploma, or certificate; it also includes a technical or vocational program designed to provide a person with skills for, or improve a person's skills in, an occupation at an educational institution certified by ESDC.

- there **is no limit on the amount of EAPs that can be paid** if the beneficiary continues to qualify to receive EAPs.[34]
    - It is not necessary for the beneficiary to be paying the EAP directly to tuition at an institution
    - "Reasonable" – in relation to living costs, tuition, text books, etc.
- That said, the terms of the RESP may prescribe limits/conditions and/or the subscriber has control over how much is withdrawn and paid to the beneficiary each year

- Also, to receive any government grants (i.e. CESGs), the **beneficiary must be a Canadian resident at the time of the payment.**

- Tax treatment:
    - Any EAPs received by a beneficiary in the year will be taxable under **paragraph 56(1)(q)** as "Other Income":
        - This means that government grants (in CESG) and income/gains paid to the beneficiary will be subject to tax
        - Will be taxed at the beneficiary's applicable tax rates
        - This can be a tax avoidance strategy because if the money had been put into a taxable account by the subscriber, income on the account would have been taxed at the subscriber's marginal rate
            - This way, the income is taxed at the marginal rate of a student, who likely has low income and low marginal tax rates

Question: what if the named beneficiary does not attend post-secondary education?

- If the beneficiary does not go to post-secondary education, then it may be possible to replace the named beneficiary with a brother or sister (who is part of the same family plan).
- It may also be possible to transfer from one RESP to another (i.e. if each child has his/her own individual non-family plan).
    - **Tax implications:**
        - **If the transfers are from one sibling to another**, then generally, there will be no negative tax implications, particularly when the transferee is under 21 years of age at the time of the transfer
        - **where the transfer is not made to a sibling**, then the transferred RESP contributions are deemed to have been contributed to the beneficiary's RESP at the time(s) it was contributed to the original RESP
            - This means that if these transferred contributions, combined with the beneficiary's contributions, exceed the $50,000 maximum contributions, the 1% per month penalty tax will be engaged.

SCENARIO: BENEFICIARY DOES NOT QUALIFY TO OBTAIN PAYMENTS PURSUANT TO THE RESP & NO OTHER ELIGIBLE BENEFICIARIES UNDER A FAMILY PLAN & NO ABILITY TO TRANSFER TO ANOTHER RESP – ACCUMULATED INCOME PAYMENTS

- In the case that the beneficiary does not qualify to obtain payments pursuant to the RESP and there are no other eligible beneficiaries under a family plan or the ability to transfer to another RESP, then:
    - The **subscriber's contributions** can be returned without any tax implications
    - Any **government grants received** by the RESP must be repaid to the government; and (income on the grant need not be repaid)
    - Subject to the terms of the RESP, **any income on the contributions and the grants, defined as "accumulated income payment" (AIP)** in **subsection 146.1(1)** may be distributed to the subscriber (if the subscriber is a Canadian resident at the time of payment), **but:**

[34] The CRA has administratively stated that after the beneficiary's first year of post-secondary studies, EAPs under $20,000 will generally be considered reasonable in the circumstances (and more may be reasonable depending upon the educational expenses of the particular beneficiary).

- Pursuant to **paragraph 146.1(2)(d.1)**, such payments cannot be made unless:
    - **1)** The AIP is made after the 9th year that follows the year in which the plan was entered into and each beneficiary of the plan (a) is not entitled to an EAP and (b) is at least 21 years of age,
    - **2)** The AIP is made in the year in which the plan is required to be terminated (which under **paragraph 146.1(2)(i)** is generally after the 35th year following the year in which the plan was entered into), or
    - **3)** Each individual who was a beneficiary under the plan is deceased when the payment is made
- **Tax implications:**
    - in addition to that amount being taxable as income to the subscriber pursuant to **subsection 146.1(7.1)**, there is a **20% penalty tax** (in addition to the subscriber's applicable marginal tax rate) pursuant to **section 204.94**
        - [Given this penalty tax, it appears that Parliament does not want subscribers using RESPs as additional RRSPs – which provide tax deferrals]
        - However, this penalty tax may be avoided if these funds are transferred directly into the subscriber's RRSP (which means that the subscriber must have sufficient Contribution Room to allow the transfer)

SUMMARY OF RESPS AND TAX PLANNING OPPORTUNITIES

- No added tax benefit to the subscriber immediately upon contributing (which differs from an RRSP)
    - Contribution is not deductible
- The contributions are not taxable upon withdrawal to either the subscriber or beneficiary
- No taxing of the income/gains while in the account (similar to RRSPs)
    - This is different from non-registered fully taxable investments
    - This allows for the income to be fully re-invested while in the RESP, as it is not taxed as the income accumulates in the RESP before being re-invested
- Income gains are taxed upon payment out of the RESP (similar to RRSPs)
    - Means that this is a tax deferral strategy, but is also often a tax avoidance strategy as the beneficiary will usually be in a lower tax bracket than the subscriber when the income is received from the RESP
    - If the money was put into a non-registered, fully taxable account, the income gains are taxed each year
- **When would you recommend this plan:**
    - When the parent is in a high income tax bracket and the beneficiary is likely to be in a lower income tax bracket
        - **Benefits:** tax avoidance, you get free money from the government (CESGs) and the income gained on the funds is not taxed until being paid out of the account (reinvestment benefits while the income on the contributions and CESGs remain in the RESP)
        - **Disadvantages:**
            - no immediate tax advantage from making a contribution
            - income gains realized are taxed upon being paid to the child (unlike a TFSA)
            - some accessibility issues with the income earned on the RESP – have to wait a certain amount of time before it can be paid out of the RESP
            - terms of the group plan may be detrimental if the beneficiary become ineligible or dies
- **GARR analysis:**
    - 1) tax benefit?
        - Yes – there's a deferral and potential avoidance
    - 2) Avoidance transaction
        - Causes the benefit – yes
        - Primarily for avoiding taxes - debatable
    - 3) misuse or abuse of the Act?
        - Generally, no, as legislatures have created the program to encourage saving for the education of children/grandchildren

- But it is possible for RESPs to be used in a manner that would be an abuse
    - E.g. getting around the $50,000 max contribution or finding a way to get the income from the re-invested income in the RESP
    - E.g. AIP paid to beneficiary and the beneficiary doesn't need it so they gift it back to the subscriber – maybe a potential abuse

UNIT #7 – TAX FREE SAVINGS ACCOUNTS

OVERVIEW

- A Tax-Free Savings Account (TFSA) is (another) special type of savings account under the Act designed to encourage Canadian resident individuals to save and **make passive investments** (which generate interest, dividends, and/or capital gains).
    - Unlike for RESPs, there is no mandated purpose for TFSAs; they can be used as a general savings account

Two main participants in a TFSA (referred to as a "qualifying arrangement" in subsection 146.2(1)):

1. The **Holder:**
    - person who opens the TFSA (i.e. a Canadian resident individual 18 years of age or older with a social insurance number) and then makes contributions, investments (within the TFSA) and withdrawals, and
2. The **Issuer:**
    - Person who maintains the TFSA on behalf of (and pursuant to the instructions of) the **Holder** in accordance with the Act (i.e. a financial institution).

There are two other persons described in (or at least contemplated by) section 146.2 (types of beneficiaries):

- **Designated Beneficiary** can be either:
    - **1) Spouse/common law partner, further divided into:**
        - **A) Survivor (**spouse or common-law partner of the **Holder** immediately before the **Holder's** death)
            - A survivor does not receive all rights and entitlements of the original holder
                - E.g. No right to remove beneficiary designations
            - Spouse will only be a survivor if other beneficiaries are named as well
            - **Note:** it is possible to be a **Survivor** and not a **Successor Holder (**where the **Survivor** does not receive the right to revoke the beneficiary designation made by the **Holder)**
        - **B) Successor holder** (spouse or common law partner)
            - If a **Survivor** is the **Designated Beneficiary** of the TFSA **AND** if the **Survivor** receives all of the **Holder's** rights with respect to the TFSA by virtue of being the beneficiary, – including the unconditional right to revoke any beneficiary designation made by the **Holder –** then this **Survivor** is referred to as a **Successor Holder**[35]
            - When spouse is the sole beneficiary – effectively takes on all rights of the holder
            - receives all of the **Holder's** rights with respect to the TFSA by virtue of being the beneficiary
    - **2) Someone else (referred to as "designated beneficiary" in the Act)**
        - A **Designated Beneficiary –** who is the named beneficiary of a TFSA but who is not the spouse or common-law partner of the **Holder** prior to the **Holder's** death
        - E.g. kids of the holder

[35] As noted in the TFSA Guide for Individuals (page 13), these rights can be bestowed by the TFSA contract itself or pursuant to the **Holder's** will. Note: all provinces and territories have passed legislation to accept TFSA beneficiary designations.

CONTRIBUTING TO A TFSA

- TFSAs were created effective for the 2009 calendar year for resident Canadians 18 years of age and older.
- For such Canadian residents, s/he accumulates the new contribution room pursuant to the definition of the **TFSA Dollar Limit** in **subsection 207.01(1)** as follows:
    - $5,000 per year for the years 2009 to 2012,
    - $5,500 per year for the years 2013 and 2014,
    - $10,000 for 2015, and
    - $5,500 for 2016 and 2017
- Consequently, if an individual was 18 years of age prior to 2009 and was a Canadian resident from 2009 to the present,[36] then the individual would have a total contribution **room of $52,000** if s/he had not made any contributions to date
    - Entitlement does not expire unless the government removes the program
- **Valid contribution:**
    - To be able to make a valid contribution not subject to any penalty taxes, the **Holder** must be a Canadian resident at the time of the contribution (based on residency at the beginning of the year to gain the new contribution room and must be a Canadian resident at the time of making the contribution)
        - The fact that the **Holder** may become a non-resident later in the year is irrelevant (i.e. the annual contribution room is not pro-rated or taken away if the **Holder** subsequently becomes a non-resident)
    - **Penalty:**
        - If the **Holder** is a non-resident at the time the contribution to the TFSA is made, then that contribution will be subject to a 1% per month tax pursuant to **section 207.03** (until the month in which the **Holder** withdraws the contribution or becomes a Canadian resident)
        - If a **Holder's** yearly contributions exceed the total contribution limit for that year, then the excess contributions are subject to a 1% per month tax (on the highest excess amount) per **section 207.02**
- **Direct transfers vs withdrawal and contribute to another TFSA:**
    - Direct transfers between TFSAs having the same **Holder** do not constitute contributions (and do not use up contribution room)
        - However, if the **Holder** withdraws the amount from one TFSA and then contributes the funds to another, the contribution will require sufficient contribution room
        - You can have more than one TFSA but the maximum contribution applies to you, across all of your TFSA accounts (so you can have ten accounts, but the combined amount invested must be under the contribution limit e.g. $52,000 total if you were 18 in 2009)
    - It is possible to make cash and/or in-kind contributions (i.e. publicly-traded shares already owned as non-registered fully taxable investments, bonds, or debt instruments)
        - Contributions of cash have no tax consequences
        - But there may be some immediate tax consequences to non-cash contributions:
            - Must characterize as either capital property or business property (inventory)
                - E.g. capital shares that are capital property (intention at time of purchase was to earn dividends)
            - When you transfer those capital shares into your TFSA, it will be considered as a deemed disposition - 248(1)(f)(i)
                - So, if you bought the shares at $1000 and value is now $1,200, you have a capital gain that you are taxed on when you transfer the shares into your TFSA

[36] Note: to obtain new contribution room for a particular calendar year, the individual must be a Canadian resident for at least a portion of that year. No contribution room accumulates in years in which the individual was not a Canadian resident for the **entire year.**

- If the financial instrument increases in value, you will have to report the gain in your tax return
- If you have a loss (shares that depreciated), the Act will deny the loss when you contribute it into one of the TFSA plans
    - So you cannot carry the loss forward to offset other capital gains that you end having (s 40(2))
    - So it would be better for you to sell the shares, report the loss, then deposit the cash into the TFSA; you can then reinvest in the shares while the cash is in the TFSA

- **Timing for contribution:**
    - You want to put an investment into your TFSA as soon as possible if a gain is expected to protect the gain from taxes
- **Contributions between spouses:**
    - It is possible for a spouse or common-law partner to give money to the **Holder,** which the **Holder** then contributes to his/her TFSA, which <u>will not trigger the application of the "attribution rules"</u> by virtue of **paragraph 74.5(12)(c)**[37]
        - This is an exception to the attribution rules
        - **BUT:** If you received cash from your spouse, you invested it in a TFSA, then you took it out and invested in passive income generating property, that income will likely be attributed back to the original spouse
        - Normally, money will be attributed back to the originating spouse
            - **Note:** attribute rules do not tax the value of a gift made to a spouse (not triggered by the gift itself); it is the income or gains from the gift that is attributed back to the donor
- **Tax Treatment**
    - <u>Like RESP contributions</u>, TFSA contributions are made with after-tax income; put another way, there is no tax deduction/benefit for making a contribution to a TFSA
- **Contribution Room:**
    - When a **Holder** makes a contribution to his/her TFSA, this reduces his/her contribution room accordingly

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TREATMENT OF CONTRIBUTIONS IN A TFSA

- Once received, the **Issuer** (i.e. the financial institution) will invest the contributions in accordance with the **Holder's** instructions.
- **Qualified Investments**
    - In all cases however, like investments in RESPs, these investments must constitute "**qualified investments**", which include:
        - cash deposits, guaranteed investment certificates (GICs), government and corporate bonds, and publicly-traded shares and mutual fund units.[38]
        - Goal of qualified investment requirement: stop people from using TFSAs for purposes not intended by Parliament
    - **If at any time, any of the investments do not constitute "qualified investments" as defined in section 204 (and referred to in subsection 207.01(1)):**
        - the value of those non-qualified investments will be subject to a penalty tax pursuant to **subsection 207.04(1)**
- **<u>Taxable treatment of income in TFSA</u>**

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[37] Note: in TI 2010-0354491E5, the CRA takes the administrative position that the attribution rules would apply if a taxpayer gifted money to his/her spouse to contribute to the spouse's TFSA and the spouse immediately withdrew the same amount of the money from his/her TFSA to purchase dividend-paying shares

[38] See Income Tax Folio S3-F10-C1, "Qualified Investments – RRSPs, RESPs, RRIFs, and TFSAs" (2 September 2016) for further details.

- These investments will hopefully generate income/gains in the TFSA which **will not be subject to tax while in the TFSA** pursuant to **subsection 146.2(6)**.
- **Exception:**
  - if the TFSA is found to be **carrying on a business** (as opposed to earning passive investment income/gains), then the **business income will be taxable to the TFSA**
  - **Carrying on a business –** buying and selling stock so they can profit on short term basis
    - This income is not eligible to be

WITHDRAWALS FROM A TFSA

Unique features of TFSA:

- **1) When a Holder withdraws an amount from his/her TFSA, which can occur at the Holder's discretion, none of the amount constitutes income for tax purposes.**
  - **Note:** even if you are a non-resident at the time of the withdrawal, you will not be subject to Canadian tax on it
  - **In this respect, TFSAs are different than RESPs (in which at least a portion of the withdrawal will constitute income for tax purposes).**
    - Because any income arising from a TFSA investment will never be taxable (i.e. not a source of income under the Act), it will not be used in determining eligibility for government benefits and credits
      - Government benefits and credits are income-based and subject to claw back if the recipient taxpayer's income is too high – i.e. Canada Child Benefit, GST Tax Credit, Old Age Security Benefits, Guaranteed Income Supplement and Employment Insurance Benefits)
- **2) Withdrawal creates contribution room in subsequent year**
  - **A unique feature of TFSAs is that withdrawals from a TFSA in the current year form part of the contribution room to the TFSA in a subsequent year.**
    - This is accomplished by adding the current year's withdrawals to the **Holder's** contribution limit for the subsequent year.
    - For RRSPs, you do not gain new contribution room when you take cash out of the RSSP, so TFSAs are better in that one respect
  - TFSAs are therefore attractive to both high income and very low income people
    - Particularly for retirement savings – because you want to qualify for government program benefits
    - Since none of the TFSA is reportable as income, it will allow lower income retired people to avoid losing government program benefits, will be ineligible if you have too high of a reportable income
    - In the case of RRSPs, when you make a withdrawal it is taxable, so you have to report it as income

CONTRUBITON ROOM PRACTICE PROBLEMS

- Julia turned 18 on June 3, 2010. On May 4, 2012, she opened a TFSA. For all relevant years, she has been a Canadian resident. **What is the maximum amount she can contribute to her TFSA in 2012?**
  - **Answer:**
    - 2010-2012 ($5000/year)
    - 5000 x 3 = 15,000
- Julia contributes $10,000 to her TFSA in 2012 and uses that money to purchase shares in Blackberry Corporation. Her $10,000 investment grows to $30,000 by 2014. She is so happy that she withdraws $25,000 on July 2, 2014 to purchase a new Honda Civic. **How much does she have to report in her income for income tax purposes in 2014 in respect of this withdrawal? What is the maximum amount that she can contribute to her TFSA in 2014? What is the maximum amount that she can contribute to her TFSA in 2015?**
  - **Answers:**
    - Report on tax income in 2014: None – income on tax free savings account is not taxed on withdrawal
    - Maximum amount to contribute in 2014:

        - 2012 contribution room = $15,000
            - 2012 contribution: $10,000
            - End of 2012 contribution room = $5,000
        - 2013 + 2014 contribution room ($5500 x 2) = $11,000
            - 2014 total contribution room = $16,000
    - Maximum amount to contribute in 2015:
        - 2014 total contribution room = $16,000
            - + 2015 added room ($10,000) = $26,000
            - + withdrawal from 2014 ($25,000) = $51,000
        - Important note: contribution in one year only adds to the contribution room of the following year
            - So you can expand your TFSA by making good investments within your TFSA, withdrawing, and recontributing your gains (expanding the contribution room with gains within the TFSA)
- Through hard work and saving everything she can, Julia contributes the maximum amount that she can for 2015 on December 23, 2015. She invests all of her TFSA contributions in common shares of HMV Corporation. On March 31, 2016, HMV declares bankruptcy. Given the value of HMV's secured debt and outstanding preferred shares, HMV's common shares are worthless and are delisted from the Toronto Stock Exchange. **What is the maximum amount that Julia can contribute to her TFSA in 2016?**
    - **Answer**: $5,500 (new 2016 contribution room)
        - You do not gain contribution room for losses within the TFSA
        - Therefore: losses effectively reduce your contribution rooms

TAX TREATMENT UPON THE HOLDER'S DEATH

When **Holder** of a TFSA dies, the applicable tax treatment will depend primarily on who the **Designated Beneficiary** is and what his/her rights with respect to the **Holder's** TFSA are. More specifically:

Scenario 1: Successor Holder

- If the **Designated Beneficiary** is a **Successor Holder** (either through the designation in the TFSA itself or pursuant to the **Holder's** will), then the **Successor Holder** becomes the new "holder" of the TFSA (as the title indicates)
    - **Implications:**
        - no tax implications to the **Successor Holder's** existing TFSAs or to the deceased **Holder's** final tax return
        - The holder's TFSA then becomes a TFSA of the successor holder
        - Contribution room of successor holder is not impacted by receiving the holder's TFSA
        - Successor holder can make future withdrawals and contributions with the same tax implications that apply to their own TFSA
            - Note: contribution room moving forward counts for all TFSA accounts of the successor holder (does not gain contribution room moving forward)
        - It is possible for the successor holder to transfer all of the holder's TFSA into the successor holder's pre-existing TFSA

Scenario 2: Survivor

- If the **Designated Beneficiary** is not a **Successor Holder,** but is a **Survivor** (i.e. a spouse or common-law partner of the Holder prior to his/her death), then generally speaking:[39]
    - The TFSA ceases to exist on the **Holder's** death pursuant to **subsection 146.2(5)**.
    - The TFSA is deemed to have disposed of and reacquired all of its investments immediately prior to the **Holder's** death pursuant to **subsection 146.2(8)** at their fair market value (FMV)
        - Dispositions will not be subject to tax
    - **Exempt Contributions**

[39] There are some special rules where the TFSA constitutes a "trust" – but these rules (and level of detail) are beyond the scope of this course.

- The **Survivor** may contribute and designate all or a portion of the TFSA investments as an **"exempt contribution"** to his/her own TFSA, subject to:
    - as long as this transfer occurs by the end of the <u>calendar year following the year of the **Holder's** death (referred to as the "rollover period")</u> and the required forms are completed and submitted to the CRA
        - So the survivor spouse can still contribute the paid-out amount from the holder's TFSA into her TFSA, regardless of the contribution room that she has
    - Going forward, all withdrawals and gains from the TFSA are not taxable
- Main difference between successor holder and survivor:
    - Any amount in excess of the FMV of the TFSA on the **Holder's** death will have to be reported as taxable income to the **Survivor**[40]
        - Meaning: Any income of that money from the holder's TFSA realized before she makes the exempt contribution will be taxable to her

<u>Scenario 3:</u> Designated Beneficiary (someone other than spouse or common law partner)

- If the **Designated Beneficiary** is not a **Successor Holder** or a **Survivor** (i.e. someone other than the current spouse or common-law partner of the **Holder** prior to his/her death), then:
    - The TFSA ceases to exist on the **Holder's** death pursuant to **subsection 146.2(5)**.
        - The TFSA is deemed to have been disposed of and reacquired all of its investments immediately prior to the **Holder's** death pursuant to **subsection 146.2(8)** at their fair market value (FMV)
        - Since this occurs prior to the termination of the TFSA, it will not trigger any taxable income to either the **Holder** (in his/her terminal return) or a **Designated Beneficiary** since the TFSA is still not taxable (pursuant to **subsection 146.2(6))**
- The **Designated Beneficiary** can receive up to the FMV of the TFSA at the time of the **Holder's** death tax-free
    - any increases in value post-death that are distributed to the **Designated Beneficiary** constitutes taxable income to the **Designated Beneficiary**
- **No Exempt contributions**
    - The Designated Beneficiary may contribute some/all of the investments into his/her TFSA, but only if the Designated Beneficiary has sufficient contribution room
        - Put another way, the Designated Beneficiary cannot make an "exempt contribution" to his/her TFSA

CARRYING ON A BUSINESS THROUGH A TFSA

- It has been reported in practitioner articles that the CRA has recently been assessing some TFSAs on the basis that they have been carrying on a securities trading business (which is not exempt from tax under the TFSA rules)
    - Business income within a TFSA is not exempt from income tax

HOW THE CRA WILL COME TO THE CONCLUSION THAT THE TFSA IS CARRYING ON A BUSINESS:

- the CRA effectively states that it is relying on the **<u>primary intention test</u>** – as applied in a securities transaction context (i.e. did the Holder purchase the security with the primary intention of selling for a profit) and relying on indicia including:
    - the frequency of trading transactions, the length of ownership of a particular security, the Holder's knowledge of securities markets and relation to his/her primary source of income (as say, a financial advisor, day-trader, etc.), etc.

[40] This is the key difference between the tax treatment for **Successor Holders** and **Survivors –** in the former case, any increases in the **Holder's** TFSA post-death continue to be tax-free to the **Successor Holder,** although a **Survivor** can effectively get the same tax treatment if s/he immediately makes an "exempt contribution" to his/her TFSA.

OTHER MISCELLANEOUS POINTS

- **TFSA as security for a loan**
  - Subject to the requirements set out in **subsection 146.2(4),** a TFSA can be used as security for a loan.
    - Noteworthy, because you cannot use an RRSP as a security for a loan
- **Amounts borrowed for TFSA or associated costs**
  - Pursuant to **paragraph 18(11)(j),** monies borrowed for the purpose of contributing to the TFSA are not deductible; pursuant to **paragraph 18(1)(u),** any amount paid for services in respect of a TFSA (i.e. administration fees, investment counselling fees, etc.) are similarly not deductible.
    - In order for expense to be deductible, the associated income must be taxable (that is why you can't deduct expenses related to TFSAs)
- **Marital breakdown and transfer**
  - Where there is a breakdown in a marriage or common-law partnership, an amount can be transferred directly from one individual's TFSA to the other's TFSA as **a "qualifying transfer"** pursuant to **subsection 207.01(1)** without affecting either individual's contribution room (or having any other immediate tax effect[41])
  - To **qualify for this treatment:**
    - The individuals must be living separate and apart at the time of the transfer, and
    - An individual is entitled to receive, or required to pay, the amount under a decree, order or judgment of the court, or under a written separation agreement to settle rights arising out of the relationship on or after the breakdown of the relationship.

SUMMARY OF TFSAS AND TAX PLANNING OPPORTUNITIES

- If you're in a relatively high tax bracket, you may prefer contributions to an RRSP to gain some immediate tax relief, because they provide for tax deferral
- Similar to RESPs, TFSAs are contributed to with after-tax income
  - This differs from RRSPs – because RRSP provides for a tax deduction, meaning that it is effectively not taxed until it is withdrawn
- Ability to participate does not, like RRSPs, require the contributors to do something to gain contribution room
- Any income realized while money is in the TFSA is not taxed
- Income is also not taxable upon withdrawal
  - This makes a TFSA a great vehicle for investing in something with major upside potential (great potential for increasing in value)
  - Appreciation on value in the TFSA is never subject to tax (as long as it is not considered business income)
- Useful for high income earners because their investments in the TFSA will provide tax free withdrawals and tax free gains
- **Also useful for low income earners**
  - Helpful for low income earners because when you take money out upon retirement, you don't have to include the TFSA withdrawals in your taxable income, which means that the earner is not disqualified from government benefits and programs
- After tax, you end up with the same after-tax amount whether you invest in a TFSA or an RRSP (if you have the same tax rates and same investment)
  - So it is a matter of whether you want the money to be taxable and reported on the back end (upon withdrawal)
- May be good to consider first putting high rate, interest earning investments in TFSAs because those gains will not taxed (so first, limit TFSAs for use with your investments that will experience great gains in value)
  - Also, it will be preferable to have interest earning investments in your TFSA as compared to capital investments (because the interest earning income is taxed at a higher rate… capital gains are only taxed at 50% so those don't need to be sheltered as much as interest earning income)

[41] For instance, the transfer will not constitute a withdrawal.

- **Protection from creditors:**
  - RRSPs have the most protection
  - TFSAs do not receive protection from creditors in Alberta

UNIT #8 – REGISTERED RETIREMENT SAVINGS PLANS

OVERVIEW

- A Registered Retirement Savings Plan (RRSP) is (another) special type of savings account under the Act that is designed to encourage Canadian resident individuals to save for their retirement.
- There are three main participants in an RRSP:
  - The **Contributor –** who is the individual who makes contributions to the RRSP
  - The **Annuitant** – who is the individual who will make withdrawals from the RRSP, and
    - In most cases, the **Contributor** and the **Annuitant** will be the same person – but as we will discuss later in the Unit, not always.
  - The **Issuer** – who manages the RRSP

CONTRIBUTING TO AN RRSP

- Unlike RESPs (which have no annual contribution limit, only a maximum contribution limit per beneficiary) and TFSAs (which automatically provides eligible Canadian resident taxpayers with new contribution room annually), in the case of RRSPs, the taxpayer must first **acquire the entitlement** to contribute to an RRSP (contribution room).
  - You must do something to gain contribution room to an RRSP
- This is governed by the definition/formula of the **RRSP Deduction Limit** contained in **subsection 146(1),** which for our purposes will be:
  - RRSP Deduction Limit for Current Year =
    - unused RRSP deduction limit for the previous year +
    - the lesser of [1) the RRSP dollar limit for the current year, or 2) 18% of earned income for the previous year] –
    - pension adjustment for the previous year

Components of the formula:

- **RRSP Deduction Limit for the Current Year**
  - E.g. 2017
- **Unused RRSP deduction limit for the previous year:**
  - **Unused RRSP Deduction Room** - effectively ensures that to the extent that a taxpayer earns the entitlement to contribute to an RRSP in a prior year and does not exercise that entitlement, that the right is preserved into the future (i.e. don't lose the capacity if don't use it in a particular year).
    - accumulates up until age 71
  - E.g. 2016
- **1) RRSP dollar limit for the current year (2017):**
  - **RRSP Dollar Limit** is defined in **subsection 146(1)** as being the **Money Purchase Limit** for the **preceding year**.
    - In other words, to determine the maximum **RRSP contribution for the 2017 taxation year**, you look up the **Money Purchase Limit for the 2016 taxation year**
    - **Money Purchase Limit** is defined in **subsection 147.1(1)** (the Registered Pension Plan section) and for the 2016 year is $26,010 (see Notes in Practitioners' Act).
    - Put more simply, the **maximum** that any taxpayer can contribute to an RRSP in respect of his/her **2017 taxation year** (excluding any Unused RRSP Deduction Room) **is:**

- **$26,010**.[42]
  - E.g. This is the money purchase limit for the previous year (2016): $ 26,010
- **2) 18% of earned income for the previous year (2016)**
  - **Earned Income** is defined in **subsection 146(1)** as, generally speaking, net income from **employment, business, real estate rentals and royalties from a work/invention where the taxpayer is the inventor**
    - ***does not include investment income (e.g. interest, dividends, other than mentioned above) or capital gains***
      - So when you own your own corporation, you can decide how much to pay yourself in salary versus dividends: a common practice is to pay out to such individuals in salary and employment bonuses at least enough to max out your RRSP contributions for the year, and then pay out the rest in dividends, etc.
      - Earned Income also includes **spousal support, research grants, and disability pension**
  - E.g. income earned: since the maximum allowed will be $26,010, a salary of $144,500 would max out the allowed annual limit for RRSP contribution (because 144,500 x 18% = $26,010)
- **Pension adjustment for the previous year (2016)**
  - The deduction from the lesser of the **RRSP Dollar Limit** and **18% of Earned Income** is any **Pension Adjustment** for the previous year
    - this is effectively a calculated amount representing the taxpayer (and the taxpayer's employer's) participation in a Registered Pension Plan (this will be provided to the taxpayer employee on his/her T4 slip)
    - This reduces the amount that you can contribute in a single year
    - Governments want everyone to receive the same tax benefits, so payments into a pension plan will reduce the amount that you can contribute to your RRSP

CONTRIBUTIONS AND NON-SOURCE SPECIFIC DEDUCTIONS

- When a taxpayer makes a contribution to an RRSP, **paragraph 60(i)** in conjunction with **subsection 146(5)** gives the taxpayer contributor **the right to claim** a (non-source specific) **tax deduction** for contributions
  - While the contribution and the actual application of the deduction are interrelated and often go together**, it is important to appreciate that there are in fact two distinct components to RRSP contributions** (two separate decisions), namely:
    - (1) contributing to the RRSP, and
    - (2) deducting the contribution for income tax purposes.
- **Delaying the deduction of a contribution for tax purposes**
  - While in most cases, a taxpayer will deduct all of the contributions that s/he makes to an RRSP in the year of the contribution, it is important to note that the taxpayer doesn't have to claim the full amount of the contribution as a deduction for that year
    - the taxpayer can decide to wait and claim the deduction in a subsequent year.
  - **Question:** why would the taxpayer do this?
    - **Answer:** a taxpayer would do this if they expect that their income will increase in the next year
      - You therefore want to save the deduction for the next year or two, which will allow you to have a greater benefit, because the value of the benefit increases with the marginal tax bracket you fall within (a deduction at a higher marginal rate will make for a greater tax saving e.g. you multiply the deduction by the marginal tax rate you are being taxed at)
  - **Note**: if a taxpayer does not claim the RRSP deduction in the year that s/he makes the RRSP contribution, while this defers the tax deduction benefit, it does not stop the tax deferral benefit (i.e. that any income/gains on the contributions accrue tax-free while in the RRSP).
    - So you are not prejudicing yourself by delaying the tax benefit
- **60-days limit (into following year) for deductibility of RRSP**

[42] For ease of reference, the maximum amount that a taxpayer could contribute to his/her RRSP in 2016 (excluding any Unused RRSP Deduction Room) is $25,370, which represents the 2015 Money Purchase Limit.

- To be deductible for a particular year, the RRSP contributions must be made during the year or within 60 days of the following year - **subsection 146(5)**
- If the 60th day falls on a weekend, then the taxpayer gets an "extension" to the following Monday.

- **Carrying forward of contribution room & maturity of RRSP**
  - As the formula set out above indicates, any unused contribution room carries forward until the RRSP "matures"
    - it is not lost if you don't contribute to an RRSP in the year you acquire the entitlement to contribute.
  - **Note:** as part of the conditions for registration of an RRSP, **paragraph 146(2)(b.4)** provides that an RRSP must "mature" (i.e. be wound up) after the end of the year that the **Annuitant** turns 71.
  - **Note:** the maturity date is based upon the **Annuitant's** age, as opposed to the Contributor's age
- **THIS IS IMPORTANT:**
  - you can no longer use your deductions after you turn 71, and the withdrawal from the RRSP is still taxed, so this would effectively result in double taxation of that amount, since you did not receive your deduction

TREATMENT OF CONTRIBUTIONS IN AN RRSP

- Once received, the **Issuer** (i.e. the financial institution) will invest the contributions in accordance with the Contributor's instructions.
  - In all cases however, like investments in RESPs and TFSAs, these investments must constitute "**qualified investments**", which include: cash deposits, guaranteed investment certificates (GICs), government and corporate bonds, and publicly-traded shares and mutual fund units.
  - If at any time, any of the investments do not constitute "qualified investments" as defined in **section 204** (and referred to in **subsection 146(1)):**
    - then any income/gains from such non-qualified investments will be taxed pursuant to **subsection 146(10.1)** and the value of those non-qualified investments will be subject to a penalty tax pursuant to **section 207.04**

Tax treatment while in the RRSP

- These investments will hopefully generate income/gains in the RRSP which **will not be subject to tax while in the RRSP** pursuant to **subsection 146(4)**.
- **Exception:**
  - if the RRSP is found to be carrying on a business (as opposed to earning passive investment income/gains), then the business income will be taxable pursuant to **paragraph 146(4)(b)**[43]
    - This is the same case as TFSAs
      - However, the CRA is not taking as proactive of a position in assessing whether there is business being carried out within an RRSP (as is the case in TFSAs), because the gains within the RRSP will still be taxed upon withdrawal

WITHDRAWALS FROM AN RRSP

Tax Treatment on Withdrawals

- When the **Annuitant** withdraws an amount from an RRSP, then generally speaking, such withdrawal will be taxable as **Other Income** pursuant to **paragraph 56(1)(h)** and **subsection 146(8).**
  - Full amount of RRSP withdrawal is taxed is because the contributions are made with pre-tax income (contribution comes with a deduction, so it is not being taxed)

[43] As set out in the Notes to the Practitioners' Act, unlike for TFSAs, the CRA does not appear to be reassessing RRSPs on this basis (the explanation given in the notes is that for RRSPs, the income will be subject to tax upon withdrawal, whereas the income will never be subject to tax from a TFSA)

        - Therefore, the RRSP must be taxed upon withdrawal; for RESP contributions and TFSAs, the withdrawals have already been taxed, so they need not be taxed again (except for CESGs and income earned in RESPs)
    - Annuitant can withdraw at anytime upon his/her discretion up to the year after turning 71 (similar to TFSAs in flexibility of withdrawal, different from RESPs, where there is a certain time that must be waited before withdrawal can be made)
- **Withholding of income taxes**
    - When the Annuitant makes a withdrawal, **Regulations 103(4) and (6)** generally require the **Issuer** to make a withholding for income taxes based upon the amount of the withdrawal.[44]
    - The **Annuitant** can then reduce his/her tax liability in respect of the withdrawal(s) by the amount of the withholding(s).
- **Note:** generally speaking, unlike a TFSA, a withdrawal cannot be redeposited into the RRSP without first obtaining (and using) new contribution room
    - **So:** the withdrawal is being taxed and no new contribution room is created by the withdrawal

HOLDING AN RRSP ON DEATH

Genera Rule

- **If the Annuitant dies holding an RRSP, then the general rule is:**
    - that the Annuitant is deemed to receive, immediately prior to his/her death, the fair market value (FMV) of the RRSP as **Other Income** pursuant to **subsection 146(8.8)** and is taxable on it pursuant to **subsection 146(8)**
        - To the extent that the RRSP funds have been included in the Annuitant's tax return, the funds can be distributed to the beneficiaries without any tax consequences to them.
        - However, any income/gains from the RRSP funds that accrue subsequent to the **Annuitant's** death (and hence were not subject to tax in the **Annuitant's** final tax return) will be taxable either to the beneficiary(s) (if named) or to the **Annuitant's** estate.
            - Annuitant's estate: For the first 36 months, deceased's passed estate is entitled to be taxed on all the marginal brackets of individuals are, and then after that, the income is taxed at the highest marginal tax rate

Refund of Premiums Exception

- **Exception to subsection 146(8.8), subsections 146(8.9) and (8.91) provides that:**
    - if the **Annuitant's spouse or common-law partner** is a beneficiary of the RRSP, then any amounts received by this beneficiary will not be deemed to have been received by the Annuitant prior to his/her death but instead will constitute a "refund of premiums" as defined in **subsection 146(1)**
    - **Assuming the required forms are filled out and the transfers made (pursuant to paragraph 60(l)) in a timely fashion,[45]:**
        - the **Annuitant's spouse or common-law partner** can then transfer such RRSP funds to an RRSP for which the spouse or common-law partner is the **Annuitant.**
            - As such, the spouse or common-law partner will be taxable on such funds (and the income/gains from such funds) when s/he withdraws them (as described above)[46] as opposed to in the year of receipt from the **Annuitant's** estate.
            - **Contribution room exemption:**
                - Spouse or common law partner can transfer what was in the deceased's RRSP as a refunded premium without having contribution room for the transfer

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[44] For withdrawals up to $5,000, the withholding rate is 10%, for withdrawals between $5,000 and $15,000, the withholding rate is 20%, and for withdrawals in excess of $15,000, the withholding rate is 30%

[45] Generally speaking, in the year of receipt or within 60 days of the following calendar year

[46] Note: this tax treatment (rollover) will also apply where the beneficiary is a child or grandchild of the Annuitant who was financially dependent on the Annuitant at the time of the Annuitant's death.

        - So if you name your spouse or common law partner as your beneficiary, it is possible to continue to defer the tax on the RRSP amounts until they are withdrawn by the beneficiary
        - So you may want to designate more RRSPs to the spouse rather than children to capitalize on tax benefits
    - **If such forms/transfers are not completed/made in a timely fashion**:
        - then the refund of premiums will be taxable to the **Annuitant's** spouse or common-law partner in the year of receipt.

HOLDING AN RRSP ON MATURITY

- **When does an RRSP reach maturity?**
    - The Act provides that an individual can contribute to an RRSP until the end of the calendar year that the Annuitant (not the contributor) turns 71 years of age.
        - After this year ends, the RRSP is said to have reached "maturity", which means that something has to be done.

3 Main Options for RRSP Funds upon Maturity

- **Option #1:** - the RRSP can be completely collapsed and all the funds withdrawn.
    - If this option is selected, then the **Annuitant** will be **taxable** on the full amount of the RRSP in the year the RRSP is collapsed per **subsection 146(8)**.
        - This is not a great plan – if you take it all out at once, you will be taxed at higher marginal rates
        - Solution: start making some withdrawals gradually at an earlier time before age 71 so that the withdrawal is not all at once
- **Option#2**: the **Annuitant** can purchase an annuity
    - **Annuity** – in exchange for a lump sum of money up front, the donator will receive fixed amounts in return over a certain period
        - The donee institution will invest the sum and try to make money off the sum while paying you the regular smaller sums
    - **Advantages of annuities:**
        - no lump sum withdrawal of money so the income will be spread out over a number of years and therefore taxed at a lower rate
    - **two types of annuities:**
        - **fixed term annuity**
            - pays a particular amount for a fixed period of time (i.e. 25 years)
                - Generally, if the primary beneficiary dies before the expiration of the fixed term, then the surviving spouse or other secondary beneficiary will receive the remaining payments
            - Advantage: certainty in amount and timing of receiving payments
        - In a **life annuity**:
            - the plan guarantees a certain payment for the life of the annuitant (or in some cases his/her spouse) and may guarantee a minimum payout (i.e. 10 years)
            - The benefit of an annuity is that it is guaranteed - may be beneficial if the person gets a life annuity and exceeds the life expectancy - payments will continue.
                - However, this is also a risk if beneficiary dies prematurely
    - **Payments from an annuity are taxed when received**
        - (as opposed to the entire amount of the RRSP being currently taxable in the year the RRSP must be collapsed) – **paragraph 56(1)(d) –** and as such, constitutes a "rollover" and "tax deferral"
- **Option #3**: the beneficiary purchases a **Registered Retirement Income Fund (RRIF)**.
    - **Difference from an RRSP:**
        - essentially the same as an RRSP except that no new contributions can be made to an RRIF, only transfers from an existing RRSP.
        - The Act requires that a **minimum amount be withdrawn out** of an RRIF each year (i.e. a percentage of the RRIF balance).

        - based on: the FMV of the RRIF assets and the age of the beneficiary (and increases each year as the beneficiary ages).
        - After that minimum has been paid out, then it is up to the beneficiary to decide how much further income is paid out (if any).
    - Income continues to accrue on a tax-free basis within a RRIF and all of the payments made out of the RRIF are fully taxable to the recipient.
        - Annuitant in a RIFF can make the same investment decisions that someone with an RRSP can make, so it is possible for the RIFF funds to continue to increase in value
    - RRIFs are governed primarily by **section 146.3**
    - **Benefits:**
        - greater flexibility in the amount that you can withdraw each year
        - possibility to benefit from continued increase in the value of the investment
    - Similar to RRSPs:
        - annuitant can name a beneficiary, and the RIFF is dissolved and the investment is then deemed withdrawn and taxed

RRSP FEES AND INTEREST ON LOANS FOR CONTRIBUTIONS

- **Deductibility of fees:**
    - Any fees associated with the RRSP will not be deductible for tax purpose by virtue of **paragraph 18(1)(u)**

BORROWING TO CONTRIBUTE TO AN RRSP

Deductibility of interest on loans

- Generally speaking, **paragraph 20(1)(c)** provides that interest will be deductible in calculating business/property income if the borrowed funds can be directly traced into the income earning activity.

Deductibility of interest on loans taken to contribute to an RRSP

- **If** you borrow money to invest in your RRSP, the interest on such borrowings will not be deductible for tax purposes, pursuant to **paragraph 18(11)(b)**
    - **Rationale:**
        - The purpose behind RRSP regime is to encourage saving money for retirement
            - If you borrow money to invest in an RRSP, you are effectively not saving for your retirement at the time of borrowing because your net worth will remain the same
            - You will have retirement savings, but you have added an equal, offsetting debt that you will have to repay when you borrow to invest in your RRSP
            - Therefore, <u>Parliament wants to discourage borrowing to invest in RRSPs because it would not help with saving for retirement</u>;
                - that is why interest is not deductible
    - **Why would you still borrow money to invest in your RRSP?:**
        - 1) When your rate of return within the RRSP is greater than the interest rate you are paying on your loan
        - 2) By borrowing money and investing it, you can begin to receive returns that are not taxed while they remain in the RRSP, you can reinvest those returns, and you therefore receive a benefit you would not receive if you waited until later to invest
            - The longer you have money invested in your RRSP, gaining income that is reinvested, the greater the long term benefit
        - 3) Forced savings: for some clients, borrowing to invest in an RRSP forces them to save money
            - they will then have money saved for retirement and must simply pay back their loans on a monthly basis, which may be better for them
        - 4) Matching contribution programs from your employer:
            - the client can access matching contributions by borrowing money that they not have readily available; that way they are essentially getting free money from their employer

RRSPS AND CREDITORS

Security from Creditors While the Annuitant is living

- By virtue of **subsection 67(1)** of the *Bankruptcy and Insolvency* Act:
  - an RRSP (or RRIF) cannot be seized on bankruptcy (except for contributions made in the 12 months prior to bankruptcy).
  - Outside of bankruptcy:
    - provincial legislation may exempt RRSPs (and RRIFs) from being seized by creditors (see e.g. *Civil Enforcement Act* (Alberta) sections 81.1 and 92.1).
    - If such provincial legislation does not exist,[47] then RRSPs (and RRIFs) may be available to creditors (while the Annuitant is alive).

Creditor Security upon the Annuitant's Death

- **If the Annuitant makes the beneficiary designation within the RRSP itself**:
  - then upon the **Annuitant's** death, the courts have generally held that RRSP will go directly to the beneficiary and will not form part of the Annuitant's estate and hence become eligible to attachment by creditors - other than possibly the CRA
    - see e.g. ***Amherst Crane Rentals Ltd v Perring***, [2004] 5 CTC 5 (Ont CA)) - leave to appeal to SCC refused:
      - If you designate within the instrument itself, your beneficiary will receive the RRSP funds without creditors gaining access
        - Exception may be that the CRA can receive access to the funds to account for outstanding tax liabilities
        - Relying on the deceased's will potentially not protect the funds from creditors so:
          - use the beneficiary designation within the RRSP instrument, not designation within your will
  - ***Gheyssen Estate v TTH Law Firm*, 2014**
    - confirms the necessity to consider any relevant statutory provisions before making a final determination (i.e. that a provincial statute gives creditors rights to the RRSP amount)

SPOUSAL RRSPS

- Recall: for an RRSP, there is a contributor (tax payer), issuer (trustee), and annuitant (beneficiary)
  - Contributor and annuitant can be different people
- A **spousal or common-law partner plan** (defined in **subsection 146(1))** is an RRSP set up for the benefit of your spouse or common-law partner rather than yourself
  - **Put another way:** you are the **Contributor** and your spouse or common-law partner is the **Annuitant**.
- **Calculating deductions from your RRSP contribution room**
  - **For the purposes of calculating deductions from your RRSP contribution room:**
    - Any payment made to a spousal RRSP will be treated the same as if you made it to your own RRSP - subject to the same rules and restrictions as contributions to your own plan
  - **Impact on your spouse's deduction limit**
    - While a contribution to a spousal RRSP will give you a deduction and reduce your RRSP Deduction limit:
      - it will **have no affect on your spouse's income and/or taxes**, not to mention on the spouse's ability to contribute to his/her own RRSP
  - Once a contribution is made:
    - the contributor can no longer withdraw it; it belongs to the spouse

[47] To my knowledge, British Columbia, Alberta, Saskatchewan, Manitoba, PEI, and Nfld. & Labrador have all enacted legislation prohibiting creditors from seizing RRSPs (and RRIFs).

WHY CONTRIBUTE TO A SPOUSAL RRSP?

Question: Why would anyone want to contribute to an RRSP for the benefit of one's spouse or common-law partner rather than an RRSP for their own benefit?

There are at least 5 benefits of contributing to a spousal RRSP, namely:

1. Allows for equalization (income splitting) between spouses who have unequal income and unequal retirement wealth (access to government programs, employment pension plan, RRSP investments, TFSAs)
    - Eliminates abuses and power imbalances; provides security
    - Note on separate pension income splitting rules under section 60.03: one pensioner can notionally allocate up to 50% of annual pension income to a spouse or common law income for the purpose of filling out the spouses' income returns
        - This is beneficial for spouses with unequal pension income
        - Includes employment pension income, RRSP annuities (but not RRSP withdrawals), and RIFF payments, but only if the transferring spouse is aged 65 years or older (GIS not includes, nor is CPP payments or RRSP withdrawals)
        - Problem is that the transfer is notional, rather than an actual transfer of wealth, which is the case for spousal RRSPs
2. To the extent that your spouse is younger than you are: 71-year wind up age is based on the age of the annuitant not the contributor therefore can stay in RRSP longer
    - This allows for more time for the funds to stay in the RRSP and gain interest that can be reinvested without first being taxed
    - If your spouse is younger than you are and they are the annuitant, you can lengthen the benefits of the RRSP
3. The contributor can be over 71 and continue to contribute to a spousal RRSP for a spouse younger than 71, even if you can't contribute to your own (assuming you have the contribution room)
4. Any contributions you make will be protected from your creditors because funds in RRSPs are protected and furthermore, the asset in a spousal RRSP is legally owned by the spouse
    - this may be an even stronger benefit than the income splitting benefit
5. To the extent that you contribute to a spousal RRSP, this enhances your ability to utilize the Homebuyer's Plan and the Life Long Learning Plan (enables spouse to also those exceptions to being unable to withdraw from the RRSP without triggering tax liability)

Tax concern with contributing to a spousal RRSP:

- if the RRSP contribution is pulled out too early by spouse (within 2 calendar years after the calendar year in which last contribution is made):
    - the amount is attributed back to the contributing spouse by virtue of **subsection 146(8.3)**[48]
- Other than the above, generally speaking, the attribution rules do not apply to valid contributions made to spousal RRSPs - see **subsection 74.5(12)**
    - these contributions are exempt from the income attribution rules, unless they are withdrawn in the first two years after the contribution is made

EXCEPTIONS TO TAXING RRSP WITHDRAWALS

- Generally speaking, whenever you withdraw funds from an RRSP, you will be subject to withholding taxes (initially) and income taxes (ultimately).
- **However, there are a few exceptions to this general rule:**
    - 1) where a beneficiary "borrows" money from his/her RRSP to purchase a house in Canada.
    - 2) where the borrowing is used to finance full-time post-secondary education.

[48] Limited exceptions to this rule are contained in **subsection 146(8.7) –** such as where the spouse makes a withdrawal in the year the taxpayer died.

HOME BUYER'S PLAN (SECTION 146.01)

- **The Home Buyer's Plan (HBP) allows a beneficiary to borrow**:
  - up to $25,000 to purchase a house either for himself/herself or for a related person with a disability (where that house will be more suitable for that disabled person).
  - Because the withdrawal is pursuant to the HBP (an "excluded withdrawal" under **subsection 146.01(1)**):
    - There will be no withholding taxes on the amount and nothing will be included in the withdrawer's income.
    - If the proper forms are completed and followed (**T1036 - *Home Buyer's Plan Request to Withdraw Funds from an RRSP***), there will be no tax consequences to withdrawing the funds.
- **Treatment of Spouses:**
  - Under the HBP, the husband and wife (or common law partners, if applicable) are treated separately
    - each can withdraw up to $25,000 from his/her RRSPs to purchase a house (assuming they each have RRSPs for which they are the beneficiary) - <u>but then they must purchase the home in their joint names</u>

MAIN CONDITIONS FOR PARTICIPATING IN THE HOME BUYER'S PLAN (7 REQUIREMENTS):

1. You have to enter into a written agreement to buy or build a qualifying home before making a withdrawal.
2. You have to intend to occupy the qualifying home as a principal residence
   - So you must intend the home to be a personal use capital property (for you to live in personally)
3. You have to be considered a 1st time home buyer as specified in the definition of "regular eligible amount" in **paragraphs 146.01(1)(d) and (e)**
   - (note – this requirement does not apply where the beneficiary is a disabled person)
   - <u>If you are a single individual:</u>
     - you cannot have owned a home which was your principal residence for at least 4 full calendar years prior to the year you want to participate in the HBP.
       - You must also not have a positive HBP balance from prior participation in the plan
   - <u>For someone who is married or in a common-law relationship:</u>
     - Must meet "single individuals" requirement, and his/her spouse/partner could not have owned a house for the 4 calendar years prior that <u>both the taxpayer and the spouse/partner occupied as spouses/partners</u>
       - So if neither person owned a house they lived in as a principal residence in the previous 4 years, they can each withdraw $25,000 tax free
       - If one person did not own and occupy a home in the last 4 years and their spouse did, but the one person did not live in that home with the spouse, then that one person can still withdraw $25,000 tax-free, but their spouse cannot
   - 3 question test to determine if an individual qualifies (emphasis added):
     - 1. Did you, at any time during the period beginning January 1 of the fourth year before the year of withdrawal and ending 31 days before the date of the withdrawal, own a home that you occupied as your principal place of residence?
       - Yes - you are not considered a first-time home buyer
       - No - go to question 2
     - 2. Do you have a spouse or common-law partner?
       - Yes - go to question 3
       - No - You are considered a first-time home buyer
     - 3. Did your spouse or common-law partner have an owner-occupied home, at any time during the period beginning January 1 of the fourth year before the year of withdrawal and ending 31 days before the date of the withdrawal, that you occupied with that individual while you were living together as spouses or common-law partners?
       - Yes - you are not considered a first-time home buyer
       - No - you are considered a first-time home buyer
4. Must be a Canadian resident both at the time of withdrawal and during the period of time the HBP is outstanding
5. You have to complete a T1036 for every eligible withdrawal and generally have to receive all eligible withdrawals within the same calendar year (with some exceptions)

6. You generally have to buy or build the qualifying home before October 1 of the year after the year of withdrawal (with some exceptions)
    - Generally speaking, when you withdraw funds under the Home Buyer's Plan, you have to identify the home you propose to acquire.
        - However, if for whatever reason the purchase doesn't go through, then you have up to October 1 of the year following the withdrawal to purchase (another) home
    - If you don't purchase a house by October 1 of the following year, then you can return the funds to the RRSP by December 31 of that year without incurring any penalties.
7. You must have made your last contribution to the RRSP from which you intend to make the withdrawal at least 90 days before the withdrawal.
    - If it is prior to 90 days, then you may not get an RRSP deduction for your earlier contribution

Repayment of Temporary Withdrawal

- **To fully avoid an income inclusion (and the taxation thereof), the borrowed funds must be repaid (without interest) to the RRSP over a 15 year period, with annual instalments commencing in the 2nd year following the year of the withdrawal.**
    - Like an RRSP, actually have 60 days after the end of the year to make the requirement repayment instalment.:
        - **Formula is:** (1/years remaining) x outstanding loan balance
    - For the amount that you do not meet the minimum payment, you are taxed on the amount owing as a permanent RRSP withdrawal
        - Example:
            - Opening balance of loan: $15,000 (2014)
            - 2016 1st repayment: 1/15 of loan (1/number of remaining years): 1/15 x 15,000 = $1,000
                - Actual repayment: $1000
                - 2016 remaining loan balance: $14,000
                - **Note:** there is no corresponding deduction with the loan payment
            - 2017 2nd repayment: 1/14 x $14,000 = $1,000 owing
                - Actual repayment: $7,500
                - Outstanding balance: $6,500
            - 2018 3rd repayment: 1/13 x $6,500 = $500
                - Actual repayment: $200
                - Outstanding balance: $6,300
                - Tax implication: $300 not paid on debt owing is included in taxable income and is taxed
    - **Note:** you can still contribute while paying back a loan under the homebuyer's plan, so when you contribute, you should clarify whether the contribution is to pay back part of your loan or if it is a new contribution that can be deducted for tax purposes
        - Loan pay-backs are not deductible

Repayment if Borrowing Individual Dies or Ceases to be a Canadian Resident

- If the borrowing individual **ceases to be a Canadian resident or dies** prior to the RRSP loan being repaid, the general rule is that:
    - the **outstanding amount of the loan will be included in the borrower's income in that year** (i.e. the year the person ceases to be a Canadian resident or in the year of death)
        - **In the case of ceasing to be a Canadian resident:**
            - UNLESS: unless you repay the balance at the earlier of (a) when you file your return for the year, and (b) within 60 days after you cease to be a Canadian resident
        - **In the case of death**:
            - provided certain conditions are met, the deceased's spouse or common law-partner may avoid this immediate income inclusion by electing to assume the obligations of the deceased with respect to the payment of the remaining amounts.

- In addition to having an exception for borrowings from your RRSP to purchase a home, there is also an exception where the borrowing is used to finance full-time post-secondary education.
- **Individuals can withdraw up to:**
    - **$10,000 per year (Annual Limit) and $20,000 (Total Limit)** from his/her RRSP to finance full-time training or education for himself/herself or his/her spouse (or common law partner) - but not your children - without triggering any tax.
        - While the maximum withdrawal for a year is $10,000, the full amount does not have to be taken out at one time nor does it have to be taken out of one account.
    - **Period over which withdrawals can be made:**
        - Withdrawals can be made over a four-year period (starting at the time of the 1st withdrawal), with the total amount taken out for LLP not exceeding $20,000
        - The withdrawal must be made by January of the 4th year after the year of the 1st withdrawal
            - (as long as the LLP student continues to meet the requirements discussed below)
    - Spouses can do this combined (i.e. both pulling out to finance one's education) or for their respective education
    - **Direct tracing?**
        - Subject to the above limits, the LLP student can take out more than is required for tuition and books (and still enjoy the benefits of the LLP tax treatment).
            - Put another way, you don't have to directly trace the funds borrowed from the RRSP to a post-secondary expense
- **Treatment on Withdrawal**
    - Like in the case of the HBP, if the proper form is completed and followed each time a withdrawal is made (**Form RC96)**, the withdrawals will not constitute taxable income under **section 56** and no withholdings will have to be made by the financial institution.

Repayment

- Like the HBP, this is only a borrowing from the RRSP – and the funds must be returned – over a **10 year period** to avoid income inclusions.
- **End of borrowing period and start of repayment**
    - The LLP continues (and no repayments are required) while the student meets all the criteria discussed below - to a maximum of 4 years of full-time study (unless disabled).
    - **Repayments become due:**
        - Once the program ends, or after 5 years from the 1st withdrawal, whichever comes first, the borrowing part ends and the repayment period begins.
        - **So RRSP withdrawals under the LLP are repayable to the RRSP in equal instalments over a 10 year period beginning at the earlier of:**
            - 1) The year following the last year that the student was enrolled on a full-time basis (i.e. was eligible to claim at least 3 months of full-time education tax credits); and
                - In other words, after you finish your degree, you get until the end of the year to look for a job and then the following year you must start making payments
            - 2) 60 days following the 5th year after the year in which the individual first received the funds.
- **To calculate the minimum payment each year:**
    - Take the outstanding balance and divide it by the number of years in which it has to be repaid.
        - paying a larger amount than required does not give the individual a "credit" to avoid paying that amount in a subsequent year; rather it reduces the amount of the remaining payments.
        - To the extent that you do not make minimum payment, the deficiency constitutes income for that year and you are taxed on that amount
    - Just like in the case of a repayment under the HBP, the repayment must be to the withdrawer's own RRSP, and not a spousal RRSP.
- **Unlike the HBP:**
    - There are no significant limitations on how many times a person can participate in the LLP.
        - As long as they satisfy the requirements and their LLP balance from a previous program is nil, they can participate.

- **HBP and LLP at the same time:**
    - It is also possible to participate in the HBP and the LLP at the same time (assuming both sets of requirements are satisfied)

MAIN CONDITIONS FOR PARTICIPATING IN THE LLP:

1. You have to be a **Canadian resident** when you receive your funds from the RRSP. For purposes of the LLP, that person is designated as the LLP student.
    - Where the person withdrawing the money is not the LLP student, then the person withdrawing the money from his/her RRSP must also be a Canadian resident at that and all subsequent times.
2. You or your spouse (or common law partner) **must be enrolled or be committed to enrol as a full-time student in:**
    - (a) a qualifying educational program of at least 3 months in duration (at least 10 hours per week of instruction or work in the program)
    - (b) at an eligible educational institution (note – does not have to be in Canada – university, college or the like),
    - (c) usually on a full-time basis (educational institution decides what constitutes "full time" - note - separate from the "qualifying educational program requirement").
        - An exception is given to disabled students who can participate in the plan even though they are not enrolled full-time.
3. You **must enrol in the year of the withdrawal or before March 1 of the following year**.
4. **You must file an income tax return every year**

Ceasing to be a Canadian Resident or Dying

- **General rule is that if the individual participating under the LLP ceases to be a Canadian resident or dies:**
    - any outstanding balance becomes income to the individual immediately before ceasing to be a Canadian resident or in the year of death and will therefore be taxed as income in that year (subject to some rollover provisions)
        - as per **subsections 146.02(5)** and **146.02(6)**
- **Note -** it is possible to make tax deductible contributions to your RRSP in addition to making repayments to your LLP (which are not tax deductible) - assuming you have the RRSP Deduction Room.
    - Will have to specify whether you are making a new contribution or paying off the loan

PARTICIPATION IN THE HBP AND LLP

Questions: What are the advantages and disadvantages of the HBP and LLP? Would you use them yourself and/or recommend their use to a client? If so, then under what circumstances?

Advantages:

- HBP is a benefit in that you can invest in a home with money that would otherwise be unavailable
- Allows you to use money prior to being taxed (using pre-tax dollars) to pay for education or a first home
- You have already received a benefit by deducting the amount from your taxes when you contributed the money to your RRSPs
- Helps give some flexibility to using your RRSP funds for short term expenses
    - Not as flexible as TFSAs, but provides some help with major expenses and you receive the tax benefit of a deduction

Prioritizing between HBP and LLP:

- **HBP** – may be more difficult to meet qualifications
    - Transferring RRSP funds into a home means that the home is available to creditors
- Problem with loans
    - Loans plus mortgage plus homebuyer's plan repayments can be a difficult, long term challenge to the taxpayer
- Money taken out of RRSP for the HBP or LLP, that money cannot be reinvested in the RRSP to make returns while it is borrowed to buy the house or pay for education
    - So, when considering a HBP, you should compare the rate of return on your investments in your RRSP to the interest rate you are paying on your mortgage

        - If your mortgage rate % is lower than your rate of return in your RRSP investments:
            - it is better to keep funds in your RRSP rather than withdraw the RRSP funds and take out a mortgage for a lesser amount
        - But, if your mortgage rate is high, it may be better to withdraw to reduce your principal amount borrowed on your mortgage
- There may be a greater return for an LLP in some cases:
    - Because with post-secondary education investment, you can increase long term job opportunities, salary and benefits
- Negative with both plans:
    - Both have a negative in encouraging RRSP use at a young age when salary is still going to increase (in which case RRSP deductions will have a greater benefit later on)
    - Both are still loans: you must pay them back

Question: is participation in either (or both) plan(s) subject to the GAAR?

- **Answer:** No
- The benefits are intended by Parliament in permitting them in the Income Tax act

SUMMARY OF RRSPS AND TAX PLANNING OPPORTUNITIES

- **Benefits:**
    - 1) Contributing money into an RRSP results in an immediate tax benefit by receiving a tax deduction
        - This immediate benefit is not present for TFSAs, RESPs, or non-registered, fully taxable investments
    - 2) any returns made in the RRSP will not be taxed while they remain in the RRSP
        - Similar to TFSAs and RESPs
    - 3) You can reinvest funds and returns in your RRSP before they are taxed, thereby increasing the rate at which you can earn on your investments
        - Greater gains and greater dividends to reinvest because they are reinvested prior to being taxed (similar to TFSAs and RESPs for being able to reinvest returns before taxation of those returns)
    - 3) When withdrawing from the RRSP, you should be in lower tax bracket, so you achieve some tax avoidance
    - 4) Safety from creditors
- **Negatives:**
    - When you withdraw from your RRSP, the withdrawal is fully taxable as other income
    - This means that you lose the 24% savings for capital gains (because of 50% inclusion rate) for property that has the potential for large capital gain
        - Remember, you are limited in how much you can contribute to an RRSP each year
        - You may want to invest in high-capital gain assets in non-registered, fully taxable investments so you are taxed at the lower rate as a capital asset (take advantage of the 50% inclusion rate for capital gains
            - If put in an RRSP, those investments will be fully taxable
        - This is especially true for people who have more money than can be annually invested in RRSPs – you should prioritize what investments you make in your RRSP
    - Long term investment with limited ability to withdraw because a withdrawal does not create contribution room
    - Withdrawals when you retire will place you in a higher tax bracket, which will disentitle you to government benefits and tax credits that would otherwise be available
- NOTE: If you want the tax benefit and safety from creditor protection, one way to mitigate the income inclusion that may make it so that government credits are clawed back, you can recommend early retirement and withdrawal of the RRSP funds before the age when you can start receiving government benefits; that way, those benefits are not clawed back
    - You don't have to spend the money early, you just need to withdraw it from the RRSP early so that it is included in income at that time, when you don't qualify for government benefits and you have low income

UNIT #9: DEDUCTIBILITY OF INTEREST EXPENSE

INTRODUCTION

- The ability to borrow is very important to most, if not all, of us – both for personal and income earning purposes.
- From a tax perspective, the borrowing of money itself and its repayment generally does not have any income tax consequences to the borrower.
- **Why?**
- **Answer:**
    - Because your net worth does not increase when you borrow money (you gain liquid assets but you also incur an equal debt)
        - **That said,** while the borrowed funds themselves do not generally speaking generate any income tax consequences, the interest paid on borrowed funds **may** be deductible for tax purposes – affecting the cost of borrowing (and making it less expensive)

Starting Point for interest deductibility (General Rule):

- generally speaking, the deduction of interest expense is disallowed by virtue of **paragraph 18(1)(b)** as being a **payment on account of capital** (see e.g. *Canada Safeway Ltd. v. M.N.R.*, [1957] S.C.R. 717).[49]
- **However,** the Act provides exceptions to this general prohibition where a deduction will be allowed under **paragraphs 20(1)(c), (d)** and **(e)**.

BORROWING FOR THE PURPOSE OF EARNING BUSINESS AND/OR PROPERTY INCOME

Paragraph 20(1)(c):

- allows a deduction in computing income from a business or property for a reasonable amount of interest paid or payable in respect of the year pursuant to a legal obligation to pay interest on the borrowed money in the following two circumstances:
    - **Subparagraph 20(1)(c)(i):** where the borrowed money is **used for the purpose of earning income from a business or property,** and
        - **E.**g. borrowing money to buy watches to resell them
    - **Subparagraph 20(1)(c)(ii):** where the borrowed money is used to acquire property for the purpose of gaining or producing income from a business or property
        - **E.**g. buying a 3D printer, which you use to produce watches, which you then sell for profit

SHELL CANADA LTD. V R, [1999] 3 S.C.R. 2622, MCLACHLIN C.J. SUMMARIZED THE FOUR REQUIREMENTS CONTAINED IN PARAGRAPH 20(1)(C):

1. the amount must be paid in the year or be payable in the year in which it is sought to be deducted;
2. the amount must be paid pursuant to a legal obligation to pay interest on the borrowed money;[50]
3. the borrowed money must be used for the purpose of earning non-exempt income from a business or property; and
4. the amount must be reasonable, as assessed by reference to the first three requirements.
    - This is also a general requirement under **section 67.**
    - Where an interest rate is established in a market of lenders and borrowers acting at arm's length from each other, it is generally a reasonable rate... (*Shell*)

REQUIREMENT 3: USED FOR THE PURPOSE OF EARNING NON-EXEMPT INCOME

- **In order for the interest to be deductible, the borrowed money must be used for the purpose of earning income from a business or property.**

[49] Note – there have been a few cases (i.e. *Gifford v R.*, [2004] 1 S.C.R. 411) where the courts have found an interest-bearing debt to be on account of income (rather than capital) and hence deductible under section 9 (and not generally prohibited by virtue of paragraph 18(1)(b)). These cases are beyond the scope of this course.

[50] Generally speaking, for interest expense to be deductible, the taxpayer has to have a legal obligation to pay the interest and such liability must be absolute and non-contingent.

- **Court in *Bronfman* specifies that the condition in paragraph 20(1)(c) actually has 2 key requirements, namely:**
  - 1) A **purpose requirement –** that the funds be borrowed for the purpose of earning income from business and property, and
    - **Purpose test:**
      - A) Taxpayer must satisfy the court that its *bona fide* intention in using the funds was to earn income from business or property (not capital gains)! ***(Bronfman)***
      - B) Requisite test for deductibility under 20(1)(c) is not a "primary" or "exclusive" test ***(Ludco)***
        - As long as one of the taxpayer's purposes (if multiple) for borrowing was to earn income from the borrowed funds, the taxpayer should be able to deduct the associated interest expense
      - C) This is an intention test, and not a results test (must just be reasonable expectation of earning income, but does not necessarily mean that income is actually earned) ***(Ludco)***
        - No net income or profit requirement from the investment of borrowed funds ***(Ludco)***
        - Income doesn't lose its characterization simply because the costs to acquire such income exceed the income itself
  - 2) A **use requirement** – that the funds be **directly traced** to a **current** income earning **use**
    - **A)** The borrowed funds must be directly traced into an income earning purpose/asset (onus is on the taxpayer)
      - So the taxpayer must continuously be able to trace the funds to a current use for earning income (not a point-in-time test, rather, it is applied on an ongoing basis)
    - **B)** It is the current (as opposed to the initial) use of the funds that governs whether an interest deduction exists.
      - The test is therefore applied on an ongoing basis (Bronfman)
    - **C)** The inquiry must be centred on the specific use to which the taxpayer put the borrowed funds (as opposed to the general tax planning "purpose" of the borrowing in general) ***(Singleton)***
      - As long as the direct, immediate use of the borrowed funds is for an income earning purpose, it is not a problem that the end result is saving taxes on a personal investment (e.g. restructuring finances, as in *Singleton*)

- Money borrowed for purposes **other** than for the purpose of earning income from business or property (or to purchase an asset that will be used for the purpose of generating business or property income), like to finance a personal vacation or investing in capital assets:
  - then the interest thereon will generally not be deductible for tax purposes under **paragraph 20(1)(c)**
    - The interest deduction would be disallowed by virtue of the general restriction in **paragraph 18(1)(b)** and possibly, in addition, on the basis that the money was used to incur a personal expenditure - which is disallowed by **paragraph 18(1)(h)**
- **Key Point:** Cash Damming
  - You should use personal cash for personal purposes and borrow money only for income earning purposes if possible (to be able to deduct the interest payments on the loan)

WHAT IS INTEREST?

- Very generally, interest has been defined by the courts (since there is no definition of "interest" in the *Income Tax Act)* as:
  - "the return or consideration or compensation for the use or retention by one person of a sum of money, belonging to, in a colloquial sense, or owed to another" - *Saskatchewan (Attorney General) v Canada (Attorney General)* [1947] SCR 394.
- **This definition of interest provided by the courts is as follows**:
  - It is (or can be) calculated on a day-to-day basis;

        - The courts have also held that an amount paid as compensation for the use of money for a stipulated period can be said to accrue day-to-day.
    - It is referable to (or calculated on) a principal sum (i.e. a percentage thereof); and
    - It represents compensation for the use or retention of borrowed money (as opposed to the repayment of the principal or a dividend/shareholder loan);
- Dividends, as a general rule, are paid with after-tax dollars (because dividends are a share of profit, not paying interest on borrowed funds)

SHERWAY CENTRE LTD. V. R., [1998] 2 C.T.C. 343 (F.C.A.) – PARTICIPATION PAYMENTS CONSTITUTE INTEREST PAYMENTS DEDUCTIBLE UNDER S. 20(1)(C) – TEST FOR PARTICIPATION PAYMENT DEDUCTION – COMMERCIAL REALITY FLEXIBILITY

Ratio: Courts, on occasion, will grant some flexibility under s. 20(1)(c) to acknowledge commercial realities.

- Courts will allow participation payments to be deducted as interest expense under 20(1)(c) where:
  (a) there was a low interest rate on the loan,
  (b) the participation payment was intended to "bump up" the overall interest rate to roughly the commercial interest rate on such a loan, and
  (c) the ceiling on the participation payments approximated the commercial interest rate.

Facts: the taxpayer had to borrow money to finance the construction of a large shopping centre in Toronto. At the time of construction (and borrowing), the applicable interest rate was 10.25%.

- Rather than issue bonds paying this market rate (which the Taxpayer really couldn't afford and would put it at risk of bankruptcy), the Taxpayer issued bonds at a lower interest rate (i.e. 9.75%) plus a "participation payment" equal to 15% of operating surplus in excess of 2.9 million (paying a share of profits)
- The 15% participation rate was selected as the Taxpayer thought that this would, in effect, give lenders the 10.25% market rate it was looking for overall (assuming the Taxpayer's venture was successful).
- The CRA denied the deduction of the participation payments on the basis that it did not satisfy either the interest expense requirements under paragraph 20(1)(c) or the financing expense requirements under paragraph 20(1)(e).
    - S. 20(1)(c) - permitting deduction of interest on borrowed money used to earn income from business or property
    - S. 20(1)(e) - permitting deduction of expenses associated with issuing, selling of units, interests or shares or cost of borrowing money
    - CRA said that the payments looked more like dividends, so should be paid with after-tax dollars, and not deducted
- **T**he Tax court overturned the assessment and held that the participating payments should be allowed.
    - The Tax Court held that the payments were not interest because they neither accrued day to day, nor were they based on the principal outstanding at anytime, but on the operating surplus of the shopping centre (so not deductible unde s 20(1)(c), BUT:
    - It allowed the deductions under paragraph 20(1)(e).

Issue: Could Sherway deduct the additional "participation payment" pursuant to 20(1)(c) – key is whether it constitutes "interest"?

Decision: Appeal dismissed; deduction allowed under both paragraphs 20(1)(c) and (e).

Reasons:

20(1)(c) deduction:

- **one of the essential characteristics of interest is that it accrues daily**
    - appropriate interpretation to be given to daily accrual of interest is that each holder's entitlement to interest must be ascertainable on a daily basis
    - An amount paid as compensation for the use of money for a stipulated period can be said to accrue day to day.
    - While the participatory interest was only payable once a year, it was based on a percentage of the operating surplus for the year.
        - It was therefore capable of being allocated on a day-to-day basis and met the test for day-to-day accrual.
- **Provided a payment is related to the principal sum, it might be deductible as interest.**
    - The participatory interest was related to the principal sum because it was payable only so long as there was principal outstanding.

- To not allow the deduction would ignore the new commercial realities that were not considered by the courts when past decisions were rendered
  - It would send a message that the Income Tax Act discourages entrepreneurship because those individuals starting up new businesses, who need to find new and innovative ways of financing their ventures will not be entitled to deductions under the Act.
- This decision continues to be "good law" with respect to this type of participation payment being deductible under **paragraph 20(1)(c)**.[51]

- **the Court allowed participation payments to be deducted as interest expense under 20(1)(c) where:**
  - (a) there was a low interest rate on the loan,
  - (b) the participation payment was intended to "bump up" the overall interest rate to roughly the commercial interest rate on such a loan, and
  - (c) the ceiling on the participation payments approximated the commercial interest rate.
- **Note:** CRA requires that there be no indication that participating payments are, in reality, a distribution of profit.

CASE LAW FOR DEDUCTIBILITY OF INTEREST UNDER 20(1)(C)

BRONFMAN TRUST V. R., [1987] 1 S.C.R. 32 – 2 KEY REQUIREMENTS FOR 20(1)(C) DEDUCTIBILITY – PURPOSE AND CURRENT, DIRECTLY TRACEABLE USE – INTEREST PAYMENT DEDUCTIONS DENIED FOR LOAN TO PAY BENEFICIARY OF TRUST INSTEAD OF LIQUATING TRUST CAPITAL, TAKING OUT A LOAN, AND BUYING BACK THE INVESTMENTS

Ratio: paragraph 20(1)(c) has 2 key requirements for deductibility of interest payments on loans**:**

1) **A purpose requirement –** that the funds be borrowed for the purpose of earning income from business and property, and
2) **A use requirement –** that the funds be directly traced to an income earning use (direct, current use)

Facts: Bronfman Trust decides to make two discretionary distributions of capital to one of the beneficiaries of the Trust (Phyllis).

- instead of liquidating capital assets to make the allocations, the trustees considered it advantageous to retain the Trust investments temporarily and finance the allocations by borrowing funds from a bank.
  - This is desirable for the taxpayer because they did not want to dispose of the investments (part of the family empire)
  - Disposing of the assets could trigger tax implications for the assets that were capital assets (disposition of capital gain) – did not want to be taxed
- What probably should have been done:
  - dispose of some of the investments, pay tax on gains, make distribution to the beneficiary who needed it, then taken out a loan to re-purchase the investments, and then the trustee could then pay back the loan from the trust and deduct interest on the loan (because the funds were borrowed to purchase assets to earn income)
- The Trust deducted the interest on the borrowed money, an amount grossly in excess of the amount saved by not selling assets to meet the requirements of the allocation
- Tax Review Board and the Federal Court, Trial Division, on appeal by way of trial de novo, upheld the Minister's decision to disallow the deductions.
- The Federal Court of Appeal allowed an appeal from that judgment.

Issue: Was the interest expense deductible for tax purposes in these circumstances – where the borrowed funds were not used "directly" for the purpose of earning income but "indirectly" to preserve income-producing assets that would otherwise have had to have been liquidated?

- **Taxpayer's position**: If you look at the end result of the transactions (or the "big picture"), it is the same as if the Trust sold the assets, made the distribution and then borrowed money to repurchase the assets (which for sure would be deductible)
  - So, the position was that they were preserving their assets that were already earning income
  - Also argued that for trusts and corporations, who are created for the purpose of earning income, should face more relaxed rule application than would individuals

[51] For evidence of continuing CRA support, see Folio paras 1.2-1.5.

- **CRA's position**: The direct use of the borrowed money was to make capital distributions to a beneficiary, which is not an income-producing purpose.
    - Does not matter whether you are a corporation, individual, or trust, the same rule applies

Decision: Appeal allowed; interest on loan not deductible under s 20(1)(c)

Analysis:

- **Starting Point:**
    - without **paragraph 20(1)(c)**, there would be no deduction for interest expense as it is considered to be a payment on account of capital and hence prohibited by **paragraph 18(1)(b)**.
    - Also, not all borrowings are deductible for tax purposes (i.e. monies borrowed to earn non-taxable income or to acquire life insurance)
- The onus is on the taxpayer to **directly trace** the borrowed funds to an identifiable use which triggers the deduction.[52]
    - Court specifies that **paragraph 20(1)(c)** actually has 2 key requirements, namely:
        - 1) A **purpose requirement –** that the funds be borrowed for the purpose of earning income from business and property, and
            - Taxpayer must satisfy the court that its bona fide purpose in using the funds was to earn income
        - 2) A **use requirement** – that the funds be directly traced to an income earning use (which was, in this case, the more important requirement)
            - Must directly trace the borrowed funds to the income earning asset
    - **Current or future use:**
        - For ongoing borrowings (and repayments), it is the **current** use of the borrowed funds by the taxpayer which is relevant in assessing the deductibility of interest payments.
            - So the taxpayer must continuously be able to trace the funds to a current use for earning income (not a point-in-time test, rather, it is applied on an ongoing basis)
        - taxpayer who uses or intends to use borrowed money for an ineligible purpose, but later uses the funds to earn non-exempt income from a business or property, ought not to be deprived of the deduction for the **current, eligible use**
            - BUT: borrowed funds must still be in the hands of the taxpayer, as traced through the proceeds of disposition of the preceding ineligible use, if the taxpayer is to claim the deduction on the basis of a current eligible use
- **Despite the fact that the borrowing could be characterized as indirectly preserving income (or income producing assets):**
    - borrowing money for an ineligible direct purpose generally does not to entitle a taxpayer to deduct the associated interest payments
- **Argument that the Trust ought not be precluded a deduction for interest merely because it achieved the same effect without the formalities of sale and repurchase of assets.**
    - The Court states that it must deal with **what the taxpayer actually did and not what he might have done**.
    - Form is very important (not just the substance)
- **Upshot:** important not to intermingle money borrowed that is then used for personal purposes rather than income earning purposes

APPLYING THE *BRONFMAN* PRINCIPLES TO ASSET SALES/ACQUISITIONS AND REFINANCINGS

- **As noted above, in order to validly deduct interest expenses for tax purposes:**
    - The borrowed funds must be directly traced into an income earning purpose/asset, and

[52] Note: over the years, there have been a few "exceptional" cases where the courts have (at least arguably) not required such "direct tracing" – including one case referred to in the *Bronfman* decision, namely: *Trans-Prairie Pipelines Ltd. v. The Queen*, [1970] C.T.C. 537 (Ex. Ct.). A more recent example (following the same reasoning in *Trans-Prairie*) is *Penn Ventilator Canada Ltd. v R.*, [2002] 2 C.T.C. 2636 (T.C.C.).

- It is the current (as opposed to the initial) use of the funds that governs whether an interest deduction exists.

Question: what if the borrowed funds are initially used to purchase an asset (to be used to generate income), but that asset is sold and the proceeds are invested in:

(a) a new income producing asset or
(b) a non-income producing asset.

Answer:

a) the interest on the borrowed funds can still be deducted because the "current use" is still for earning income
    a. You can trace the borrowed funds to an income earning interest
b) the interest on the borrowed funds is no longer deductible (current use is no longer for earning income)

Question: What if the taxpayer lost money on their first investment, disposed of the assets, and reinvested in another income earning purpose?
Answer:

- As long as the full proceeds from the original income earning asset are invested in another income earning asset, the taxpayer can still deduct the full amount of the interest payment

Question: Selling assets from an initial investment and reinvesting in one personal asset and one income earning asset? What is the interest deductibility?
Answer:

- Interest will be deductible on a pro-rata basis (depending on how much continues to be invested in an income earning purpose and how much is no longer invested in an eligible purpose)

Question: what if the taxpayer borrows funds for an income earning purpose (say to purchase an asset used to generate income) and that asset becomes worthless or the taxpayer discontinues the income earning activity? What happens to the interest deduction on the still outstanding borrowed funds?
Answer:

- ITA s. 20.1 says that where you borrow to purchase capital property or business, and the assets become worthless, those borrowed funds are deemed to have been for an income earning purchase, so you can continue to deduct the interest

Question: What happens to the taxpayer's interest deduction if a taxpayer refinances an existing loan and the original loan proceeds were used for a qualifying purpose and can be directly traced into an income-producing use?
Answer: the funds would then be directly traceable to paying off the loan, rather than being directly used for an income earning purpose (so its interest would not be deductible following Bronfman, but Parliament has stepped to modify the law):

- ITA, s. 20(3) provides that when you take a loan out to pay off the first loan, then the Act deems the purpose of the second loan to be for the same purpose as the first loan, so the interest is deductible

What if you bought shares with no dividend entitlement using borrowed money? Would the interest be deductible?

- Yes, you could say that you were buying the shares with the primary intention of selling them for profit at the time of acquisition, which makes them business assets, and the proceeds from disposition are included in business income

LUDCO ENTERPRISES LTD. V. THE QUEEN, [2001] 2 S.C.R. 1082 – LOANS WITH 1% INTEREST TO PURCHASE SHARES PROVIDING SMALL DIVIDENDS (INCOME, BUT NOT NET INCOME FROM DIRECT BORROWING/INVESTMENT) – INTEREST PAYMENTS FOUND DEDUCTIBLE – DEDUCTING INTEREST ON LOAN UNDER 20(1)(C): PURPOSE OF EARNING INCOME NEED NOT BE PRIMARY/SOLE PURPOSE – MUST ONLY BE A REASONABLE EXPECTATION OF PROFIT, NOT NECESSARILY PROFIT

Ratio: Test to determine the purpose of interest deductibility under paragraph 20(1)(c): whether, considering all of the circumstances, the taxpayer had a reasonable expectation of income at the time the investment is made

- As long as one of the taxpayer's purposes (if multiple) for borrowing was to earn income from the borrowed funds, the taxpayer should be able to deduct the associated interest expense
- Reference to "income" in paragraph 20(1)(c) refers to income generally that is subject to tax (as opposed to tax exempt income) – but not "net income" or "profit"

Facts: the Taxpayers borrowed money to purchase shares in 2 Panamanian Companies, who in turn invested the monies that they received in Canadian and U.S. debt securities in such a way as to avoid Canada's rules (at that time) with respect to foreign income (the individual Canadians only had to pay taxes on dividends received, and dividends were paid out only in small amounts, so the company's shares would increase in worth and could eventually be disposed to achieve a capital gain)

- Canada has changed the rules to trace the investments back to Canadian investors
- The Companies' business/investment policy was to reinvest almost all of its profits and leave only a small portion for the purpose of paying dividends to its shareholders (including the Taxpayers)
    - This was effectively a tax shelter – experience losses for years until you can have capital gains
        - The Companies' dividend policy was later amended to provide that the Board would declare and pay dividends on some portion of its earnings
        - **Question:** why did the Companies amend their dividend policy?
            - **Answer:** to strengthen their case that the investments made by the investors (from their borrowed funds) were for the purpose of earning income (case improves when the investors are receiving more dividends)
    - In the 8 years that the Taxpayers were shareholders of the Companies, the Taxpayers received a total of **$600,000 in dividends**.
        - The Taxpayers borrowed funds from Canadian chartered banks at floating interest rates of roughly prime plus 1%.
        - In the 8 years that the Taxpayers were shareholders of the Companies, they incurred roughly **$6 million in interest charges**.
            - So the taxpayers experienced losses (dividends less than interest charges)
        - When the foreign income reporting rules were amended (which eliminated the tax benefits) that the Taxpayers were enjoying, the Taxpayers sold their shares in the Companies and **realized a $9.24 million capital gain**.
    - **The Minister of National Revenue took the position that the amount borrowed had not been "used for the purpose of earning income from a business or property" as stipulated in s. 20(1)(c)(i),**
        - Rather, it had been used to defer taxes and convert income into capital gains.
        - The Tax Court of Canada, the Federal Court, Trial Division, and the majority of the Federal Court of Appeal all upheld the Minister's reassessments.

Issues: What is the proper test for the deductibility of interest under **paragraph 20(1)(c)** and did the facts in this case qualify the Taxpayers for this deduction? Should special costs be awarded in this case (given that CRA assessed contrary to its longstanding published position)?

SCC Decision: appeal allowed; interest costs were deductible under s. 20(1)(c)(i); The use of the borrowed money complied with the requirements expressed in s. 20(1)(c)(i), including the requirement that the borrowed money be "used for the purpose of earning income".

Reasons:

- Justice Iacobucci began his analysis by determining whether the borrowed funds had been put to an **eligible use.** This required:
    1. A characterization of the **use** of the borrowed funds and
    2. A characterization of the taxpayer's **purpose** in using the funds in a particular manner.
- Key Points on Purpose Test:
    - Must be a purpose of the borrowing to earn income (but not the sole purpose)
    - This is an intention test, and not a results test (must just be reasonable expectation of earning income, but does not necessarily mean that income is actually earned)

Purpose Test

- **The requisite test for deductibility under 20(1)(c) is not a "primary" or "exclusive" test**
    - Therefore, as long as **one of the taxpayer's purposes** (if multiple) for borrowing was to earn income from the borrowed funds, the taxpayer should be able to deduct the associated interest expense
- interest deductibility under paragraph 20(1)(c):

- **whether, considering all of the circumstances, the taxpayer had a reasonable expectation of income at the time the investment is made.**
    - courts should *objectively* view the nature of the purpose guided by both *subjective* and *objective manifestations* of such purpose to determine:
    - **"reasonableness requirement" contained in paragraph 20(1)(c):**
        - "where an interest rate is established in a market of lenders and borrowers acting at arm's length from each other, it is generally a reasonable rate"
- **Net income or profit requirement (from shares)**
    - The reference to "income" in paragraph 20(1)(c) refers to income generally that is subject to tax (as opposed to tax exempt income) – but not "net income" or "profit" (paras. 57-65)
    - income doesn't lose its characterization simply because the costs to acquire such income exceed the income itself

- **Application:**
    - **Issue was whether, in using the borrowed money to purchase the shares in the Companies, the taxpayers had a reasonable expectation of (gross) income (para. 66):**
        - Question answered in the affirmative
        - there was objective evidence that the taxpayers had a reasonable expectation to receive income – not to mention that they in fact received dividend income - $600,000
            - The **fact that this wasn't the Taxpayers' primary purpose did not disqualify them from deducting their associated interest expense**.

CRA's current administrative position regarding the deductibility of interest expense on borrowed funds used to purchase common shares, it states (at Folio para 1.70) that:

- If there is "a reasonable expectation that the common shareholder will receive dividends", the purpose test will generally be met, but
    - "If a corporation has asserted that it does not pay dividends and that dividend are not expected to be paid in the foreseeable future such that shareholders are required to sell their shares in order to realize their value, the purpose test will not likely be met."
- "However, if a corporation is silent with respect to its dividend policy, or its policy is that dividends will be paid when operational circumstances permit, the purpose test will likely be met."

TDL GROUP CO V R (2016 FCA 67) – INTEREST ON LOAN USED TO PURCHASE SHARES WITH LITTLE LIKELIHOOD OF PAYING DIVIDENDS & FUNDS SUBSEQUENTLY RE-LOANED ON NO-INTEREST BASIS (CIRCULAR LOANS) – INTEREST DEDUCTION ALLOWED – TAX COURT APPLIED PURPOSE AND USE TEST ON AN ONGOING BASIS (CORRECTLY) - APPEAL DECISION OVERTURNED TAX COURT, BUT WAS LIKELY OFF IN THEIR REASONING

Ratio: For deductibility of interest, 1) the loan must be made for the purpose of earning business or property income (and there must be a reasonable expectation of earning that income) and 2) the loan must be directly used for that income earning purpose;

Facts: Wendy's International Inc. (Wendy's), the ultimate parent of TDL, loaned $234 million to Delcan, a U.S. subsidiary at an interest rate not to exceed 7%.

- Delcan then loaned the same amount to TDL, a Nova Scotia unlimited liability corporation, at 7.125%.
    - TDL used the funds to purchase additional common shares in its wholly-owned subsidiary Tim Donut U.S. Limited, Inc. (Tim's US).
- While "the plan" was for Tim's US to loan the money back to Wendy's (with an attached interest rate), due to a variety of reasons, for the first 7 months, it was loaned to Wendy's interest-free.
    - While TDL deducted the interest expense that it paid to Delcan, the Minister denied the deduction on the basis that the borrowed funds were not used (by TDL) for the purpose of earning income during the initial 7 month period – but rather to allow Tim's US to make an interest-free loan back to Wendy's.

Tax Court Decision:

- **paragraph 20(1)(c)** requires that the **use** of the borrowed funds first be ascertained, and then its **purpose** (para 15)
    - With respect to the **use** of the funds, there was no dispute –
        - the borrowed funds were directly used (and traceable) to purchase (additional) common shares in TDL's wholly-owned subsidiary, Tim's US.

- The issue in the case was its **purpose** – whether the common shares were acquired for the purpose of earning non-exempt income.
    - TDL's position was that it was at least an ancillary purpose (if not the primary purpose) for it to earn dividend income from Tim's US common shares that it acquired with the borrowed funds
    - In contrast, the Minister's position was that TDL's sole purpose for purchasing Tim's US's common shares was "to arrange for funds to be available to Wendy's at zero percent interest while generating an interest expense…" (para 23)

- **Justice Pizzitelli:** "purpose test must be applied **at the time the investment is made**, namely at the date the Appellant acquired the shares in Tim's US, and furthermore that '**all circumstances must be considered'**" [emphasis added]
    - **Circumstances:**
        - Court found that the use of the funds by Tim's US should be considered – as well as "any series of transactions related to the direct investment" (later described as the "ultimate use of the borrowed funds")
        - TDL **could not be said to have a reasonable expectation to earn income** (i.e. dividend income and/or capital gains[53]), either immediately or in the future (para 31) because:
            - Tim's US was not in a position financially to pay any immediate or short term dividends; they had significant losses
            - Tim Hortons as a whole had a policy of not paying dividends until all capital expenditures were funded;
            - Tim's US's 10 year plan did not include the payment of any dividends; and
            - fact that Tim's US immediately loaned out the funds that it received from TDL to Wendy's interest-free indicated that Tim's US's ability to pay dividends in the future was not enhanced by TDL's share purchase.
                - As such, he **denied TDL's interest deduction for this 7 month period**
    - **Note:** the Minister's reassessment was only for this 7 month period.
        - She allowed TDL to deduct its interest expense related to its Tim's US common share acquisition after Tim's US's interest-free loan to Wendy's was converted into an interest bearing loan.

Appeal Decision: Tax Court's decision overturned; TDL's interest deduction allowed

- Court noted the "unanswered paradox… how is it that there was no income earning purpose during the first seven months the additional common shares were owned by the appellant, but an income earning purpose thereafter?"
    - Talking about how, after 7 months, the loan to Wendy's was restructured to charge interest, and thereafter, the Minister had no complaint
- **But:** The Federal Court should have looked at Bronfman and found that the interest income provision states that there is ongoing requirement for an income earning use and an income earning purpose
    - For the first 7 months, there was no interest income purpose
    - After the loan was restructured, the purpose changed to an income earning purpose
- **Important note:** capital gain is not included in property/business income, and as such, loans for investments in assets that produce capital gains do not create DEDUCTIBLE INTEREST PAYMENTS

SINGLETON V. R., [2001] 2 S.C.R. 1046 – INTEREST ON LOAN TO REFINANCE LAW FIRM AFTER FIRM'S EQUITY REMOVED TO PURCHASE HOUSE WAS DEDUCTIBLE - PURPOSE OF THE BORROWED MONEY LOOKS TO THE DIRECT, IMMEDIATE USE OF THE LOAN

Ratio: To qualify for the deductibility of interest under s 20(1)(c) of the ITA, the legislative requirement "that the borrowed money must be used for the purpose of earning non-exempt income from a business or property" means: the direct, specific use to which the taxpayer put the borrowed funds (as opposed to the general "purpose" of the borrowing, which may be financing a house)

[53] This component of Justice Pizzitelli's decision is curious given **subsection 9(3),** which provides that "income from a property does not include any capital gain from the disposition of that property…"

Facts: The taxpayer was a partner in a law firm; he used $300,000 of equity in his law firm to purchase a house and then he refinanced his law firm equity with borrowed money.

- In one day, the taxpayer (a) pulled $300,000 out of his capital account (includes buy into the partnership and share of income form the partnership that has not yet been paid to the taxpayer – this is after-tax income, as it has already been notionally allocated and taxed to the partner), (b) used the money to buy a house with his wife, (c) then went back to the bank and borrowed $300,000 (using the house as security) and (d) re-deposited the money in his capital account.
- The taxpayer then sought to deduct the interest on the $300,000 loan on the basis that the borrowing was incurred for the purpose of earning income from his legal business, pursuant to s. 20(1)(c)(i) of the Income Tax Act, claiming that the borrowed money now represented his investment in the law firm.
- The Minister of National Revenue reassessed and denied the interest deduction on the grounds that the borrowed money was used to finance the purchase of the house and not as a business investment.
- The Tax Court of Canada dismissed the respondent's appeal. The majority of the Federal Court of Appeal allowed the respondent's appeal.

Issue: Was the borrowed money "used for the purpose of earning income from a business" such that the interest is deductible pursuant to s. 20(1)(c)(i) of the Act?

Decision: Appeal dismissed; The interest payments were deductible under s. 20(1)(c)(i) of the Income Tax Act.

Reasons:

- **s. 20(1)(c)(i) contains four elements (*Shell*):**
  - (1) the amount must be paid in the year or be payable in the year in which it is sought to be deducted;
  - (2) the amount must be paid pursuant to a legal obligation to pay interest on borrowed money;
  - (3) the borrowed money must be used for the purpose of earning non-exempt income from a business or property; and
  - (4) the amount must be reasonable, as assessed by reference to the first three requirements. [Emphasis added.]
- Legislative requirement that "the borrowed money be used for the purpose of earning non-exempt business or property income":
  - **"purpose" pertains to the "taxpayer's purpose in using the money"** - as opposed to the taxpayer's overall tax planning (or other) purpose
    - plain from the reasoning in Shell that the issue to be determined is the direct use to which the borrowed funds were put.
    - So the Court looked only at the direct use of the borrowed funds (to invest in an income earning purpose, that is, the firm's capital account)
  - **Inquiry must be centred on the specific use to which the taxpayer put the borrowed funds (as opposed to the "purpose" of the borrowing in general)**
    - In this this case, the general purpose of the borrowing could have been argued to be to purchase a personal house
- A direct link can be drawn between the borrowed money and an eligible use, so the respondent was entitled to deduct from his income the relevant interest payments
  - Corporations can refinance equity with debt and deduct the interest on the associated debt.
- **Lesson:**
  - If someone comes to you with $300,000 and wants to 1) invest in a firm and 2) buy a $300,000 house, what do you do:
    - Take a loan to invest in the firm and use the cash for your personal house expense
- **Important Point -** the CRA did not argue the application of the GAAR in this case.
  - GAAR was still very new and was not being actively applied
  - The CRA were worried about it being struck down for overbreadth so they were wary about assessing on GAAR
  - GAAR:
    - 1) tax benefit: deduction of interest
    - 2) transaction or series of transactions for the primary purpose of avoiding tax: arguably, yes
    - 3) misuse or abuse of the spirit of the provisions or the Act
      - Argument for no abuse: just restructuring finances

- Argument for abuse or misuse: intention of the Act is to disallow persons from deducting interest for investments like purchasing a house for personal use, and that was exactly what was done by Singleton

LIPSON (*SCC*) ON A PROPOSED GAAR ASSESSMENT OF THE *SINGLETON* SCENARIO – RESTRUCTURING FINANCES LIKE SINGLETON DOES NOT ATTRACT GAAR

- New house, new mortgage, taxpayer attempted to deduct interest and was denied by the SCC
- The opinions of the various judges explicitly or implicitly said that the kind of planning in Singleton would not violate GAAR (saying that restructuring finances is fine)

SMITH MANOEUVRE

Simple Description: taking out a mortgage to pay for a house, then taking out a loan (line of credit) each month/year for the amount equal to the principal amount you have paid back on the mortgage (thereby maintaining your debt at the same amount) and investing the line of credit loan in an income earning asset, so that the interest payments on the line of credit are tax deductible as per s. 20(1)(c) and you start increasing the value of your assets

The Main Goal:

- By the time your house is paid off, you will have saved up the income earned on your line of credit
- You should have assets that are appreciated in value to pay off your $100,000 in debt and still have money left over for retirement

Assumptions:

- **Scenario 1**
  - Take out a $100,000 mortgage
  - Mortgage interest rate = 3%
    - Assume simple interest (in actuality, it would be compound interest)
  - Monthly interest payment = $100,000 x 3% x 1/12 = $250
  - Total monthly mortgage payment: $250 interest + 1,000 principle payment = $1,250
  - Mortgage over a year (principle)
    - Repayments of $12,000 ($1,000 x 12)
    - Outstanding debt: $88,000
  - Interest expense over a year
    - Repayment of $3,000 ($250 x 12)
  - Result: individuals are repaying their mortgage for a long time
- **Scenario 2**
  - As you pay back the mortgage on your house, where the interest in non-deductible, you should take a new loan from your bank and invest in an income earning asset
    - You should be re-borrowing the payments you already made on your mortgage to keep your debt level at the same amount ($100,000)
    - So, as per the above scenario, at the end of year one, when you have $88,000 outstanding debt left, you take out a loan for $12,000 (call it a line of credit)
    - The interest payments on the line of credit will be deductible and you will be earning income on that investment
  - After year 2:
    - You will have outstanding debt on your mortgage in the amount of $76,000
    - You will have a line of credit of $24,000, upon which your interest rates are deductible

When does this actually work:

- You need your return on investments to be at least equal to the interest you are paying on your line of credit
  - If the return on investment is less than the interest rate on your line of credit, you are losing money
- Good candidates for the Smith Manoeuvre are people who are comfortable servicing 'good' debt, want to maximize tax returns and understand leveraging their real estate assets to increase their net worth.

Big Risks:

- You are not paying off the principal amounts on your line of credit, so you're maintaining the same debt and hoping that your investments increase in value at a greater rate than the interest payments you are paying
    - **So:** if your assets become worthless or drop in value, you will end up older and still paying off the debt (you will be worse off)

CREDIT FOR INTEREST ON STUDENT LOANS – ITA S. 118.62

Section 118.62 allows a tax credit for interest paid under specific statutes:

- *Canada Student Loans Act*,
- *Canada Student Financial Assistance Act*, or
- A provincial statute governing the granting of financial assistance to students at the post-secondary level.

It's a "credit" as opposed to a "deduction" because:

- It does not reduce any particular source of income;
- It does not change based on the taxpayer's marginal tax bracket (i.e. calculated federally at 15% of the amount paid - see definition of "appropriate percentage" contained in **subsection 248(1)**);
    - Alberta has its own 10% provincial tax credit
- It is non-refundable (i.e. you don't get money from the government if you haven't paid any taxes that can be refunded); and
- It is claimed in the same area as all of the other "tax credits"

Calculating Tax Credit Deduction

- **To calculate the amount of the deduction, you take the appropriate percentage (i.e. 25% federally and Alberta combined) and multiply it by the amount of interest paid** under one of the above acts either by the student himself or herself, or someone related to the student.
    - Take the amount of interest paid and x the applicable rates (lowest federal rate to lower federal tax liability and by the lowest provincial marginal rate to lower the provincial tax liability)
    - Put another way, a parent can make his/her child's student loan payments and the child will still be able to claim the credit under **section 118.62**.
        - The child has to be the one claiming the credit
- **Further, the student is allowed to claim up to 5 years' worth of interest payments in a particular year as long as those payments have not been claimed in a prior year.**
    - This allows students to stock up on the credit until such time as he/she has income tax otherwise owing
    - But the credit still only applies at the lowest marginal rates (so there is no added benefit of saving up the credits and applying them all in one year)

Vilenski v R, 2003 TCC 418: demonstrates that in order to qualify for a deduction (more properly in this case a credit), you must fit exactly within the scope of the provision.

VILENSKI V R, 2003 TCC 418 – STRICT INTERPRETATION OF ABILITY TO GAIN TAX CREDITS FOR INTEREST ON STUDENT LOANS – MUST BE A LOAN UNDER THE STATUTES LISTED IN THE INCOME TAX ACT, NOT ANOTHER LOAN TAKEN OUT TO PAY OFF THE STUDENT LOAN

Facts: Vilenski had a student loan under the *Canada Student Loans Act*. While in school, he was offered a line of credit at an interest rate of 2% lower than under the student loan by the Bank of Nova Scotia.

- **Note -** the line of credit was called the Scotia Professional Student Plan.
    - This line of credit was not under the listed legislation in **section 118.62**.
- Vilenski decided to take out the line of credit and use the proceeds to repay his student loan.
    - He then made payments to pay off the loan under the line of credit and sought to deduct the interest owing on that line of credit loan under **section 118.62**.
- The CRA said no.

Decision: Appeal dismissed; interest could not receive tax credits

Reasons:

- The Tax Court agreed with CRA
- Even though the proceeds from the line of credit could be traced directly to the payment of the student loan such that, in effect, the line of credit replaced the student loan, the line of credit wasn't issued under the requisite legislation
    - tax credits are restricted to loans under statutes listed in section 118.62 and the student line of credit did not fall within any of those statutes
    - Therefore, no credit could be granted.

- Put another way, in this case, there was no **subsection 20(3)** provision available to "preserve" the interest credit.
    - **Note:** refinancing a loan deems the new loan taken out to pay off the first loan to be for the same purpose of the first loan (will generally allow for extension of interest deductibility), but does not apply in the case of student tax credits, due to strict interpretation

Question: - Assuming Vilenski's student loan rate was 5% and his line of credit rate was 3%, under which loan is he better off (assuming combined effective tax credit rate of 25%)?
Answer: quantitatively, the line of credit is better, despite the tax credit not being available (see calculations below)

- Outstanding loan: $50,000
    - Student loan interest rate: 5%
    - Line of Credit rate: 3%
- Take a student loan:
    - Interest Payment (year one): 50,000 x 5% = $2500
    - Tax Credit: 2,500 x 25% (10% federal and 15 % provincial) = 625
    - Net Cost: $2,500 - $625 = $1,875
    - Remember: you get the tax credit but you don't get to deduct the interest
- Take a line of credit rate:
    - Interest: 50,000 x 3% = $1,500
    - Cost is $1,500
    - Savings of $375 compared to student loan!
- However, must take into account non-numerical consideration:
    - Repayment schedule (may be interest free period)
    - May be portion of loan upon which interest is not charged

LAZARESCU-KING V R, [2004] 1 CTC 3063 (TCC) – SPOUSE CANNOT DEDUCT INTEREST PAYMENTS AS TAX CREDITS WHEN INTEREST IS ON SPOUSE'S STUDENT LOANS – TAX CREDIT MUST BE APPLIED TO THE STUDENT

Facts: Minister of National Revenue (the "Minister") disallowed the deduction claimed by the Appellant for the interest she paid in respect of a student loan in her spouse's name (the loan was taken out by the spouse, not the appellant, who paid the interest)

- s. 118.62 reads as follows:
    - For the purpose of computing an individual's tax, there may be deducted an amount equal to the appropriate percentage multiplied by the amount of interest paid in the year by the individual, or [by] a person related to the individual, on a loan made to the individual.

Issue: whether, pursuant to s. 118.62 of the Income Tax Act (the "Act"), the Appellant is entitled to a non-refundable tax credit in respect of the interest she paid on her spouse's student loan for the 2001 taxation year?
Decision: appeal dismissed; only the person who took out the student loan may deduct from their income, the payment of interest owed on that loan