

TaxTalk

TAX MATTERS OF NOTE

The following will provide information with respect to planning opportunities and recent developments that we believe will be of interest to our clients and contacts.

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Family Tax Planning – Good Time to Make a Loan!

CCRA¹ establishes its prescribed interest rate on a quarterly basis. The prescribed interest rate is relevant for many areas of income taxation, including loans made between family members. Until June 30, 2002, the prescribed rate is only 2%. The rate will increase to 3% on July 1, 2002.

With interest rates at their lowest levels in years, **it is an ideal time to consider an income-splitting arrangement using a loan.** For the strategy to work, the loan recipient must pay interest to the creditor at the prescribed interest rate in effect at the time the loan is made, i.e. 2% for loans that arise before June 30, 2002.

The loan should be documented and interest payable on the loan for each year must be paid no later than January 30 of the following year, i.e. for a loan made in 2002, the 2002 interest must be paid no later than January 30, 2003. If interest is not paid 'on time', then the attribution rules will apply² for the year the interest payment is missed and every year thereafter.

¹ Canada Customs and Revenue Agency ('CCRA').

² If the attribution rules apply, then the investment income earned on the loaned property, i.e. interest, dividends etc., (and capital gains and losses, in the case of loans between spouses) is

Although the 2% interest income is taxed in the hands of the creditor, the investment income over the 2% earned (now or in the future) on the investment will be taxed in the hands of the lower-income individual.

For example, A loans his or her spouse B \$100,000, and B makes an investment that earns 5%. B must pay A \$2,000 in interest every year and A will report the \$2,000 as taxable income. B will report \$5,000 of investment income and deduct³ carrying charges of \$2,000 for interest paid to A. The net annual income of \$3,000 will be taxable income to B. If B's tax rate is lower than A's, B will pay less tax on the income than A would have otherwise paid, had A made the investment. Furthermore, this annual tax saving could easily increase in future years if investment rates increase, as B would still only be required to pay A the same \$2,000 of interest annually until the loan is repaid.

Tax Collection – The Long-Arm of CCRA

CCRA has many powers at its disposal to collect taxes that are owed. One 'tool' that it can use is found in Section 160 of the Income Tax Act, a provision that **can apply to block the transfer of property between parties not dealing at arm's length⁴ when taxes are owing.**

Section 160 provides that the recipient of a transfer of property may be *jointly and severally* liable to pay the taxes of the transferor, up to the excess of the fair market value of the property over the consideration paid for the property when the property is transferred. The purpose of the section is to prevent a taxpayer from avoiding tax by transferring his or her property to a person, which will allow the taxpayer to

attributable to the creditor, in which case, the income splitting benefits are eliminated.

³ B may deduct the interest if the loan is for investment purposes.

⁴ Related persons, i.e. spouses, parents, children etc., do not deal at arm's length. The Income Tax Act states that it is a 'question of fact' whether non-related persons deal at arm's length, i.e. CCRA could assert that non-related persons do not deal at arm's length, in which case section 160 could apply.

continue to 'control' the property. The section covers direct and indirect transfers of property.⁵

Section 160 of the Act is extremely wide in scope. It covers transfers:

- between spouses. In the past few years the tax legislation has been extended to include, as spouses, common-law partners and same sex partners. In addition, even if you are not the spouse of an individual at the time of a property transfer, this section could be applied if you become the individual's spouse after the transfer. As such, there could be a nasty surprise if the person transferring the property to you owes money to the CCRA and subsequently becomes your spouse.
- to a person under 18⁶ or
- to persons with whom you are not at arm's length. This could include, for instance, a transfer of property to or from your business corporation, adult child, brother, sister, father, mother, brother-in-law or sister-in-law, etc.

In all these situations, the transferee and the transferor are jointly and severally liable for tax debts of the transferor pre-dating the transfer⁷. These debts do not necessarily have to be related to the transferred property and can exist totally unbeknownst to the recipient.

The debt to CCRA could arise in numerous ways, such as:

- the debtor's own income tax,
- a failure to remit payroll withholdings (source deductions) collected by a person carrying on business, and/or
- a director's assessment for the failure of a corporation to remit source deductions.

Additionally, there is a similar rule that covers tax liabilities arising under the Excise Tax Act for GST.

As a result of section 160, and its counterpart for GST, it is essential to be very careful when transferring property between related parties in order to avoid problems with the tax authorities.

⁵ For instance, transfers of securities, private company shares, rental buildings, residential buildings, and condominiums, even if located abroad.

⁶ Any minor child, whether related or not.

⁷ These provisions apply to assessments occurring after the transfer, if the tax debt relates to a period before the transfer.

Expectation of Profit – CCRA Loses

Even if the scope of CCRA to collect taxes is broad, it cannot collect taxes when the courts rule that they have incorrectly applied tax legislation. In this regard, **CCRA recently suffered significant defeats as a result of the rulings by the Supreme Court of Canada (SCC)** in two cases related to the "Reasonable Expectation of Profit" doctrine. The long awaited decisions were released May 23, 2002,⁸ and confirm the view of many tax practitioners that CCRA's use of the doctrine was inappropriate in many circumstances.

The SCC is Canada's highest court, and when it rules, it sets precedents for the lower courts and CCRA to follow. The SCC has ruled that the reasonable expectation of profit test is only appropriate in circumstances where a personal element is present. Even if a personal element exists, if the activity is carried out in a "sufficiently commercial manner", there may be a reasonable expectation of profit, and hence the ability to claim tax relief for losses that may occur. The SCC judgment goes further to state that once it has been established that a commercial activity exists, the reasonability of an expense must be determined by analyzing the particular expense⁹ and not whether or not the expense creates or increases a loss. Furthermore, the presence of a tax-motivating factor does not preclude the deductibility of losses if "a source of income from business or property" has been established.

The following provides a brief overview of the cases.

Case 1 - Brian J. Stewart¹⁰

Mr. Stewart, an experienced real estate investor, purchased via a real estate syndication, four condominium units to earn rental income therefrom. The purchases were funded predominantly with debt. Initial income projections did not materialize and Mr. Stewart realized and claimed rental losses for the years 1990 to 1992¹¹. These losses were disallowed by the Minister of National Revenue, and Mr. Stewart's appeals to the Tax Court of Canada and the Federal Court of Appeal were unfruitful. Nonetheless, he persevered and his appeal to the SCC proved to be successful.

⁸ These two cases will form the basis of reassessments for the many objections filed by taxpayers regarding losses disallowed by CCRA due to no "reasonable expectation of profit".

⁹ Section 67 provides for the denial of expenses where they are 'not reasonable in the circumstances.'

¹⁰ Brian J. Stewart v The Queen, 2002 SCC 46

¹¹ It has taken ten years for this matter to wind its way through the system, from the year of claim to the year of decision at the SCC.

The SCC stated the approach to analyzing whether an activity is a source of income (and hence allow the deduction of expenses in excess of gross revenue from business or property) should be done in two stages.

- “ (i) *Is the taxpayer’s activity undertaken in pursuit of profit, or is it a personal endeavour?*
 (ii) *If it is not a personal endeavour, is the source of the income a business or property?*”

The purpose of the first test is to distinguish activities that are commercial in nature from those that are personal in nature. If there is no personal or hobby element, the activity would be considered to be in “pursuit of profit” and there is no need to examine whether a reasonable expectation of profit exists. Even if a personal element exists, if the activity is carried out in a business-like fashion with a view to a profit, the “reasonable expectation of profit” is only one of the elements in determining whether a commercial activity exists.

Once it is determined whether a source of income exists under the first stage, it must then be determined if that source of income is from a business or property. In the case of Mr. Stewart, the income arose from the rental of property and therefore met the second stage/test.

The decision examines, at length, the pitfalls of employing the “reasonable expectation of profit” doctrine to determine whether a source of income exists. The case also states once it is established that a source of income from business or property exists, the deductibility of specific expenses is not based on the ability of the activity to generate a profit, but rather on the reasonability of that expense as considered on its own. Further, the judgment indicates that anticipated capital gains should be taken into account in determining whether the taxpayer’s activity is commercial in nature.

*Case 2 - Jack Walls and Robert Buyyer*¹²

Jack Walls and Robert Buyyer were partners in a limited partnership, which purchased a mini-warehouse to run a storage park operation. Losses were realized and claimed in 1984 and 1985, which CCRA denied. The taxpayer lost at the Tax Court level, and won at the Federal Court of Appeal, after which CCRA appealed to the SCC.

In its judgment, the SCC applied the two stage approach laid out in *Stewart* and determined that the partnership was engaged in a commercial activity with no personal element; and hence a source of income (from business or property) existed as contemplated in the Income Tax Act, and therefore the losses should be allowed.

¹² The Queen v Jack Walls and Robert Buyyer, 2002 SCC 47

In this case, the SCC also explicitly addressed the issue that one of the motivating factors of the investment by Walls and Buyyer were tax write-offs. The SCC determined that the presence of a tax element does **not** undermine the commercial nature of an operation.

The SCC distinguished this decision from another case - *Moloney*¹³ - where tax was found to be the **only** motivating factor of an investment, and the alleged business activity was considered a sham. If the sole motivation for an investment is a reduction in taxes, no source of income from business or property can be established, and therefore no basis exists for the deduction of expenses or losses.

The losses by CCRA in these two cases are significant, and, absent a change in legislation, **CCRA will be forced to curtail/restrict its aggressive pursuit of taxpayers in many similar cases**. Cases that CCRA has held in abeyance awaiting the SCC decisions will now be resolved in favour of taxpayers who claimed losses. For taxpayers who have lost cases of this nature, provided that their avenue to appeal is still open, they are well advised to seek professional assistance to perhaps obtain a just and equitable tax result, in light of the principles advanced by the SCC in these two decisions.

Professionals Can Now Incorporate

The 2000 Ontario Budget provided for the incorporation of Chartered Accountants, Lawyers, Certified General Accountants, Veterinarians, Social Workers and Health Professionals covered by Schedule 1 of the Health Professions Act.¹⁴ The legislation was proclaimed into law on November 1, 2001. However, each profession’s regulating body needed to enact by-laws and/or regulations to accommodate incorporation. To date, all but the Health Professionals¹⁵ have enacted by-laws/regulations.

Incorporating

The process of incorporation will involve approval from the regulating body of the particular profession. Share ownership (as well as the

¹³ *Moloney vs. The Queen*, 92 D.T.C. 6570 (F.C.A.)

¹⁴ Schedule 1 of the Regulated Health Professions Act (‘RHPA’), 1991 covers audiologists, chiropodists including podiatrists, chiropractors, dental hygienists, dental surgeons, dental technologists, denturists, dieticians, massage therapists, medical laboratory technologists, medical radiation technologists, midwives, nurses, occupational therapists, opticians, optometrists, pharmacists, physicians and surgeons, physiotherapists, psychologists, speech language pathologists, and respiratory therapists

¹⁵ Changes to the RHPA were enacted February 28, 2002 allowing each of the Colleges to develop the required by-laws.

appointment of directors and officers of the corporation) is restricted to individuals of the particular profession. The professional corporation's business must be restricted to the practice of that profession.

Some of the transitional issues to be addressed are:

- the administrative cost of incorporating,
- the tax implications¹⁶ of transferring a business from a proprietorship or partnership to a corporation,
- the best time to incorporate, and
- the appropriate year-end of the new corporation(s).

Whether incorporation will be beneficial will be dependent on each professional's circumstances; and each situation must be viewed separately. Certain factors to consider are outlined below.

Professional Liability

A professional corporation does **not** limit the professional liability of its shareholders and **could lead to increased liability** for partners who are currently members of an LLP (Limited Liability Partnership). Acts of the professional corporation will be considered to be acts of/by the shareholders, employees or its agents. Each shareholder of a professional corporation is jointly and severally liable (along with the corporation) for all professional liability claims made with respect to errors and omissions occurring during the period he/she owns shares in the professional corporation. On the other hand, the liability of a partner of an LLP is restricted to professional liability (not satisfied by the assets of the LLP), arising from his or her own acts (and those acts of employees and agents under the partner's supervision).

Tax Implications

The legislation restricts ownership of shares in a professional corporation to members of the profession,

imposing a barrier to family income splitting (except in rare cases where the spouse or child is also a member of the same profession). Other aspects of incorporation may be attractive and include:

- access to the small business tax rate of 19.12% on the first \$200,000 of active business income, possibly allowing for tax deferral, and
- the potential to capitalize on the \$500,000 capital gains exemption (if the shares meet certain qualifications) on a disposition of those shares (to other professionals).

In this regard, if the professional is spending most or all of the income that they make on an annual basis, the benefits of accessing the low corporate tax rate is minimal and would not, by itself, justify incorporation.

Certain other tax issues should be considered. For example:

- incorporation may hasten the inclusion of the reserve in taxable income, such as the 1995 business income reserve,
- a shareholder will receive income in the form of salary and/or dividends, as opposed to self-employment income,
- if losses are expected, they are locked in the corporation (such losses may be carried back three years and forward seven, to the extent the corporation has taxable income), while an individual may apply losses against other sources of income, and
- drawing funds or using corporate property may result in unintended (taxable) benefits attributing to the shareholder, (and therefore resulting in negative tax consequences).

Should you wish to explore the possibilities of incorporation, we suggest professional advice be sought.

A memorandum of this nature cannot be all-encompassing and is not intended to replace professional advice. Its purpose is to highlight tax planning possibilities and identify areas of possible concern. Anyone wishing to discuss the contents or to make any comments or suggestions about this TaxTalk is invited to contact one of our offices.

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