2019 STEP Canada CRA Roundtable

Moodys Private Client
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On Friday June 7, 2019, the Canada Revenue Agency ("CRA") Roundtable of the annual STEP Canada National Conference was held. I had the pleasure of once again being involved in the crafting / selection of the questions along with my good friend Michael Cadesky of Cadesky Tax. The Canada Revenue Agency was represented by Steve Fron and Marina Panourgias who all work hard with their CRA colleagues to ensure that the material presented is useful to taxpayers as a whole and to the advisors who advise on such matters.

The official answers to the questions will be released by the CRA later this year but, in the meantime, friends of our firm may be interested in some of the non-official answers that were provided at the conference. For a complete list of the questions, they can be viewed here.

Here are some of the highlights:

1. Question 3 – Tax on Split Income and the Number of Hours Worked

This question dealt with the application of the tax on split income ("TOSI") and the number of hours worked by a person to meet the exception to the application of the rules. The question asked is as follows:

A safe harbour for purposes of the Excluded Business definition applies where a person works on average at least 20 hours a week during the part of the year that the business is carried on. If this test is met, then the business is considered an Excluded Business and the TOSI rules do not apply by virtue of the amount being an Excluded Amount.

It is noted that the 20-hour week rule is a safe harbour. Working less than 20 hours per week might still meet the requirement for an Excluded Business, since the wording is general in nature, using the phrase "actively engaged on a regular, continuous and substantial basis in the activities of the business".

Suppose a business is carried on through a corporation owned by husband and wife. Both husband and wife contribute an equal amount of effort, but the business only requires 10 hours of work per week on average, with each spouse contributing five hours. In these circumstances, can the business be an Excluded Business?

To clarify, the safe harbour referred to in the question refers to paragraph 120.4(1.1)(a) of the Income Tax Act (as is referred to in Question 4 below as well). The CRA answered this question by basically agreeing that meeting the threshold of being "*actively engaged on a regular, continuous and substantial basis in the activities of a business*" can be met by working less than 20 hours per week but ultimately each case would depend on its facts.

MGTL comment – this answer is not surprising and ultimately, in our opinion, is consistent with the law.

2. Question 4 – TOSI and the Excluded Business Exception

This question dealt with a scenario where a spouse of a professional owned non-voting shares of a professional corporation where all of the voting shares of the PC were owned by the other professional spouse. The non-voting spouse shareholder provided part-time receptionist duties and worked for the PC on average 20 hours per week. The fair market value of such services would be $18,000 per year. However, the non-voting spouse was a paid a dividend of $150,000 during the year. The question asked for confirmation that the $150,000 dividend would be an “excluded amount” by virtue of the amount being derived from an excluded business since the spouse worked 20 hours per week.

In an answer that was not surprising, the CRA confirmed that the $150K dividend would indeed **not** be subject to TOSI since paragraph 120.4(1.1)(a) deems the non-voting spouse to be actively engaged on a regular, continuous and substantial basis if that spouse works in the business at least an average of 20 hours per week during the portion of the year in which the business operates. The definition of “excluded business” requires the specified individual (the non-voting spouse shareholder in this example) to be actively engaged on regular, continuous and substantial basis in the activities of the business and thus this requirement would be met.

MGTL comment – as mentioned above, this response was not surprising and ultimately the correct response.

3. Question 6(a): Tracing of Owner or Property Attributes

This two-part question deals with how the TOSI legislation works when a person dies, and someone inherits property as a consequence of the death. Paragraph 120.4(1.1)(b) of the Income Tax Act contains a set of rules that – overly simplified – enables the inheritor to step into the shoes of the deceased and thus they inherit the attributes that the deceased previously held for purposes of applying the TOSI rules. Accordingly, the following question was asked:

It is unclear how the rules in subsection 120.4(1.1) will work where there have been multiple deaths. For example, assume Mr. and Mrs. A own all the shares of Opco, which operates a services business. Mrs. A has been actively engaged in the business for at least five years, whereas Mr. A has not been actively engaged in the business. Mrs. A passes away and all her shares are gifted through her will to Mr. A. Subsequent distributions from Opco to Mr. A would not be split income as Opco would be deemed to be an excluded business in respect of Mr. A, even if he is not actively engaged in the business. But how will the deeming rules apply if Mr. A subsequently dies and those shares are gifted to the children. Will they be deemed to have made the same contributions as Mrs. A? Or do the deeming rules only reference Mr.

A's contributions? If the latter, then the children could become subject to the TOSI rules unless they can rely on another exemption.

The CRA's response appeared to open the door that the attributes of the original deceased – Mrs. A – could indeed be transferred down to the next generation when Mr. A ultimately dies and his surviving children inherit the shares of Opco. Accordingly, Mrs. A's "good attributes" could ultimately extend to the surviving children after Mr. A passes away and thus TOSI would not apply to any dividends paid on such inherited shares.

> *MGTL comment* – This is, in our opinion, the correct interpretation of paragraph 120.4(1.1)(b) and a good answer by the CRA.

4. Question 6(b): Tracing of Attributes (Continued)

This question was an extension of the above. It asked the following:

Consider the situation where Mr. A passed away in Year 1 and Mrs. A passed away in Year 2. In each of their will, they each bequest ½ of their shares of Opco to each of their 2 inactive children. As a result, each child received ½ of his/her shares of Opco from Mr. A and the other ½ from Mrs. A. Is each child entitled to the excluded business exemption in respect of all future dividends received from Opco?

The CRA's preliminary answer stated that beginning in the taxation year in which the children inherit Mrs. A's Opco shares, each child would be deemed to be actively engaged in the business and thus any income received from the Opco shares – including the shares received from Mr. A – would not be subject to TOSI.

> *MGTL comment* – this is a good answer from the CRA and likely the correct interpretation of the legislation but a generous interpretation.

5. Question 8: CRA's Views on Contingency Fees and WIP

This question dealt with the CRA's views on how certain professionals who charge contingent fees must deal with the taxation of work-in-progress ("WIP") as a result of changes that arose from the 2017 federal budget. Specifically, the question asked the following:

As a result of recent changes to the taxation of WIP for certain professionals, the CRA has published the following statement as it relates to contingency fee arrangements made by certain professionals under FAQ #5 at https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/federal-government-budgets/budget-2017-building-a-strong-middle-class/billed-basis-accounting.html :

- *Under the terms of a contingency fee arrangement, all or a portion of a designated professional's fees may only become known and billable at some time after the taxation year in which the professional provided services under the arrangement (e.g., where, under the terms of a written contingency fee agreement between a personal injury lawyer and a client, legal fees are only billable by the lawyer on a periodic basis as amounts are received by the client under a negotiated settlement or a court judgment). Until such time, there is often no liability on the professional's client to pay any fee; consequently, no amount is receivable by the professional until the right to collect the amount is established. Under these circumstances, for purposes of determining the value of the professional's work in progress at the end of the year, no amount would normally be recognized. As a result, the proposed change to eliminate the ability of designated professionals to elect to use billed-basis accounting is not expected to have any impact on these types of contingency fee arrangements where the terms and conditions of such arrangements are bona fide.*

While this position is very generous for the professional that has entered into a contingent fee arrangement, we question whether this position is correct. Specifically paragraph 10(4)(a) of the Act states:

- *work in progress at the end of a taxation year of a business that is a profession means* ***the amount that can reasonably be expected to become receivable*** *in respect thereof after the end of the year;*

Accordingly, the amount of WIP that a professional is required to value is the amount that can reasonably be expected to become receivable after the end of the year. It would not seem unreasonable that a professional should be able to value its contingent fee files to determine what amounts could reasonably be expected to become receivable after the end of the year. Can the CRA reconcile its administrative position to the law?

The CRA's response to this question acknowledged that they have previously commented on this issue in Technical Interpretations issued in 2017 and 2018. The CRA acknowledged that in some circumstances it is possible that the professional would be able to establish an amount that can reasonably be expected to become receivable in respect of the contingent file after the end of the year. In those cases, it is the CRA's view that the fair market value of that WIP should be reflected accordingly.

> *MGTL comment* – this response more accurately reflects the law in our opinion. During the oral portion of the CRA Roundtable, a suggestion was made by the panel that the FAQ #5 as referenced above should be amended to reflect the CRA's comments provided.

6. Question 13: TOSI and Preferred Beneficiary Election

This question – and also Question 14 of the Roundtable – dealt with TOSI and the preferred beneficiary election. Specifically, the following was asked:

The preferred beneficiary election is made jointly by a trust and a preferred beneficiary pursuant to subsection 104(14). The term "preferred beneficiary" is defined in subsection 108(1) to be an individual resident in Canada who is a beneficiary of a trust who has either a severe and prolonged impairment in physical or mental functions that qualifies for the disability amount, or, if at least age 18, is dependent on another individual because of mental or physical infirmity and whose income does not exceed an amount referenced to the basic personal tax credit for single status. In addition, the individual must be a settlor of the trust, a spouse, common law partner or former spouse or common law partner of the settlor, or a child, grandchild or great grandchild of the settlor, or the spouse or common law partner of such person.

The preferred beneficiary election allows the trust to "allocate" income of the trust to the preferred beneficiary, whereupon the trust can take a deduction and the amount is included in the income of the preferred beneficiary.

The question is whether an amount included in a beneficiary's income under a preferred beneficiary election is split income or not under paragraph (c) of the definition of "split income" in the TOSI rules. Paragraph (c) refers to an amount included in a beneficiary's income because of the application of subsection 104(13) or 105(2) and does not refer to the preferred beneficiary election where the designated amount is included in the beneficiary's income pursuant to subsection 104(14).

Not surprisingly, the CRA noted that the definition of "split income" in the Act does not capture amounts that are included in income pursuant to subsection 104(14) and thus amounts included in a person's income by virtue of the application of the preferred beneficiary election, TOSI would not apply to such amounts. However, if the income allocated to the preferred beneficiary was in respect of taxable dividends and a subsection 104(19) designation was made in respect of such amounts (which essentially preserves the character of the dividend in the hands of the beneficiary) then such amounts would be subject to TOSI.

> *MGTL comment* – this answer is not surprising and is consistent with the law. However, if preferred beneficiary designations are being made by trustees, extreme care should be made when dealing with taxable dividends so as to ensure that a subsection 104(19) designation is not made. The CRA provided helpful comments in its response with respect to this and stated that in order to avoid making a subsection 104(19) designation, any dividend amounts received by the trust should simply be included in box 26 of the T3 slip (other income).

7. Question 17: Part XVIII of the Act – FATCA

This straight forward question was posed to simply get an update from the CRA as to how the collection and administration of the information collected from Canadian financial institutions as required under Part XVIII of the Act. The following was asked:

Can the CRA provide recent statistical data with respect to data that it is required to collect and transmit to the US IRS pursuant to Part XVIII of the Act and the Inter-Governmental Agreement between the US and Canada? For example, how many accounts' information was transmitted during the last transmission period? Has the US requested any further information in respect of any of the transmitted data?

The CRA answered that for the 2017 taxation year, the CRA has sent over 700,000 records to the US Internal Revenue Service as of April 1, 2019. The CRA has not received any requests from the IRS in respect of the data.

> *MGTL comment* – for one taxation year – 2017 – the transmission of 700,000 records to the IRS seems like a lot of data transmission to us. If no requests for further information have been received by the IRS to the CRA, one can only speculate as to what that might mean. Is it too much data for the IRS to handle? The IRS is simply reviewing the information and ultimately will respond and reconcile? Time will tell…