TAX FOR THE Owner-Manager

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2023 Budget Proposals To Amend the AMT: Observations, Issues, and Suggestions

The Liberals' 2021 election platform promised a "minimum tax rule" whereby "everyone pays their fair share." Collective head-scratching ensued in the tax community, since division E.1 of the Act already contained an alternative minimum tax (AMT) regime. The 2023 federal budget finally provided clarity on what was intended—namely, tweaking the existing AMT rules so as to broaden the AMT base and increase the AMT rate, while materially increasing the AMT exemption so that Canadians earning modest income or gains will generally be exempt from AMT. If enacted, the proposed changes to the AMT regime will come into force for taxation years that begin after 2023.

This article summarizes the proposed amendments as they were described in the 2023 federal budget, and it highlights several technical and policy issues (particularly issues related to the application of the AMT to trusts). Finance did not release draft legislation concurrently with the budget, so some of the issues that we identify in this article might by now have been considered by Finance and may be non-issues.

The Act has had an AMT regime since 1986. Let us begin with a general description of how it works. An individual taxpayer (which may be a trust) whose regular income tax for the year is less than a "minimum amount" (as determined under section 127.51) is required by section 127.5 to pay the shortfall as AMT. Section 120.2 provides that the taxpayer, after paying the AMT, has seven years to use the AMT paid to offset regular income tax in those years to the extent that regular income tax payable exceeds the minimum amount. The minimum amount of a taxpayer for a year is computed as 15 percent (the rate applicable to the lowest federal tax bracket) of adjusted taxable income (ATI), less a $40,000 basic exemption amount for non-trust individuals or graduated rate estates (GREs). The minimum amount is also reduced by the taxpayer's "basic minimum tax credits" for the year.

Section 127.52 gives the definition of ATI. It is the taxpayer's taxable income for the year adjusted to restrict the benefit from certain tax-preferential items. This definition provides for commonly encountered adjustments in the computation of ATI, including the following:

- Capital gains are included at 80 percent rather than 50 percent, except in the case of a capital gain arising on a donation to a qualified donee.
- The 50 percent stock option benefit deduction under paragraphs 110(1)(d) and (d.1) is limited to two-fifths of the original amount, so that effectively 80 percent of a stock option benefit is included (which is similar to the treatment of capital gains). The two-fifths restriction does not apply to the additional stock option benefit deduction provided by paragraph 110(1)(d.01), which arises when securities acquired via option are donated to a qualified donee.
- For rental or leasing income, CCA, interest, and financing expenses are restricted to the amount of net rental or leasing income and net taxable capital gain on the disposition of rental or leasing property.
- Taxable dividends received from Canadian-resident corporations are not subject to the gross-up and dividend tax credit regime; thus, they are effectively treated as ordinary income (see paragraph 127.52(1)(f) and the definition of basic minimum tax credits in section 127.531).

When federal AMT applies, provincial AMT will generally also apply because the provincial AMT regime mostly piggybacks on the federal AMT amount, charging (or recovering) a fixed percentage of federal AMT.

Proposed Amendments

The 2023 budget proposed the following changes:

- Increase from 15 percent to 20.5 percent the AMT rate used to calculate the minimum amount.
- Increase the $40,000 AMT exemption to the bottom end of the fourth federal tax bracket (estimated to be

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$173,000 for 2024), to be indexed annually to inflation. (The indexing change is sorely needed, given that the $40,000 amount has remained static since 1986. If consumer price index indexation had applied since 1986, this exemption amount would have been almost $90,000 by the end of 2021.)
- Amend the computation of ATI by
  - increasing the capital gain inclusion rate from 80 percent to 100 percent;
  - increasing the capital gain inclusion rate for donated publicly listed securities from 0 percent to 30 percent;
  - maintaining the 50 percent inclusion rate for capital loss carryovers and business investment losses (in other words, under the proposed AMT, the capital gains inclusion rate would increase from 80 percent to 100 percent, and the inclusion rate for capital losses and business investment losses would be reduced from 80 percent to 50 percent);
  - maintaining the inclusion of 30 percent of gains offset by the lifetime capital gains exemption (LCGE) (under the current AMT, the LCGE is not adjusted to reflect the 80 percent inclusion rate for capital gains);
  - denying the entire employee stock option deduction so that stock option benefits are included at 100 percent;
  - increasing from 0 percent to 30 percent the stock option benefit associated with donated publicly listed securities;
  - disallowing 50 percent of the deductions for (1) interest and carrying charges incurred to earn income from property, (2) limited partnership losses of other years, (3) non-capital loss carryovers, (4) employment expenses (other than those incurred to earn commission income), (5) CPP, QPP, and provincial parental insurance plan contributions, (6) moving expenses, (7) child-care expenses, (8) disability supports, (9) workers' compensation and social assistance payments, and guaranteed income supplement (GIS) payments, (10) northern residents, and (11) Canadian armed forces personnel and police; and
  - reducing most basic minimum tax credits by 50 percent.

Transactions and Planning Affected by the AMT Amendments

The increase in the AMT rate and in the capital gain inclusion rate will affect the taxation of capital gains realized by individuals. Planners working with clients who are looking to realize large capital gains after 2023—on the sale of a business, for example, or on a surplus-strip transaction—will need to pay more attention to AMT modelling than has been necessary under the current regime. Using the 2023 tax brackets, an individual who is eligible for only the basic personal credit, and who has no income other than a capital gain of $800,000, would have AMT slightly greater than basic federal tax.

The donation tax credit under section 118.1 is fully allowed as a basic minimum tax credit under existing rules, but it will be reduced by 50 percent under the proposed amendment. Generous taxpayers who plan to make sizable donations, especially via the gifting of publicly listed securities (30 percent of the capital gain arising from which will be included in computing ATI under the amendment), will need to model the impact of the proposed AMT regime, given that the tax benefit from such donation arrangements might be drastically reduced in some cases.

Another type of planning that will be affected is planning that involves highly leveraged insurance. Such plans often generate substantial interest expenses, deductible life insurance premiums, and guarantee fee expenses, only 50 percent of which will be permitted in the computation of ATI under the proposed amendment.

However, even as these planning strategies are caught in the broadening of the AMT base and the AMT rate, the increase of the $173,000 AMT exemption from $40,000 should mean that taxpayers with modest income for the year will not be subject to AMT. In addition, no amendment has been proposed to the seven-year carryforward period to recover AMT; therefore, most taxpayers subject to AMT under the proposed regime should still be capable of planning their affairs to fully recover AMT paid.

Concerns About the Broad Brush

Although some of the proposed amendments appear consistent with the government's stated aim of targeting high-income individuals, many of the proposed restrictions on the broad array of deductions and credits either appear to be inconsistent with that goal or raise other concerns.

The application of different inclusion rates to losses (capital or non-capital) carried over from other years may lead to significantly different results for taxpayers whose situations are identical except for the calendar year in which their gains and income or losses arise (under the proposed AMT, income and capital gains will be included at 100 percent, while capital and non-capital loss carryovers will be deductible at 50 percent). This inconsistency may be unduly punitive to individuals with volatile income patterns. The policy reason for this restriction is unclear, given that losses from tax shelters are already entirely denied under the existing AMT regime.

It seems unlikely that many high-income individuals receive significant income in the form of social assistance, GIS, or workers' compensation benefits, so it is difficult to see the

policy reasons for reducing the deduction of such items from taxable income. Similarly, we suspect that few of the individuals eligible for the special deduction granted to members of the Canadian armed forces, and to police officers, serving on a deployed international operational mission are high-income individuals, and we doubt that the individuals who may be in that income category are using these deductions for aggressive tax minimization.

Investment carrying charges are a cost of earning investment income. Some aggressive tax strategies involve incurring substantial costs of this nature, and few investment portfolios lack such costs. The existing AMT disallows interest expenses related to rental income if these expenses result in rental losses. Perhaps this restriction might be applied on a broader basis, so as to deny such expenses if they exceed the income from the property to which they relate. It is unclear whether this restriction will expand the restrictions related to the expenses of earning rental income.

Restricting the deduction of employment expenses will provide to employees whose employers reimburse expenses a tax advantage over those whose employers pay higher compensation while requiring that employees bear the cost of their own expenses.

The proposals will not reinstate the dividend gross-up or the dividend tax credit. With the higher base AMT rate, the impact of the AMT on Canadians who derive significant income in the form of dividends will increase. The gross-up and dividend tax credit are fundamental to the integration of corporate and personal tax, a fact that Finance was quick to raise in its response to Bill C-208. It seems reasonable for Finance to be as diligent in defending the principles of integration in the application of AMT to dividends as in preventing inappropriate surplus stripping.

It is difficult to envision taxpayers incurring sizable medical expenses as part of an abusive tax strategy. Many other personal credits seem unlikely to be susceptible to aggressive tax planning.

Overall, all of the deductions or credits proposed to be restricted for AMT purposes were enacted for legitimate policy reasons. Presumably, if the policies have changed, these deductions and credits could simply be repealed. Few of them seem susceptible to abusive tax-planning strategies. We would suggest that a consultation on these proposals should be undertaken, commencing with a backgrounder that sets out the specific concerns about each item proposed for restriction, so that stakeholders may address these concerns, and a better-targeted proposal can be developed.

We acknowledge, however, that these concerns are largely mitigated by the increase in the basic AMT deduction, which will spare many individual Canadians from being exposed to AMT at all. Perhaps the policy objective is similar to the objective behind the US reduction of itemized (or standard) deductions for high-income individuals—an issue that has recently become a topic of discussion in that country.

Minimum Tax Not So Minimal for Non-GRE Trusts

Because the AMT exemption provided under section 127.51 is unavailable to trusts other than GREs (that is, the exemption amount is $0), most trusts will enjoy no protection from these proposals.

The inability of regular trusts to access the AMT exemption creates an issue of tax neutrality, whereby trusts are significantly disadvantaged compared with natural individuals. Unlike individuals, trusts will be subject to the AMT on the first dollar they earn, regardless of their income level, contrary to the government's policy that the AMT targets only high-income earners. Given their legal and non-tax-related estate-planning benefits, trusts are not necessarily used only by high-income earners. Moreover, most trusts are already subject to the highest rate of tax.

The expansion of the AMT and the absence of exemptions, as described in the 2023 federal budget documents, means that trusts will become exposed to AMT for engaging in normal-course, non-tax-abusive transactions at levels well below $173,000 annually. For example, assume that a trust realizes a modest capital gain of $10,000 and has no other income. The trust's regular federal income tax payable will be $1,650 ($10,000 × 50 percent inclusion rate × 33 percent federal tax rate applicable to a non-GRE trust). The trust is not taxed under the existing AMT system because the AMT minimum amount is only $1,200 ($10,000 × 80 percent inclusion rate × 15 percent), which is less than the trust's regular income tax payable. However, under the proposed AMT system, the minimum amount will be $2,050 ($10,000 × 100 percent × 20.5 percent). Given that regular trusts do not have access to the AMT exemption, this trust, with a $10,000 capital gain and no other income, will be subject to $400 of federal AMT—the difference between its regular federal tax payable of $1,650 and the new minimum amount of $2,050. In addition, provincial AMT will likely apply.

Consider another example, in which a trust owns a rental property. During the immediately preceding year, the trust incurred a rental loss of $4,000, which became a non-capital loss. The trust earned a $4,000 profit in its current year, against which it claimed the $4,000 non-capital loss carryover. The proposed AMT would deny 50 percent of the loss carryover such that the AMT would remain on $2,000 (that is, AMT of $410, which is $2,000 × 20.5 percent), despite the absence of any economic gain over the two taxation years. The proposed restrictions on deductions are an issue for individuals, but the lack of any basic exemption for trusts makes this a much broader issue. Alternatively, the trustee could resolve to distribute the $4,000 rental income to beneficiaries so as to avoid the impact

of the AMT. But by doing so, the trust would lose the ability ever to benefit from the prior-year non-capital loss, because it can never be applied without attracting AMT.

In addition, the proposed AMT rules will have a significant impact on trusts that access funds through standard prescribed rate loans. Consider a scenario in which a grandfather establishes a trust for his grandchildren by making a $200,000 prescribed rate loan at a 5 percent interest rate. The trust earns $20,000 of investment revenue and pays $10,000 of interest to the grandfather. Under the current system, the trust would have $10,000 of net income that could be taxed inside the trust or distributed to the grandchildren beneficiaries. Under the proposed AMT rules, however, 50 percent of the interest deduction would be denied, with the result that $15,000 of ATI would be subject to AMT. Assuming that the trust distributes $10,000 to the grandchildren as income distributions, the trust would owe federal AMT of $1,025 (20.5 percent of $5,000). Trustees cannot avoid AMT by distributing $15,000 of income to the beneficiaries because the amount of income that can be distributed is limited to "its income" under subsection 104(6), as confirmed by the CRA in TI 2017-0716451E5. As well, the trust would have only $10,000 of cash to pay to its beneficiaries, even before the tax liability. It cannot distribute $15,000.

A similar issue exists when a trust earns portfolio investment income and incurs carrying charges, given that the proposed AMT rules disallow 50 percent of the carrying charges. AMT will apply to the trust even if the trust distributes all of its net income to beneficiaries.

The same AMT result could arise when a trust is in a net loss position, because the trust may have earned income on preferential items such as capital gains or dividends. In this scenario, no income can be distributed under subsection 104(6) because the trust is in a net loss position. If distributions were allowed, natural individuals could have absorbed the impact of the AMT owing to the availability of AMT exemption rooms.

All of the issues above that affect trusts are further exacerbated by the proposed broadening of the AMT base and the increase of the AMT rate to 20.5 percent.

In the absence of mitigating provisions, it appears that most trusts holding investment portfolios will have taxes payable every year because of the broadening of the AMT base. Some examples of such trusts include the following:

- spousal trusts (except for the year of death of the spousal beneficiary, excluded by paragraph 127.55(e));
- trusts for minors, such as the children of a couple who pass away in a common accident; and
- trusts for disabled persons who lack the capacity to manage their own financial affairs.

In the absence of some mitigating provisions, the proposed amendments will likely give many of these trusts an incentive to incorporate their investment activities, pushing most or all related costs into the corporation. The policy purpose behind these measures was surely not to impose the added costs and complexities of incorporation on these trusts.

Another category of trusts to consider are the proposed employee ownership trusts. Consider a hypothetical trust of this kind, which utilizes the proposed extended time frame for repaying a loan (from a corporation) that has been used to fund share acquisitions. The trust will be required to report an interest benefit under section 80.4, offset by a deduction because this is deemed interest paid under section 80.5. Assuming a loan of $5 million, and a 5 percent prescribed rate, this $250,000 income and deduction will attract federal AMT of $25,625 annually.

One possible means of addressing this inequity can perhaps be gleaned from subsection 127.2(2), under which elements with restricted deductibility under the AMT rules flow from a partnership to its partners. If elements that are restricted for AMT were also flowed out to beneficiaries, much of the inequity could be resolved. Where income is paid or payable to beneficiaries, these amounts could flow proportionately. A deeming regime, perhaps on an elective basis, could be considered as a way to permit trusts with no net income to flow out these amounts to beneficiaries. Finally, it would seem reasonable to expand the ability of trusts to designate income that is paid or payable to beneficiaries as retained and taxed in the trust for the purpose of using tax credits, such as prior AMT or credits for charitable donations.

Concluding Remarks

The policy reasons for these proposals—beyond the familiar rationale that "people with high income should pay taxes"—are unclear. We would suggest that a more formal consultation process should be undertaken, identifying the concerns about each item adjusted for AMT purposes (under both the current and the proposed regime) and revisiting, perhaps, items that have been considered (but not proposed) for inclusion in the new regime. This would enable the final amendments to better target high-income individuals who are taking undue advantage of these tax benefits. As the foregoing discussion has indicated, we see numerous problems with the proposals, but other issues would doubtless emerge through such consultations—including, perhaps, the absence of deductions or credits not currently proposed for adjustment.

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Bill C-47 and the Interaction Between Adviser Fees and Reportable Transactions

On April 20, 2023, the Department of Finance released Bill C-47 (Budget Implementation Act, 2023, No. 1; royal assent June 22, 2023) and its accompanying explanatory notes. The bill will implement many of the 2023 federal budget measures, and it includes, notably, revisions to the draft legislation regarding the reporting regime for avoidance transactions, which is in section 237.3 of the Income Tax Act (Canada). The changes to this regime were first proposed in the 2021 federal budget, and the relevant draft legislation was released on February 4, 2022 and then on August 9, 2022.

Of particular interest and concern to tax advisers were the revisions to the "hallmark" contained in paragraph (a) of the definition of "reportable transaction" in subsection 237.3(1), which relates to fees charged by advisers and promoters. The February 4 and August 9, 2022 draft legislation proposed significant revisions to that reporting regime, including a reduction in the number of "hallmarks" required to be satisfied to trigger a reporting obligation (from two hallmarks to only one).

The hallmark relating to fees, as currently drafted, encompasses essentially three circumstances. In general and simplified terms, a fee will fall within the ambit of paragraph (a) of the definition of "reportable transaction" if it is a fee that, to any extent, (1) is based on the amount of a tax benefit that results, or would result but for the application of GAAR, from the avoidance transaction or series; (2) is contingent upon the obtaining of a tax benefit that results, or would result but for the application of GAAR, from the avoidance transaction or series; or (3) is attributable to the number of persons who participate in the avoidance transaction or series or who have been provided access to advice or an opinion given by the adviser or promoter regarding the tax consequences from the avoidance transaction or series.

In conjunction with proposing to reduce the number of hallmarks that must be satisfied to trigger a reporting obligation from two to one, the original draft legislation also proposed to lower the threshold for a transaction to be an "avoidance transaction." The proposed amended definition lowers the threshold by substituting the primary purpose test in the current definition for a test based on the standard of whether "one of the main purposes" of the transaction (or of the series of which the transaction is a part) is to obtain a tax benefit. As a result, many advisers were concerned about the broad application of the hallmark relating to adviser fees because virtually any ordinary tax planning would presumably constitute an "avoidance transaction" under this revised definition.

Concerns regarding the proposed mandatory reporting disclosure regime were submitted to the Department of Finance by various parties, including the Joint Committee on Taxation of the Canadian Bar Association and the Chartered Professional Accountants of Canada ("the joint committee") in a submission dated April 5, 2022. The joint committee's submission argued that the broad language regarding adviser fees could capture commercial situations that the joint committee regarded as not being consistent with the goals of the legislation. The broad areas of concern highlighted by the submission were "value billing," contingency work, and fees based on the number of taxpayers participating (an example of which, according to the joint committee, would be a rate given for the bulk preparation of T2057 forms).

Despite these submissions, Bill C-47's only revision to the hallmark relating to fees was the exclusion of a fee in relation to a prescribed form required to be filed under subsection 37(11) (which relates to the SR & ED regime). The explanatory notes accompanying the bill include several comments that appear inspired by the criticisms levelled at the broadness of this hallmark and its potential to capture ordinary commercial arrangements. The explanatory notes provide examples of billing practices that, in the view of the Department of Finance, would not generally be expected to result in a reporting obligation for an adviser, absent additional facts or circumstances that might suggest a different result.

The explanatory notes went on to consider categories of billing that should not create a reporting obligation.

Value Billing

The explanatory notes conclude that a reporting obligation is not expected to arise solely as a result of a fee that is based solely on the value of the services provided in respect of a transaction or series and that is determined without reference to the tax results of the transaction or series. Such billing, in the view of the Department of Finance, would include "value billing" by professionals such as lawyers and accountants, whereby a fee is agreed to at the time of billing and is based on criteria other than the value of the tax benefit resulting from the transaction or series. Factors that would be acceptable to consider in the value-billing arrangement would be the following: the level of training and experience of the persons engaged in the work, the time expended by the persons engaged in the work, the degree of risk and responsibility that the work entails, the priority and importance of the work to the client, and the value of the work to the client.

Contingency Fees in Respect of Tax Litigation

The explanatory notes also conclude that a reporting obligation is not expected to arise from a contingent litigation fee arrangement in relation to an appeal of a tax assessment in respect of a tax benefit from a transaction or series of transactions. This would be the case, in the view of the Department of Finance, provided that the litigation fee arrangement is implemented after the completion of the transaction or series that is the

subject of an appeal. The explanatory notes conclude, however, that a reporting obligation would be expected to arise for a litigator from a contingent litigation fee arrangement that is put in place with a taxpayer, adviser, or promoter in respect of a transaction or series of transactions before the completion of the avoidance transaction or series of transactions.

Fees Collected by Financial Institutions

Finally, the explanatory notes state that, absent other facts to the contrary, the collection of a standard fee (that is, a fee that would generally be charged to the public under normal commercial terms and in comparable circumstances) by a financial institution would not trigger a reporting obligation. Examples of such non-reportable fees include

- fees for the establishment and ongoing administration of a financial account, including where the fee is determined in relation to the amount of the investment;
- a fee offered to a client where the fee is discounted in relation to the number of financial accounts maintained by the financial institution for the particular client; and
- per-transaction charges for each security trade in the context of a year-end tax-loss selling program operated by a financial institution.

The comments on commercial fees came with a caveat:

> [A] reporting obligation would be expected to arise for the financial institution if other facts and circumstances demonstrate that the financial institution is otherwise considered an advisor in respect of the transaction or series, including where the financial institution can reasonably be expected to know that the financial account will be used in a transaction or series that is a reportable transaction to their client.

Fees Based on the Number of Taxpayers Participating

The explanatory notes did not address the question of fees determined in relation to the number of taxpayers participating in the transaction.

How Should Advisers Approach Fees Under the New Regime?

Unfortunately, the inconsistency between the broad language contained in the draft legislation and the Department of Finance's comments in the explanatory notes puts tax advisers in an awkward position. While the Department of Finance's comments will provide some comfort to advisers, it is worth noting that these comments are extrinsic evidence and are not in and of themselves law (although they may be persuasive in the context of tax litigation). Furthermore, in our view, the comments come with various caveats that undermine the comments' persuasive efficacy in the context of future litigation.

Finally, we note that, with respect to fees, any amount can be expressed as a multiple or fraction of any other amount. The Department of Finance's comments that value billing would not trigger a reporting obligation were contingent on the billing not being based on the value of the tax benefit resulting from the transaction. However, most if not all tax planning provides some kind of tax benefit, which may be large in dollar terms regardless of whether it would be regarded as abusive. We leave it to the reader to consider how easy it would be for the CRA to recharacterize a fee as being based in part on the tax benefit if, for example, the fee appears "large," or if hourly rates appear "high." As a practical matter, advisers are left with two options: (1) proactively disclose transactions out of an abundance of caution (despite the fact that the disclosure process can be costly and cumbersome) or (2) apply a pragmatic "smell test" approach and rely on the safe harbours provided in the explanatory notes discussed above. It is likely that the first case to interpret the meaning of these provisions will not be decided for years. In the meantime, uncertainty will be the order of the day as to when an adviser fee triggers a reporting obligation.

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GAAR Remix: Will It Affect Owner-Managers?

In August 2022, Finance released a consultation paper setting out its concerns with how the general anti-avoidance rule (GAAR) in section 245 of the ITA was being applied (or not applied) by the courts, and suggesting possible legislative solutions. This consultation paper, which was reviewed in detail by Brian Arnold (*Arnold Report* posting no. 240, September 13, 2022; no. 241, October 4, 2022; and no. 242, October 4, 2022), clarifies the concerns about GAAR that were motivating Finance. The 2023 federal budget confirmed that Finance intends to proceed with amendments to GAAR, and it included proposals that will amend section 245 so as to address some of the issues discussed in the consultation paper.

Definition of Avoidance Transaction

The current definition of "avoidance transaction" in subsection 245(3) provides that a transaction resulting in a tax benefit, or a transaction that is part of a series of transactions resulting in a tax benefit, is an avoidance transaction unless the transaction may reasonably be considered to have been undertaken primarily for bona fide purposes other than to obtain the tax benefit. The 2023 budget proposes to replace this definition, to the effect that a transaction will be an avoidance transaction if the transaction or the series of transactions of which it forms

a part would result in a tax benefit and it may reasonably be considered that one of the main purposes for undertaking the transaction or series of transactions was to obtain the tax benefit.

The objective of the "avoidance transaction" definition is to serve as a filter to ensure that transactions not motivated by tax are not subject to GAAR even if they produce incidental tax benefits. It is not clear that this definition is especially effective as a filter: as noted in the consultation paper, taxpayers routinely concede the existence of an avoidance transaction. Even when the existence of an avoidance transaction is not conceded, taxpayers fail 71 percent of the time to prove that no avoidance transaction exists. Taxpayers' routine concessions on this point reflect the fact that the existence of an avoidance transaction is usually obvious. Moreover, longstanding trends in legislative drafting often require taxpayers to undertake steps for no reason other than to avoid tax pitfalls. A further broadening of the already broad concept of an "avoidance transaction" is unlikely to have a material impact on most GAAR cases.

The courts, in cases such as *Groupe Honco* (2013 FCA 128), have taken a broad approach to "one of the main purposes" tests, and an objective test is imported by the "reasonably be considered" language. We expect that most transactions giving rise to a tax benefit significant enough to attract a GAAR assessment will have at least one main purpose of obtaining the tax benefit. This proposed amendment will likely achieve Finance's objective of ensuring that almost all potentially abusive transactions are considered avoidance transactions.

Preamble

Proposed subsection 245(0.1) would enact a preamble to GAAR that, while not expressly affecting the operation of the rule, will help courts interpret how GAAR should apply. The preamble contains three statements:

- GAAR applies to deny tax benefits from abusive avoidance transactions, while allowing taxpayers to obtain tax benefits contemplated by the relevant provisions. As noted by Brian Arnold (*Arnold Report* posting no. 256, April 19, 2023), it is not clear that this statement adds anything because it merely restates what GAAR is understood to do.
- GAAR is intended to strike a balance between taxpayers' need for certainty and the fairness of the tax system as a whole (that is, the distributional effects of tax avoidance). This is essentially the position taken by the attorney general for Ontario as an intervenor before the SCC in *Deans Knight* (2023 SCC 16). This portion of the proposed preamble is also consistent with the SCC's comments in *Deans Knight*, to the following effect: Parliament recognized that although GAAR would decrease certainty in tax planning, a rigorous GAAR analysis ensures reasonable certainty for all but a small subset of transactions.
- GAAR can apply regardless of whether a tax strategy is foreseen. This statement is intended to express Parliament's disapproval of the reasoning in cases such as *Alta Energy* (2021 SCC 49).

It is difficult to predict whether (or how) the courts will give real effect to the preamble in deciding cases after the amendments are enacted. Concerns about the fairness of the tax system could alter how strategies related to rate arbitrage, income reduction, or mass-marketed shelters are perceived.

Economic Substance

Proposed subsection 245(4.1) is intended to guide the courts by suggesting (without stipulating) that transactions that significantly lack economic substance are abusive. That subsection also contains a non-exhaustive list of factors that may indicate a lack of economic substance:

- The taxpayer does not have any substantial opportunity for gain or risk of loss because of the circular flow of funds, offsetting financial positions, or timing of steps.
- The expected value of the tax benefit is reasonably expected to exceed the expected non-tax economic return (other than the tax benefit and foreign tax savings).
- It is reasonable to conclude that the entire, or almost the entire, purpose of the transaction or series was to obtain the tax benefit.

It appears from the explanatory notes that Finance does not intend to create a rebuttable presumption that abusive tax avoidance exists where transactions significantly lack economic substance (hence the "tends to" language). It is thus left to the courts and the CRA to decide how they will give effect to this provision, although Finance seems to believe that it will act as a thumb on the scale in determining whether the tax benefit is consistent with the object, spirit, and purpose of the relevant provisions. The CRA will probably apply subsection 245(4.1) as a not-so-rebuttable presumption.

It is unlikely, for example, that a lack of economic substance could cause a reorganization to which paragraph 55(3)(a) or (b) applies to be considered abusive, even though the taxpayer and non-arm's-length persons would be in the same economic position, especially considering the new preamble. Taking into account economic substance could have a more material impact on, for example, foreign currency straddles and loss-trading arrangements.

Penalty, Limitations, and Coming into Force

Proposed subsection 245(5.1) would allow the assessment of a penalty equal to 25 percent of the tax benefit that is denied

under GAAR, while proposed subsection 245(5.2) clarifies that this penalty will not apply to tax attributes that have not been used. The rationale for a penalty is that taxpayers who undertake abusive transactions should be left worse off than if they had done nothing, thereby changing the risk-reward calculus; the proposed penalty will probably have the desired effect. It goes without saying that the penalty should be subject to a due diligence defence under common-law principles because the penalty is not drafted as an absolute liability offence.

Taxpayers will be able to avoid the penalty if they disclose their potentially abusive transactions either under subsection 237.3(2) or under the proposed voluntary disclosure provision in subsection 237.3(12.1). Interestingly, the disclosure of a notifiable transaction under proposed subsection 237.4(4) or the disclosure of a tax shelter under subsection 237.1(7) will not eliminate the potential penalty; the policy rationale for requiring duplicative disclosure in these circumstances is unclear. If taxpayers do not disclose under subsection 237.3(2) or proposed subsection 237.3(12.1), proposed subparagraph 152(4)(b)(viii) will extend the normal reassessment period for an additional three years in respect of the non-disclosed transaction.

The 2023 budget does not include coming-into-force provisions for the GAAR amendments. The explanatory notes state that application rules will be announced following a consultation period that concluded on May 31, 2023.

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Employee Ownership Trusts: Proposals from Budget 2023

In the July 2022 issue of *Tax for the Owner-Manager*, we discussed the announcement, in the 2022 budget, of the federal government's intention to introduce employee ownership trusts (EOTs). The 2023 budget introduced draft amendments to the ITA to create EOTs, effective as of January 1, 2024.

Summary

EOTs are a welcome development in Canada; their introduction reflects the fact that the US and UK experiences with them have been positive. As detailed below, the government's proposals set out the design features necessary for an EOT to be a viable structure, but the prescriptive rules and minimal incentives for vendors will be barriers to the adoption of EOTs. The federal government and Finance should be commended for bringing these proposals forward. That said, we hope that the draft rules are amended to address some of the concerns discussed below.

Conditions To Qualify as an EOT

The proposals define an EOT as an irrevocable trust that satisfies the following conditions:

- *Residence*. The trust must be resident in Canada (but not a subsection 94(3) deemed resident trust).
- *Permitted beneficiaries*. The trust must be exclusively for the benefit of individuals each of whom is an employee of one or more "qualifying businesses" (discussed below) controlled by the trust, other than employees that have not completed an applicable probationary period. In addition, the beneficiaries must not—other than through their interest in the EOT—hold more than a specified maximum interest in the qualifying business controlled by the trust, including in the time immediately before the qualifying business is transferred to the trust.
- *Interests of beneficiaries in the trust*. The interest of each beneficiary must be determined in the same manner—that is, it must be based solely on the beneficiary's pay, hours worked, and duration of employment. The trust must be prohibited from acting in the interests of one beneficiary (or group of beneficiaries) to the prejudice of another.
- *Restrictions on distributions of shares*. The trust must be prohibited from distributing shares of a qualifying business to any beneficiary.
- *Trustees*. Trustees must be elected by the beneficiaries for a period not exceeding five years. Each trustee must be either a licensed Canadian-resident trust company or a Canadian-resident individual, and each trustee must have an equal vote in the conduct and affairs of the trust. Individuals who, together with related or affiliated persons, held a significant interest in the qualifying business immediately before such business was transferred to the trust cannot, generally speaking, represent more than 40 percent of the trustees.
- *Trust property*. All or substantially all of the FMV of the property of the trust must be attributable to shares of qualifying businesses that the trust controls and by which all beneficiaries of the trust are employed ("the EOT asset test").
- *Qualifying business*. As mentioned above, the trust must be exclusively for the benefit of employees of "qualifying businesses." A qualifying business is a CCPC controlled by the trust, all or substantially all of the FMV of the assets of which is attributable to assets (other than an interest in a partnership) used principally in an active business carried on primarily in Canada by the particular corporation or a corporation

that the particular corporation controls (“the QB asset test”). In addition, the corporation must generally satisfy tests that prevent the former controlling vendor from controlling or not dealing at arm’s length with the corporation.

Taxation of EOTs

Generally speaking, EOTs, unless they meet specific criteria, are subject to the same tax rules as other personal trusts. The following are some of the tax-related advantages of EOTs:

- *Employee beneficiaries.* The employees do not have to pay for their interest in the EOT, and presumably it is the intention of these proposals that employees not have a taxable transaction either when they become a beneficiary or when they cease to be a beneficiary. Thus, EOTs provide an uncomplicated way for employees to obtain an interest in the EOT and thereby an indirect interest in the qualifying business.
- *Shareholder loans.* EOTs are able to repay a shareholder loan from the qualifying business over a 15-year period without including the loan in income under subsection 15(2), if the loan was made to purchase the qualifying business. This allows cash from the qualifying business to fund the purchase price paid to the vendor.
- *Capital gains and extended capital gains reserve.* If the vendor’s proceeds of dispositions are paid out over an extended period, a capital gains reserve of up to 10 years may be available for the vendor (as opposed to the regular capital gains reserve of up to 5 years).
- *21-year deemed disposition rule for trusts.* It is proposed that EOTs be exempted from the 21-year deemed disposition rule in subsection 104(4), which would allow an EOT to hold the shares of the qualifying business indefinitely without a deemed gain on the shares.

Our Thoughts

We welcome the introduction of EOTs, but we have a number of concerns with the proposed legislation:

- *Limited tax benefits.* Vendors will likely bear much of the risk and cost for structuring the sale of a qualifying business to an EOT, and thus they need more incentives to undertake those steps.

  The key tax benefit for a vendor is the 10-year capital gains reserve. Most vendors are unlikely to wait 10 years to be paid, which means that an extended reserve is of limited utility. In the United Kingdom, by contrast, the vendor of a business to an EOT, provided that certain requirements are met, can be completely exempt from capital gains tax on the sale, which is a meaningful incentive.

  The key tax benefit for the EOT itself is the ability to borrow from the qualifying business without triggering a subsection 15(2) shareholder loan benefit. Ultimately, however, that loan must be repaid, which would presumably be funded from dividends received from the qualifying business. The EOT, as an inter vivos trust, would be taxed at the top marginal rate on those dividends. This could significantly reduce the amounts that the EOT can distribute to its beneficiaries. Consideration should be given to eliminating the need to repay the loan (as would be the case if a holding company, instead of a trust, was used to purchase the qualifying business). Furthermore, no deemed interest benefit under subsection 80.4(2) should apply to the loan.
- *Restrictions on vendor control.* If vendors are being repaid by the EOT over a number of years, or if vendors want to gradually transition the qualifying business to the EOT, they should be permitted to retain—at least for a period of time—some elements of control over the qualifying business after a sale to an EOT. The restrictions on vendors being trustees or directors of the qualifying business after the sale to an EOT should be significantly relaxed.
- *The QB asset test.* The “all or substantially all” test in the QB asset test prevents EOT-owned businesses from expanding outside Canada, which will significantly reduce the number of Canadian businesses that might qualify for sale to an EOT. The required threshold should be reduced, perhaps, from “all or substantially all” to “primarily.” Further consideration should be given to whether the test should be met at all times or—in order to ease compliance—periodically.
- *Technical tax concerns.* The following are some other legislative refinements that would be helpful:
  - Ensure that employees do not have a taxable benefit or taxable event when they become or cease to be a beneficiary of the EOT.
  - Ensure that the EOT has no withholding and remittance obligation on distributions to the employees.
  - Include a carve-out from the application of subsection 84(2), if part of the purchase price is financed through the use of funds loaned by the qualifying business to the EOT. The possible recharacterization of proceeds of disposition as a taxable dividend would deter vendors from selling their business to an EOT.
  - Ensure that the “employee benefit plan” rules do not apply. Assuming that, historically, the qualifying business had paid dividends to the EOT (which could be viewed as a contribution for employee benefit plan purposes), the EOT should not be tainted as an employee benefit plan. For example,

if an EOT sold its qualifying business and was left with cash alone, it would not, at that time, meet the EOT asset test. It seems inappropriate for the trust to then be considered an employee benefit plan with a distribution of capital that is treated as an income distribution to the beneficiaries.
- Provide a method to "purify" corporations such that they become qualifying businesses that can be held by an EOT—for example, by allowing the removal of any passive investment assets that have accumulated in the corporation on a tax-deferred basis.

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Subsection 85(1) Election Form Changes

The CRA recently revised form T2057, "Election on Disposition of Property by a Taxpayer to a Taxable Canadian Corporation," which is the form used by a transferor and a transferee corporation to jointly elect to make a tax-deferred transfer of eligible property under subsection 85(1) of the Act. As a result of these changes, taxpayers who intend to make this election must now provide the CRA with additional information about such tax-deferred property transfers. This information must now include up front, as an attachment to the form, a calculation of the adjusted cost base (ACB) of all transferred properties.

The CRA does not provide details on the information that taxpayers are expected to provide for the ACB calculations, but this change in the requirements could be significant. Previously, taxpayers were required to attach the ACB calculation only for a transferred partnership interest and had to provide additional ACB information for other transferred assets only if requested.

Note that the CRA has similarly revised form T2058, "Election on Disposition of Property by a Partnership to a Taxable Canadian Corporation," and form T2059, "Election on Disposition of Property by a Taxpayer to a Canadian Partnership."

Some of the changes to form T2057 are as follows.

Identification

Taxpayers are now required to indicate whether the transferor or the transferor's spouse was self-employed for the year of the election (line 025) and to provide the name of the contact person's firm (line 024).

Information About the Transfer

Taxpayers must include additional details about the transfer. Specifically, taxpayers must now attach a schedule of the calculation of the ACB of all transferred properties according to the instructions in part 3 of the form. In addition, taxpayers will have to indicate whether the transferee owns more than 10 percent of the capital stock of a corporation after the transfer of shares of the corporation (line 206).

Under the changes to the form, taxpayers will now have to report additional information in schedule A about the property disposed of and the consideration received, including information (which must be provided separately) about share transfers and about the FMV of the non-share and share consideration received.

Valuation Requirements

Taxpayers must indicate whether there is a valuation report for the transferred assets (line 201). The revised form T2057 states that a valuation report is an independent assessment of the FMV of the transferred property.

The CRA previously published guidance on valuations in the context of the intergenerational business transfer amendments to section 84.1 in Bill C-208. This guidance outlines the CRA's criteria for determining whether a valuation is an independent assessment of FMV.

In this guidance, the CRA states that it will accept a valuation as an independent assessment of FMV only if it is completed by a valuator who

- is unrelated to the corporation or vendor and does not have any financial interest in the transactions, and
- has sufficient knowledge and experience in valuation and the related industry (which will vary depending on the size and complexity of the business).

The CRA states that the specific contents of the valuation report will depend on the nature of the corporation, its location, and its operations, but it notes that a valuation report typically includes

- calculations of value;
- analysis of the business, industry, location, and economy, so as to assess risk;
- explanations of the calculations and the methodology rationale;
- appraisals of farm equipment and livestock;
- appraisals of real property (if the corporation's value is based on assets);
- analysis of the rights and restrictions of the corporation's shares and other agreements (for example, shareholders' agreements); and
- a description of the assumptions underlying the analysis.

The CRA states that it will accept a report that meets the Canadian Institute of Chartered Business Valuators standards, but it does not require taxpayers to hire a chartered business valuator to complete the valuation.

Other Changes

The changes to the form now allow taxpayers to indicate that they are filing an amended election (line 010).

Note that taxpayers are no longer required to provide details related to valuation day; the CRA has removed these requirements. Furthermore, taxpayers no longer have to attach a copy of the authorizing agreement for an authorized person of the transferor, as was previously required.

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Related-Party Butterflies and Paragraph 55(5)(e)

The concept of a butterfly reorganization is fairly straightforward. It allows a corporation to transfer assets to another corporation on a tax-deferred basis. A butterfly is commonly used when an operating company desires to "purify" itself for the purposes of the capital gains exemption, by distributing its non-business assets to another corporation.

Provided that all of the parties involved in the reorganization are related, this type of butterfly can usually be executed pursuant to paragraph 55(3)(a). This provision allows all dividends paid in the course of the butterfly distribution to be exempt from the rules of subsection 55(2). Unfortunately, the ability to rely on paragraph 55(3)(a) requires that all conditions imposed by subparagraphs 55(3)(a)(i) to (v) be met. These provisions impose quite restrictive conditions on the butterfly.

This article will focus on the conditions imposed by subparagraphs 55(3)(a)(ii), (iii), and (v). These conditions are as follows:

- Subparagraph 55(3)(a)(ii) provides that a significant increase (other than as a consequence of a disposition at FMV) in the total direct interest in any corporation of one or more persons that were unrelated persons immediately before the particular time must not be part of a transaction or event (or a series of transactions or events) as a part of which the butterfly dividend was received.
- Subparagraph 55(3)(a)(iii) provides that a disposition to an unrelated person of shares of the dividend payer (or of property whose value is derived from the dividend payer) must not be part of a transaction or event (or a series of transactions or events) as a part of which the butterfly dividend was received.
- Subparagraph 55(3)(a)(v) provides that a significant increase in the total direct interest in the dividend payer of one or more persons that were unrelated persons immediately before the particular time must not be part of a transaction or event (or a series of transactions or events) as a part of which the butterfly dividend was received.

Paragraph 55(3.01)(a) defines "unrelated persons" to mean (1) persons (other than the dividend recipient) to whom the dividend recipient is not related or (2) partnerships any member of which (other than the dividend recipient) is not related to the dividend recipient.

Generally, in a related-party butterfly, the operating company (the distributing company) and the holding company (the transferee company) are owned by related shareholders; therefore, meeting the conditions imposed by subparagraphs 55(3)(a)(i) to (v) should be unproblematic.

However, let us consider a situation with the following fact pattern:

- The operating company (Opco) carries on an active business and does not own any "non-business" assets.
- 100 percent of the shares of Opco are owned by a holding company (Holdco).
- 100 percent of the voting common shares of Holdco are owned by a family trust.
- 100 percent of the non-voting preferred shares of Holdco are owned by Dad.
- The trustees of the trust are Dad, Dad's accountant, and Dad's lawyer. Neither Dad's accountant nor Dad's lawyer is related to Dad.
- The beneficiaries of the trust are Dad, Mom, and the two children of Dad and Mom.
- In addition to the shares of Opco, Holdco owns assets that are not used in an active business; thus, the shares of Holdco would not qualify as "qualified small business corporation shares," as defined in subsection 110.6(1).
- In order to qualify for the capital gains exemption, the shareholders desire to "butterfly" the shares of Opco from Holdco to a new company (Newco).

Because the trust owns 100 percent of the voting shares, the trust (and therefore the trustees, by virtue of subsection 104(1)) controls Holdco and Opco.

Because the trustees that control Holdco and Opco are not a related group, and Dad does not otherwise have any legal control over Holdco or Opco, Dad would not be related to Holdco or Opco.

The transferee company, Newco, is also controlled by the trust; therefore, Dad would not be related to Newco, either.

When the butterfly is executed, Dad would receive a significant increase in a direct interest in Newco. However, Dad would be an unrelated person as defined by paragraph 55(3.01)(a), because he is not related to either Opco or Newco. Because the conditions imposed by subparagraph 55(3)(a)(ii) require that an unrelated person not receive a significant increase in any corporation (other than as a transfer at FMV, which is not the case here) as part of the butterfly, this condition will not be met.

As another part of the butterfly, Dad will dispose of shares of Holdco to Newco. As noted above, Newco is an unrelated person in respect of Dad. Because the conditions imposed by subparagraph 55(3)(a)(iii) require that a person not dispose of property to an unrelated person as part of the butterfly, this condition will not be met.

Furthermore, as part of the butterfly, Dad will acquire an increase in shares of a dividend payer (Newco). In the course of the reorganization, Newco will be deemed to pay a dividend to Holdco. As noted above, Dad is an unrelated person in respect of Holdco. Because the conditions imposed by subparagraph 55(3)(a)(v) require that an unrelated person not receive a significant increase in a butterfly dividend payer, this condition will not be met.

Because none of the conditions imposed by subparagraphs 55(3)(a)(ii), (iii), and (v) have been met, the butterfly will be offside. It should be noted that even if only one condition is violated, the butterfly will be offside.

Fortunately, there is a remedy for this situation. Subparagraph 55(5)(e)(ii) deems certain persons to be related for the purposes of section 55. This deeming rule holds that when a person is related to each beneficiary under a trust, that person is deemed to be related to the trust. It is interesting to note that subparagraph 55(5)(e)(ii) specifically holds that, for the purposes of applying this provision, a person is deemed to be related to himself.

In this particular case, the beneficiaries of the trust are Dad, Mom, and the two children. Dad is related to Mom and their two children under paragraph 251(2)(a). Although Dad is not related to himself under section 251 (a topic that we addressed in the October 2021 issue of this newsletter), he is deemed to be related to himself for the purposes of applying subparagraph 55(5)(e)(ii). Thus, Dad is related to each beneficiary of the trust. As a result, Dad is deemed by this subparagraph to be related to the trust for the purposes of section 55. Because the trust is a person (under subsection 104(2)) who controls both Opco and Holdco, the trust and Opco are related under subparagraph 251(2)(b)(i)—an interpretation confirmed by the CRA in *Income Tax Folio* S1-F5-C1, at paragraph 1.46. The trust and Holdco would also be related, on the basis of the analysis above. Furthermore, because Dad is related to the trust on the basis of subparagraph 55(5)(e)(ii), Dad is related to both Opco and Holdco under subparagraph 251(2)(b)(iii). Therefore, the conditions in subparagraphs 55(3)(a)(ii), (iv), and (v) would be met, and the butterfly could be executed successfully.

It is also worth noting that if the ownership of the common shares and preferred shares were reversed, such that Dad owned the voting common shares and the trust owned the non-voting preferred shares, a similar issue would arise: the trust would not be related to any of the companies in the group, but for the deeming rule in subparagraph 55(5)(e)(ii).

This situation highlights how the examination of every detail, along with an analysis of subparagraphs 55(3)(a)(i) to (v), is critical to the implementation of a successful paragraph 55(3)(a) butterfly: in most cases, an estate freeze and the implementation of a family trust would not introduce non-related persons into a structure, but this time it did. Failure to examine the details would have resulted in a nasty surprise for the taxpayer.

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TCC Case Highlights the CRA's Obsolete Position on Corporate Life Insurance

The TCC case of *Gestion M.-A. Roy Inc. c. Le Roi* (2022 CCI 144; heard with *4452712 Canada Inc. v. The King*) applied subsections 15(1) and 246(1) in two situations where the owner of a life insurance policy and the policy beneficiary were different corporations. The court's application of subsection 246(1) raises questions about the CRA's use of this provision to crack down on the once common life insurance ownership structure whereby a parent company is the policy owner and the subsidiary is the policy beneficiary.

In *Gestion*, Mr. Roy was a majority shareholder of Gestion M.-A. Roy inc. ("Gestion Roy") and the sole shareholder of 4452712 Canada inc. ("Canada 445"). Gestion Roy and 445 Canada were holding companies. Gestion Roy was a controlling shareholder of an operating company named R3D Conseil Inc. ("R3D").

R3D had insured buyout arrangements in place through a shareholders' agreement whereby the company would use life insurance proceeds to redeem those of its shares that were owned by either a deceased shareholder or R3D's holding company. Pursuant to this arrangement, Gestion Roy owned two life insurance policies on Mr. Roy's life, and Canada 445 owned four policies on his life. The policies had significant cash value, and R3D was the revocable beneficiary of each. R3D also paid the annual premiums for each of the six policies, which gave rise to the CRA's problem with the arrangement.

Gestion Roy had four taxation years reassessed under subsection 15(1), which resulted in $266,346 of additional income. Canada 445 had the same taxation years reassessed under subsection 246(1), which resulted in $279,763 of additional income for the company in each year. The assessments were based on the amounts of the insurance premiums paid by R3D.

Gestion Roy and Canada 445 appealed their assessments to the TCC. The issue before the court was whether R3D's payments of the life insurance premiums constituted a subsection 15(1) benefit for Gestion Roy and a subsection 246(1) benefit for Canada 445.

The taxpayers argued that R3D was the real owner of the policies and that it was the only entity benefiting from the policies as beneficiary. To support their argument, the taxpayers highlighted how R3D had received the cash proceeds through a partial withdrawal from a policy owned by Gestion Roy in 2017, and had received all of the cash value when the policies, with one exception, were fully surrendered in 2019.

The TCC rejected this argument, finding that Gestion Roy and Canada 445 had full rights to the insurance contracts as policy owners. In finding that R3D's premium payments gave rise to a corresponding subsection 15(1) benefit to Gestion Roy and a subsection 246(1) benefit to Canada 445, the court stated: "Practically and realistically, the appellants got rich, since they did not have to pay the premiums in question, while . . . R3D got poorer, hoping to receive the benefit and the investment accounts in the event of death" (our translation) (at paragraph 93).

The TCC's decision was fundamentally correct. The premiums were Gestion Roy's and Canada 445's liabilities, which were paid by R3D. The policies' cash values made the economic benefit of the arrangement to the appellants more obvious, but the result would likely have been the same if the policies provided term coverage having no cash value. The issue with the TCC's decision is that the court, in applying both subsections 15(1) and 246(1), assigned no value to R3D being the beneficiary of the life insurance policies. If the court had assigned value in this regard, the amount of the taxable benefits assessed to Gestion Roy and Canada 445 would have been reduced.

In the context of subsection 15(1), the assigning of no value to being a policy beneficiary is arguably at odds with prior TCC cases, in which premiums paid by a corporate policy owner resulted in a shareholder benefit of a corresponding amount when the shareholder, or a non-arm's-length individual, was the beneficiary of the policy (see *Harding v. The Queen*, 2022 TCC 3). This is likewise the CRA's approach to subsection 15(1); a shareholder benefit equal to the premium amount is assessed when a shareholder is the beneficiary of a corporate-owned policy (see CRA document no. 2004-0081901I7, June 29, 2004).

In the context of subsection 246(1), the assignment of no value to being a policy beneficiary is arguably at odds with the CRA's application of this provision in a situation where a parent company is the policy owner and premium payer and a subsidiary is the policy beneficiary. The CRA has stated that in this situation, it would consider the premium payments made by the parent company as having given rise to a corresponding subsection 246(1) benefit to the subsidiary (see CRA document no. 2010-0359421C6, May 4, 2010). This means that if R3D, instead of paying the insurance premiums itself, had paid a tax-free intercorporate dividend to Gestion Roy so that it could pay the insurance premium, the CRA would have assessed a subsection 246(1) benefit to R3D. It is currently a no-win situation if a corporate policy owner needs to designate a subsidiary as beneficiary—but it need not be, as we discuss below. The CRA has also stated that if the subsidiary reimburses the parent company for the premium, the latter may have subsection 9(1) income or realize a taxable reimbursement under paragraph 12(1)(x).

The CRA, in applying both subsections 15(1) and 246(1), considers the full amount of the premium to be a taxable benefit to the beneficiary. Evidently, being the beneficiary of a life insurance policy is quite a valuable benefit, but the court in *Gestion* found otherwise: 100 percent of R3D's premium payments resulted in taxable benefits for the policy owners, with no reduction to account for R3D's status as beneficiary.

Gestion highlights the unenviable position we are in regarding the taxation of corporate-owned life insurance. The trick to fitting into the box created for us by the CRA is to have the corporate policy owner be the beneficiary of the policy, too. This arrangement works well in most cases, particularly when the insurance coverage is for the life insured's personal estate planning. This arrangement does not work so well in other cases, particularly for insured buyouts that use a permanent life insurance policy. There are two reasons for this. First, permanent coverage is best owned in a holding company, for creditor protection purposes. Second, transferring a policy before a sale could result in a taxable policy gain, and therefore owning it in a holding company at the outset is preferable (a corporation cannot transfer a policy on a tax-deferred basis). This explains why policy ownership structures such as those seen in *Gestion* were set up and continue to exist.

The CRA needs to reconsider its position on the application of subsection 246(1) to situations where a parent company is the policy owner and a non-arm's-length subsidiary is the policy beneficiary. This position arose from the CRA's desire to crack down on a planning technique that was used to maximize a corporation's capital dividend account (CDA) credit from receiving a death benefit. Before amendments to the definition of CDA were introduced in the 2016 federal budget, a corporation's CDA credit from receiving a death benefit was reduced by the policy's ACB with respect to the corporation receiving the death benefit. Thus, if a subsidiary corporation is the beneficiary but the parent company is the policy owner, the subsidiary would not have an ACB in the policy, and the full death benefit would credit its CDA. To prevent this type of mischief, the CRA invoked subsection 246(1) to apply to the subsidiary, as noted.

The 2016 federal budget addressed this planning with an amendment to the definition of CDA, applicable to deaths occurring after March 21, 2016. In such cases, the death benefit recipient's CDA credit will be reduced by the ACB of the policy owner. That is to say, the CDA is reduced even if the corporation

receiving the death benefit is not the policy owner. As a result, the CRA no longer needs to maintain its position on subsection 246(1); a retraction of this position would enable business owners to allocate a death benefit throughout their corporate group as needed. As recently as last year, at the APFF conference, the CRA had a chance to retract this position, but unfortunately it declined to do so (CRA document no. 2022-0936281C6, October 7, 2022).

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Investissement Boeckh inc. c. Agence du revenu du Québec

Overview

In *Investissement Boeckh inc. c. Agence du revenu du Québec* (2023 QCCA 633), the Quebec Court of Appeal affirmed a broad meaning of the term "a trader or dealer in securities" in the French equivalent of paragraph 39(5)(a) of the ITA. In doing so, the QCCA followed the interpretation that is applied federally. The FCA had held, in *Vancouver Art Metal Works Ltd. v. Canada (CA)* ([1993] 2 FC 179), that under the ITA, "a trader or dealer in securities" includes any "person who is in the business of buying and selling securities as principal, through an agent or otherwise." The QCCA rejected the taxpayer's contention—which was based in part on the differences between the French versions of the provisions—that paragraph a of section 250.3 of the Taxation Act (Quebec) (QTA) had a narrower meaning than the corresponding rule in paragraph 39(5)(a) of the ITA; the court relied on the principle that the QTA should be interpreted harmoniously with the ITA, and it affirmed the longstanding interpretation that has been applied federally.

Election Concerning Disposition of Canadian Securities

Section 250.1 of the QTA mirrors subsection 39(4) of the ITA. Under these rules, a taxpayer may file an election such that every Canadian security owned by that taxpayer is deemed to be capital property and every disposition of that Canadian security by the taxpayer is deemed to be a disposition of capital property. Section 250.3 of the QTA and subsection 39(5) of the ITA, however, provide that certain taxpayers—including a trader or dealer in securities—are ineligible to make this election.

The taxpayer's argument for a narrower interpretation of the "trader or dealer in securities" exception under the QTA was largely founded on the use of different terms in the French versions of the ITA and the QTA, whereas the English wordings do not vary between the statutes:

	Paragraph a of section 250.3 QTA	*Paragraph 39(5)(a) ITA*
French	a) un négociant ou courtier en valeurs	a) un commerçant ou un courtier en valeurs mobilières;
English	(a) a trader or dealer in securities	(a) a trader or dealer in securities

Relevant Facts

Investissement Boeckh inc. ("Boeckh") held and managed a portfolio of shares in companies with strong growth potential. Boeckh's strategy involved purchasing undervalued companies in the resource and tech sectors and reselling them when market conditions were favourable. As part of its strategy, Boeckh had significant turnover in its stock portfolio, which resulted in many hundreds of stock market transactions in any given year. Typically, only 30 to 45 percent of the shares in its portfolio were held for more than two years. Furthermore, the president and founder of Boeckh was educated in finance and had significant knowledge and experience in the field of securities.

In its income tax returns for the 2007-2015 taxation years, Boeckh elected under section 250.1 of the QTA to treat the disposition of certain securities as a disposition of capital property.

Revenu Québec reassessed Boeckh for the relevant taxation years on the basis that the exclusion for a "trader or dealer in securities" applied to Boeckh and thus rendered the election ineffective.

Court of Quebec

The Court of Quebec dismissed Boeckh's appeal of the assessments. The court found that the words "négociant" in the QTA and "commerçant" in the ITA have the same common meaning. The judge therefore concluded that paragraph a of section 250.3 of the QTA is equivalent to the federal legislation and applied *Vancouver Art Metal Works* to conclude that Boeckh was indeed a "trader or dealer in securities." In reaching this conclusion, the court looked at, inter alia, the nature of the investments held, the frequency of trading, the length of time that the securities were held, and the taxpayer's special knowledge.

QCCA

On appeal, the QCCA upheld the trial judge's ruling. The main issue on appeal was whether the lower court had erred in its interpretation of the term "trader or dealer in securities" in the QTA.

Boeckh began by arguing that, because the French versions of the term "trader or dealer in securities" differ between the QTA and the ITA, the provisions should be interpreted

differently. The court rejected this argument outright. While the QTA and the ITA are distinct statutes, according to the court, there is significant intentional harmony between the two—particularly when it comes to basic principles for the calculation of income and the distinction between income and capital, where the QTA has often been amended to specifically match amendments to the ITA. Furthermore, given that the French and English versions of the tax legislation have the same legal value, the court found that the subtle difference was merely "stylistic" and that it would be "absurd" to use this as justification for interpreting the exceptions differently.

Boeckh next argued that the federal court's interpretation of subsection 39(5) of the ITA should not be followed because it is too strict and literal, and it excludes virtually all taxpayers from eligibility for the subsection 39(4) election. The taxpayer took the position that the exclusion in paragraph a of section 250.3 of the QTA should be read purposively and be limited to brokers, or to dealers in securities who earn remuneration in the form of commissions.

The court rejected this position, finding, in particular, that the FCA in *Vancouver Art Metal Works* had undertaken a purposive analysis of subsections 39(4) and (5) of the ITA and had concluded that Parliament in fact intended to deny the subsection 39(4) election to taxpayers whose dealings amount to carrying on a business and cannot be merely characterized as investor's transactions or adventures or concerns in the nature of trade. Against the taxpayer's argument that this denial unduly narrows access to the election, the court pointed out that taxpayers who engage in transactions of a commercial nature in securities, without otherwise being securities traders, could still make use of the deeming rule.

The court held, furthermore, that although *Vancouver Art Metal Works* is not binding in its interpretation of the QTA, it should not be disregarded: that would lead to a divergence between the application of equivalent provisions of the ITA and the QTA, which would be contrary to the provincial legislator's intention that there be harmony in this regard. The court added that in situations where federal and provincial provisions have substantially the same form, there is a presumption of coherence between the two; and that the taxpayer, in this case, did not succeed in rebutting that presumption.

Finally, the court affirmed the trial judge's conclusion that Boeckh was a trader in securities and thus excluded from the QTA's section 250.1 election. The frequency of the transactions undertaken by Boeckh and the short duration of its ownership of the securities were indications that a business was being operated. Furthermore, the nature of the securities—shares of companies in growth sectors—indicated that Boeckh sought to generate quick profits by correctly timing the market. The special knowledge possessed by the main actors at Boeckh regarding the securities market provided additional support for characterizing the company's conduct as carrying on a business.

Conclusion

Investissement Boeckh reinforces in Quebec the federal case law on subsection 39(4) of the ITA, confirming that in order to benefit from the election concerning the disposition of Canadian securities, a taxpayer must be able to show that it was not carrying on the business of trading in securities.

In reaching this conclusion, the QCCA provided additional support for the principle that tax laws in Quebec should be interpreted and applied consistently with federal laws when the respective provisions have substantially the same form, and that where the federal provision has already been interpreted by federal courts, Quebec courts should generally follow that interpretation. This principle may be invoked by Quebec taxpayers in other contexts, when they face different tax treatments for the same transaction under the ITA and QTA.

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Nursing Services in the Spotlight: Characterization of Supplies in A-Supreme Nursing

The characterization of supplies remains one of the most difficult aspects of proper GST/HST compliance in the health-care sector. As we have seen with recent cases such as *Axelrod v. The King* (2022 TCC 157) (a case that we wrote about here), this difficulty is a live issue in the dental and orthodontic context, but it also comes up in the complicated world of nursing and nursing-related staffing agencies. Like dentists, nurses have complex rules governing whether the underlying supplies of their services ("nursing services") are truly exempt health-care services under part II of schedule V ("the health-care schedule") of the ETA.

The TCC's recent decision in *A-Supreme Nursing & Home Care Services Inc. v. The King* (2023 TCC 39) highlights the complexities in this area, demonstrating how difficult it is to apply the health-care schedule to the unique circumstances of each case.

Legislative Background

The legislative provision at issue was section 6 of the health-care schedule, which provides that a nursing service is an exempt supply if the supply is

> [a] supply of a *nursing service rendered to an individual by* a registered nurse, a registered nursing assistant, a licensed or registered practical nurse or a registered psychiatric nurse,

> if the service is rendered within a nurse-patient relationship. [Emphasis added.]

If the services supplied meet this definition, they are exempt from GST/HST. If not, they are taxable unless otherwise exempted elsewhere in the ETA.

Practitioners will note that the word "rendered" occurs in this provision (as it occurs throughout the health-care schedule). This is very important from a GST/HST perspective: it allows the nursing service to be physically performed on an individual even though the legal liability to pay for the supply may rest with another person (who is otherwise considered to be the "recipient" of the supply for GST/HST purposes per the definition of "recipient" under subsection 123(1) of the ETA).

Facts

A-Supreme Nursing & Home Care Services Inc. ("the appellant") was a staffing agency placing registered nurses (RNs) and registered practical nurses (RPNs) in long-term care facilities and nursing homes ("LTC clients"). The appellant had another business line that supplied RNs and RPNs in private settings, providing one-on-one, private home care to individuals ("PC clients"). The appellant structured its contracts in such a way that (not unlike a staffing agency) it supplied RNs and RPNs on an as-needed basis to various LTC clients. Both the LTC clients and the PC clients would pay the appellant directly, and the appellant would in turn pay the RNs and RPNs. The appellant was responsible for maintaining liability insurance for all of its RNs and RPNs.

The appellant did not charge GST/HST on the supplies to either the LTC clients or the PC clients, believing that, in both instances, it was supplying exempt "nursing services" under section 6 of the health-care schedule.

The CRA assessed the appellant on the basis that the supplies made to the LTC clients were taxable and presumably took the view that, in this sort of "employment agency" arrangement, section 6 did not provide an exemption. At issue was just over $1 million in uncollected tax. The appellant objected and ultimately appealed to the TCC.

The TCC's Decision

On appeal, the TCC first reviewed the explanatory notes and existing jurisprudence to determine the meaning of the words "nursing service," finding that nursing services "in general" are to be treated as exempt, regardless of the venue of the treatment.

The court then turned to consider the pre-existing jurisprudence in *Hôpital Santa-Cabrini v. The Queen* (2015 TCC 264; aff'd 2016 FCA 207). *Santa-Cabrini* had held that the supply of nurses by a staffing agency to a hospital was a taxable supply of "nursing personnel" rather than an exempt supply of nursing services.

According to the TCC, the key factor in the reasoning in *Santa-Cabrini* was that the agencies were simply "leasing" the right to manage and control personnel—rather than themselves supplying nursing services. The taxpayer in *Santa-Cabrini* had appealed the TCC's decision to the FCA, which, in denying the appeal, had emphasized that the hospital had fundamental management and control over the nurses and that provincial legislation prevented the hospital from "delegating" responsibility for health care to outside workers. This meant that the hospital, not the staffing agency, was the entity providing the nursing services.

The TCC reasoned that the FCA's decision should *not* be read as requiring a supplier of exempt nursing services to have "general responsibility" for the health care; the issue, according to the court, was the degree to which the nurses had control over their own work. Relatively tight control, on the hospital's part, over how agency nurses operated (as was the case in *Santa-Cabrini*) would support the view that the *hospital* provides the nursing services, rather than the view that the agency supplies the nurses to the hospital.

The TCC proceeded to distinguish *Santa-Cabrini* from the case at bar despite noting the "analogous factual circumstances" between the two. One of the bigger differences noted by the court lay in the differing degrees of control exercised over nurses in hospitals as compared with nurses in the LTC and nursing-home environments specific to the appellant's LTC business. The court found that the appellant's nurses were often responsible for the facilities of an entire LTC or nursing home, and it was particularly compelled by the testimony from the appellant's witness that agency nurses were "in charge" at the homes, whereas that would apparently "never happen" in hospitals.

The TCC noted other differences, too: (1) the appellant was responsible for maintaining general liability insurance for the nurses as well as for training and "re-educating" a nurse who failed to meet client standards—a responsibility that did not apply in hospital environments; and (2) Ontario's LTC legislation allows homes to meet their care obligations by acquiring nurses through an agency (allowing "delegation" of responsibility, to some extent).

Ultimately, the TCC found that the appellant supplied nursing services rather than nursing personnel, allowing the appeal.

Commentary

A-Supreme Nursing is a welcome reversal to the CRA's continued audits in this area (going back as far as 2014). Our initial view of these cases was that the CRA (and the TCC and the FCA) had the wrong end of the stick in *Santa-Cabrini*. Indeed, the SCC tells us that one must consider the "text, context and purpose" when conducting statutory interpretation (see *Canada (Minister of Citizenship and Immigration) v.*

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Vavilov (2019 SCC 65, at paragraphs 117-18). The words of a statute are even more important in tax cases, given the "[great] degree of precision" required to construe tax provisions (see *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*, 2006 SCC 20, at paragraphs 21-24).

The restrictions on the scope of section 6 of the health-care schedule are limited, and none of them require the nurses to act on their own or to receive payment from the individual patients directly. Nor do these restrictions preclude someone else (for example, a hospital, an LTC facility, the child of a PC client, or even a staffing agency like the appellant's) from paying the RNs or the RPNs for the services rendered to the individual patients. Therefore, in our view, the TCC's decision in *A-Supreme Nursing* is a well-reasoned result.

Also noteworthy is the degree to which the TCC parsed the decision of the FCA (a decision that might have been considered to be binding on this case). The TCC seemed extremely careful on this issue, to the great benefit of the appellant. Had the court not made the distinction between "general responsibility" for the health care and the degree to which nurses have control over their own work, *Santa-Cabrini* could easily have been accepted as a precedent that effectively shut the door on agencies as suppliers of *exempt* nursing services (given that agencies would rarely have that requisite "general responsibility" over the health care provided).

The bottom line is that these cases again show the importance of characterizing a supply (for GST/HST purposes) in the context of its unique facts, before trying to fit it into the exempt or zero-rating provisions under schedules V and VI of the ETA.

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