TAX FOR THE Owner-Manager

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When Does the Operation of a Rental Property Become a Business?

In *McInnes v. The Queen* (2014 TCC 247, informal procedure), the issue in dispute was whether certain income from a cottage was business income or rental property income, and consequently whether losses incurred from earning such income were subject to the restriction in the Income Tax Regulations that prevents capital cost allowance (CCA) on a rental property from creating or increasing a rental loss.

On May 14, 2004, the appellant purchased a cottage in Quebec that she intended to operate as a tourist accommodation business. Among other things, the appellant registered the property with the local regional tourist association; created a website for the property; and offered a number of services, including cable-connected televisions, DVD and CD players, wi-fi service, long-distance telephone service, heating, electricity, a fully furnished kitchen, laundry facilities, all bedding, and bath amenities. Housekeeping services were made available to customers on request; however, such services usually were not requested. The appellant did not provide any meal preparation services because the property was not a bed and breakfast. The appellant was responsible for property maintenance, including landscaping and snow removal. She employed one person who prepared the cottage for occupancy, welcomed the guests when they arrived, and ensured that the cottage was secure when the guests departed.

The cottage was rented out for short stays, but the main tenant was the Domaine Forget, an international classical music academy. The Domaine had rented the property from mid-June to the end of August for the previous nine years, but it did not use most of the services available from the appellant.

Unfortunately, the appellant never made a profit and ran significant recurrent losses from year to year. When filing her income tax returns, she reported business losses in respect of her 2008 to 2010 taxation years. The minister reassessed those years, disallowing CCA on the basis that there was no net rental income from the property.

Subsection 20(1) of the Act provides a deduction for CCA. However, regulation 1100(11) limits the CCA claim so that a loss cannot be created in respect of the renting of a rental property.

Under regulation 1100(14), "rental property" is defined to mean "a building owned by the taxpayer . . . if, in the [relevant] taxation year . . . , the property was used by the taxpayer . . . for the purpose of gaining or producing gross revenue that is rent." Under regulation 1100(14.1), for the purposes of regulation 1100(14), "gross revenue derived in a taxation year from . . . the right of a person or partnership, other than the owner of a property, to use or occupy the property or a part thereof, and . . . services offered to a person or partnership that are ancillary to the use or occupation by the person or partnership of the property or the part thereof shall be considered to be rent derived in that year from the property."

Regulation 1100(14.2) further provides that regulation 1100(14.1) does not apply in any particular taxation year to "property owned by . . . an individual, where the property is used in a business carried on in the year by the individual in which he is personally active on a continuous basis throughout that portion of the year during which the business is ordinarily carried on."

These definitions interact in a complex way. Simply put, however, the regulations restrict losses derived from a "rental property," which is defined to mean a "property [that] was used principally for the purpose of gaining or producing gross revenue that is rent," and the definition of "rent" is modified so as to not be deemed to include gross revenue from a property owned by a taxpayer "used in a business carried on in the year by the individual in which he is personally active."

In order to determine whether the restriction relating to rental losses was applicable, the TCC had to determine whether the income in question was income from a business. It conducted a detailed review of the relevant case law going back to 1965 and scholarly writings on the topic. The cases included *Wertman v. MNR* (64 DTC 5158 (Ex. Ct.)); *Canadian Marconi v. R* (1986 CanLII 42 (SCC)); *Jong v. The Queen* (1998 CanLII 294 (TCC)); *Orcheson v. The Queen* (2004 TCC 427); and *Venditti v. The Queen* (2008 TCC 553).

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Masse J noted the comment of Margeson J in *Jong*:

> [A] *prima facie* case is made out that the amount received from the property was from rental and not from a business unless the Appellant can show that the range of services provided by the landlord was such that the payment received can be regarded as substantial payment for the services.

Of particular relevance were the cases of *Orcheson* and *Venditti*, which the court considered very similar to the case at bar. *Orcheson* dealt with the rental of three cottages in Ontario. The tenants of the cottages were provided with a small number of amenities (firewood, a boat, a canoe, fresh linen, and certain other amenities) and with certain services, including snow removal, a cleaned yard, and boat launching and docking. *Venditti* dealt with the rental of a Florida condo. The owner provided certain amenities including toiletries, furnishings, linen, and a heated pool. In both *Venditti* and *Orcheson*, the TCC found that the income in question was income in the nature of rent.

In Masse J's view, the question was essentially one of classification. He stated that the "higher the level of services supplied by the taxpayer, the likelier it is that the taxpayer operates a business; the lower the level of services, the likelier it is that the income is from the use of a property." However, he noted that, in general, individuals who own buildings have been found by the courts to be earning income from property. He acknowledged that there is no bright-line test, and he concluded that the question is one of degree. Unless the appellant was able to show that the range of services that she provided was such that the payment she received could be considered to be paid largely in respect of those services, the court would have to conclude that the income in question was income from a property.

The court reviewed the services provided by the appellant and noted that she did not provide personal hygiene products or a restaurant or bar service; that the tenants rarely used the housekeeping services; and that the main tenant, the Domaine, did not want many of the additional services that were offered. On the basis of the foregoing, the court concluded that it had not been established that a substantial part of the rent received by the appellant constituted payment for services rendered by her; consequently, the income in question was income from a property. The court further concluded that the property was used by the appellant for the purpose of gaining or producing gross revenue—that is, rent. The court therefore dismissed the appeal.

McInnes, which was decided under the informal procedure rules and has no precedential value, does not break new ground. Nevertheless, it provides a good review of the law on the issue and serves as a helpful reminder of the factors that influence when income from a rental property ceases to be regarded as rent and is instead viewed as income from services.

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Crystallization Planning: Less May Be More

The lifetime capital gains exemption on the sale of qualified small business corporation shares is now $800,000 (indexed annually). Conventional wisdom dictates that it is often good planning to crystallize the exemption for the future. Provided that the shares and the taxpayer meet all the necessary requirements, a crystallization typically involves a share exchange or transfer to a holding company; the provisions of subsection 85(1) are used to elect proceeds such that the desired gain is triggered. It is usually recommended that the maximum available amount be crystallized, subject to the application of, and the taxpayer's tolerance for, alternative minimum tax. However, a crystallization of the maximum amount may not ultimately yield the optimal result in the context of an estate plan. Consider the following examples.

On a deemed disposition on the death of a taxpayer, any crystallized shares will be sheltered from capital gains tax. However, assume that the taxpayer dies owning crystallized shares with a nominal PUC and no other assets with accrued capital gains. At the time of death, the taxpayer has long been retired, and the business has been wound down to the point where the corporation is now an investment holding company. Assume that the value of the company, both at the time of the crystallization and at the time of the taxpayer's death, was no greater than $800,000, the amount crystallized.

At this point, although the deceased pays no tax on the crystallized shares at death, the estate will pay tax on the subsequent redemption of the shares at dividend rates (say, 40 percent). A full redemption will cost the estate $320,000. (Note that a post mortem pipeline reorganization is precluded by the rule in subparagraph 84.1(2)(a.1)(ii), which disqualifies crystallized shares from such a plan.) In addition, a capital loss of $800,000 will be triggered; however, with no other capital gains in the estate, this loss is essentially useless. In this situation, the best advice is to keep the holding company in place and to extract funds gradually, over time, as they are needed. The crystallization of the capital gains exemption in this situation has thus provided only a tax deferral. Furthermore, the taxes to be paid upon the share redemption will be imposed at the higher dividend rates.

Alternatively, consider the result if no crystallization had taken place. The deceased would have a capital gain on death and pay tax at capital gains rates (say, 25 percent). Assuming that a successful pipeline plan is put in place to limit the tax to this deemed capital gain, the total tax bill would be reduced to $200,000.

Now consider a third example—the crystallization of only one-half of the value of the shares. In this situation, the ACB of the partially crystallized shares is $400,000. Upon death, a capital gain of $400,000 is triggered. Subsequently, a hybrid post mortem plan is put in place whereby the shares are transferred

to a new holding company. A promissory note is issued for the amount representing the $400,000 hard ACB. Preferred shares with low PUC and high ACB are issued, representing the value of the crystallized shares. The preferred shares are redeemed within the estate's first taxation year, and an election is made under subsection 164(6) to carry back the resulting $400,000 capital loss to eliminate the capital gain on death. The end result is that the capital gains exemption has provided an absolute tax saving, and the total tax bill has been reduced to $160,000—that is, the dividend tax on the redemption of the preferred shares (40% × $400,000).

Of course, is it difficult to predict what might happen to the value of a company years down the road when the death of the shareholder occurs; but it is interesting to note that in cases where values are expected to remain modest, a crystallization of the full amount of the available capital gains exemption may not always turn out to be the best alternative in the context of an estate plan.

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The Danger of Relying on a CRA Auditor's Advice

When faced with notices of assessment from the CRA that run contrary to a particular tax practice, taxpayers often defend their practice on the basis that the CRA had not previously taken issue with it. Clients will say, "The CRA didn't object to our tax compliance procedures in the past, so they shouldn't be able to object now!" Unfortunately, this argument will not be successful in the TCC, as was illustrated in *Academy of Applied Pharmaceutical Sciences* (2014 TCC 171). The decision shows that there is really no substitute for proper professional advice when one is determining GST/HST compliance.

The academy operated a postgraduate training college that offered two programs: (1) a diploma program in pharmaceutical science and (2) a workshop program that provided continuing pharmaceutical education. The workshop program was subject to GST/HST, but the diploma program was GST/HST-exempt. Pursuant to ETA section 169, the academy was entitled to ITCs in respect of GST/HST paid on expenses related to its taxable supplies (that is, the workshop program), but it could not claim ITCs for GST/HST paid on expenses related to its exempt supplies (that is, the diploma program). For expenses that related to both programs ("mixed expenses"), the academy was required to apply a "fair and reasonable" methodology for allocating such expenses to taxable and exempt supplies for the purpose of claiming ITCs (ETA subsection 141.01(5)).

The CRA conducted an audit of the academy in 2008, and the CRA auditor advised the academy that a reasonable allocation ratio of the mixed expenses was 50 percent to taxable supplies and 50 percent to exempt supplies for the period being audited. According to the academy's founder and director, the auditor also advised that from then on the academy should use the same 50-50 allocation ratio, which it did.

Another CRA audit was conducted in 2012, in which the academy was reassessed on the basis of an allocation ratio attributing only 14 percent of the mixed expenses to taxable supplies, thereby reducing the academy's ITCs (and in turn increasing its net tax payable). The academy appealed the assessment to the TCC.

It is unclear why the academy did not argue at the TCC that its 50 percent allocation method was "fair and reasonable," as is required by ETA subsection 141.01(5). Rather, it argued that it would be unfair and inequitable for the minister to be able to assess the academy by applying a different ITC allocation ratio (14 percent) after having previously advised it to use a 50-50 ratio. The TCC noted that the academy was essentially "invoking the doctrines of estoppel and officially induced error."

For the purposes of the decision, the TCC accepted the academy's evidence that the CRA auditor had advised it to use a 50-50 allocation ratio for its mixed expenses "on a go-forward basis." Nevertheless, the TCC rejected the academy's arguments and dismissed the appeal.

The TCC ruled that neither the equitable doctrine of estoppel nor the doctrine of officially induced error is available as a remedy in tax appeals. It also noted that the proper apportionment of tax-exempt earnings could easily be tracked in a given year, such that the academy could have determined the appropriate allocation ratio and that the need for annual re-evaluation of the ratio was "self-evident."

This decision serves as a reminder to taxpayers that the CRA will not be bound by its previous representations, and the only relevant issue on appeal of an assessment is compliance with the tax legislation. It is also a reminder that taxpayers should obtain professional tax advice on an ongoing basis to ensure compliance with the ETA (especially those businesses engaged in making both taxable and exempt supplies). The taxpayer cannot rely on oversights, representations, or recommendations made by the CRA on previous audits.

The decision might have been more interesting if the academy had argued that its 50 percent allocation ratio was fair and reasonable—not because the ratio was an accurate reflection of its mixed expenses used for taxable supplies, but because an allocation method that the CRA had previously advised the academy to use "on a go-forward basis" is inherently a "fair and reasonable" method for the taxpayer to employ.

Further, there is a line of cases (discussed in the judgment) that suggests that the CRA may be bound by estoppels of fact (for example, if the CRA accepts one version of the facts, it cannot later suggest a different version of the facts), and it would have been helpful to explore whether the auditor's conclusions on the 50 percent methodology might have been susceptible to characterization as an estoppel of fact by which the CRA ought to have been bound. Perhaps that outcome is unlikely on the facts of this particular case, but it is something to keep

in mind whenever one is dealing with estoppel arguments before the CRA.

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Trust's Payment of Insurance Premiums Disqualifies Spousal Trust Status

In a recent technical interpretation (2014-0529361E5, November 16, 2015), the CRA confirmed that a proposed spousal trust will not be eligible for a rollover of capital property upon its creation if income or capital from the trust will be used to pay life insurance premiums on the spouse's life. The CRA said that in this situation, the trust would not qualify for the rollover because it would not be a "spousal trust" from inception. Specifically, the CRA noted that a transfer on death in this situation would result in someone other than the spouse having use of the trust capital or income while the spouse is alive, and the transfer thus would not meet the technical requirements for rollover treatment.

A deceased taxpayer is generally deemed to have disposed of his or her capital property immediately before death for proceeds equal to FMV under subsection 70(5). However, if property to which subsection 70(5) would otherwise apply is transferred or distributed to the deceased's spouse or to a spousal trust, a rollover is generally available under subsection 70(6).

An inter vivos transfer of capital property to a spousal trust is also eligible for a rollover under subsection 73(1.01) if certain conditions in paragraph 73(1.01)(c) are met:

- the spouse must be entitled to receive all of the income of the trust that arises before the spouse's death, and
- no person except the spouse may, before the spouse's death, receive or otherwise obtain the use of any of the income or capital of the trust.

In the TI, the CRA was asked whether, in a situation where income or capital from a proposed spousal trust is to be used to pay life insurance premiums on the spouse's life, the trust would be disqualified from being characterized as a spousal trust, and thus would not be eligible for rollover treatment. In its response, the CRA confirmed its previous position that the trust would not qualify for the rollover in this situation because it would not be a "spousal trust" from its inception. Although the CRA agreed that the relevant legislation does not require that the spouse "benefit" from the trust while he or she is alive, the CRA said that it was still concerned that in this situation someone other than the spouse would obtain the use of trust capital or income.

The CRA also noted a distinction between this situation and that in which a trustee, in his or her fiduciary capacity, takes action to preserve or increase a trust's capital or invests in an asset providing income to a trust. Specifically, the CRA said that a trustee's duty to maintain certain income-producing or capital-appreciating properties that may potentially benefit a spouse during his or her lifetime is not analogous to the trustee's payment of insurance premiums to maintain rights to receive the insurance proceeds by the policy beneficiary after the spouse's death.

The CRA disagreed with the view that because the residual beneficiaries will not receive any property during the lifetime of the spouse, the payment of life insurance premiums cannot be considered to be property used by the residual beneficiary. Instead, the CRA considered the trust's payment of premiums to be property used to establish the residual beneficiaries' rights to funds from the policy that would be realized after the death of the spouse.

The CRA stated that the TI request was forwarded to the Department of Finance.

The CRA's answer in the TI is consistent with the position set out in TI 2012-0435681C6 (May 8, 2012), which was based on question 2 of the 2012 CALU CRA round table. In that TI, the CRA indicated that a duty to fund a life insurance policy owned by the trust would disqualify the trust from being a spousal trust because the premium payment, regardless of whether it was taken out of trust income or trust capital, would be for the benefit of the residual beneficiaries of the trust, not the spouse.

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Tiered Partnership Losses

In *Green v. The Queen* (2016 TCC 10), the TCC addressed the treatment of limited partnership losses in a tiered partnership structure. Limited partnership losses (LPLs) are defined in paragraph 96(2.1)(e) of the Act: where a taxpayer is a limited partner of a partnership, the excess (if any) of the taxpayer's share of business losses from the partnership beyond the taxpayer's at-risk amount (ARA) in respect of the partnership is deemed to be the taxpayer's LPL. Under paragraph 111(1)(e), LPLs can be carried forward and deducted in computing taxable income. Although a partnership is not a separate legal entity for the purposes of the Act, subsection 102(2) states that a reference in subdivision j of division B (the income computation rules for partnerships and their members) to a person or taxpayer that is a member of a partnership includes a partnership that is a member of the partnership. Subsections 96(2.1) and 102(2) are both found in subdivision j of division B. Paragraph 111(1)(e) is found in division C (the rules for computing taxable income).

The CRA's published position (2004-0062801E5, May 14, 2004, and 2004-0107981E5, February 25, 2005) is that a limited partner that is itself a partnership (that is, a "top-tier partnership") can neither use nor allocate LPLs. If a top-tier partnership

has no ARA in the bottom-tier partnership, any losses of the bottom-tier partnership that are allocated to the top-tier partnership are deemed by paragraph 96(2.1)(e) to be LPLs. Because a partnership is not a taxpayer and does not compute taxable income, the top-tier partnership cannot carry forward or claim the LPLs under paragraph 111(1)(e). Further, because there is no provision in the Act for LPLs to be allocated by a partnership, the top-tier partnership cannot flow the LPLs through to its own members. The CRA's view is that LPLs of a top-tier partnership simply vanish.

The appellants in *Green* were limited partners in a top-tier partnership, which in turn was a limited partner in several bottom-tier partnerships. The bottom-tier partnerships had incurred business losses over several years, throughout which years the top-tier partnership's ARA was nil. The appellants' ARAs in the top-tier partnership were also nil until 2009, at which time their ARAs increased. In 2009, the appellants sought to carry forward and deduct, as LPLs and to the extent of their ARAs, their share of the bottom-tier partnerships' business losses from prior years that had been allocated to them as business losses by the top-tier partnership. The CRA reassessed the appellants on the basis that they had no LPLs. The appellants appealed, and the Crown, advocating the CRA's published position, brought a pre-trial motion to determine the legal question: How are LPLs treated in a tiered partnership structure?

In a single-tier partnership structure, the LPL rules—more commonly called "the at-risk rules"—function to defer the deductibility of LPLs indefinitely and until such time (if ever) as the ARA of the limited partner is sufficiently restored to allow the losses to be deducted. It is not controversial that the at-risk rules were enacted to limit the deductibility of partnership losses against other income sources to the amount of capital actually at risk in the partnership.

The appellants argued that on a TCP analysis, the at-risk rules operate in a two-tiered partnership structure in the same way that they operate in a single-tiered structure. Paragraph 96(2.1)(e) implements the at-risk rules and has application within the context of those rules. Because LPLs function solely within the context of computing taxable income, and partnerships do not compute taxable income, the deeming rule in paragraph 96(2.1)(e) has no application when the particular limited partner is a partnership. A partnership computes business income or loss for a fiscal period; for a top-tier partnership, computations of ARAs and of any excess losses are theoretical exercises with no endgame. Business losses of a bottom-tier partnership allocated to a top-tier partnership therefore remain business losses and can be allocated by the top-tier partnership to its members.

The TCC ruled in favour of the appellants. The decision has been appealed by the Crown.

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Canadian Professional Practice: PFIC Exposure for US Citizens

US citizens who are resident in Canada and own an interest in a corporate professional practice (such as a medical practice) should consider their exposure to the passive foreign investment corporation (PFIC) rules. Canadian practitioners may be aware of the potential impact of the PFIC rules on Canadian mutual funds held by US citizens outside an RRSP. However, the scope of the rules extends beyond Canadian mutual funds.

Under the PFIC regime, US citizens who own less than a majority of a foreign corporation are subject to tax at the highest rate applicable to individuals (currently, 39.6 percent) and to a deferred interest charge on excess distributions from a PFIC. An "excess distribution" is defined as a distribution in a tax year (as measured in US dollars) that exceeds 125 percent of the average of the prior three years' distributions from the foreign corporation.

To be a PFIC, the foreign corporation must satisfy at least one of two tests. Under the income test, if 75 percent or more of the corporation's income is passive, it is a PFIC. Under the asset test, if the average value during the taxable year of the passive assets held by the corporation is 50 percent or more of its total assets, it is a PFIC.

Consider the example of a Canadian-based and Canadian-incorporated medical professional who is not a US citizen. The income of the practice is not problematic unless an inordinate amount of passive income flows into the practice. However, the accumulation of investment assets in the practice could be problematic if the practitioner is paying dividends to a US-citizen spouse.

The US PFIC rules default to the gift and estate tax valuation rules. The regulations governing the latter state that the value of a business is the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties have reasonable knowledge of the facts.

Under the asset valuation rules applicable to PFICs, one must weigh the fair market value of the professional practice absent the income generated from the personal goodwill of the selling practitioner. Put simply, how much would the professional practice be worth without the services provided by the key individual? In many cases, the value will be nominal exclusive of the value of the practice's passive investment assets.

The presence of PFIC income may not always trigger the draconian PFIC regime. If the US citizen's interest in a foreign corporation is deemed to be an interest in a controlled foreign corporation (CFC), the CFC rules will trump the PFIC regime. In general, the same type of passive income that triggers the PFIC rules will result in a subpart F income inclusion.

The subpart F rules are, in part, similar to the Canadian FAPI rules and require a contemporaneous income inclusion on the US owner's US tax return regardless of whether the income was distributed.

A foreign corporation is classified as a CFC if US persons who own at least 10 percent of the shares own more than 50 percent of either (1) the total combined voting power of all classes of stock of the corporation that are entitled to vote, or (2) the total value of the stock of the foreign corporation on any day during the tax year.

When one is testing US ownership, various entity and family attribution rules apply. Typically, the entity attribution rules adopt a lookthrough approach to the ultimate proportionate ownership. However, various thresholds of ownership must be satisfied before entity attribution can apply.

Under the family attribution rules, an individual is deemed to own stock that is owned directly or indirectly by the individual's spouse, children, or parents. There is no attribution among siblings, and stock held by grandparents is not attributed to grandchildren.

Under an important exception to the family attribution rules, stock owned by a non-resident alien individual is not attributed to a US citizen or resident. In a typical situation, therefore, the non-resident alien spouse of an incorporated professional who owns 50 percent of the corporation will not have his or her interest attributed to the US-citizen spouse. Because the US citizen will be deemed to own exactly 50 percent of the corporation, a CFC will generally not be deemed to exist. The PFIC rules should govern any distributions made to the US-citizen spouse.

The strict ownership rules governing CFCs should be considered in estate freeze situations where the US-citizen spouse could be relinquishing more than 50 percent of the votes and/or value of at least one class of stock, because it could turn a CFC into a PFIC (if the other PFIC tests are satisfied).

A number of planning steps may mitigate the impact of these rules, depending on the particular facts and circumstances:

- Where possible, bump up the US-citizen spouse's (or children's) ownership to greater than 50 percent (or determine another mechanism to gain effective control); the corporation thereby becomes a CFC. (Be mindful of the application of subpart F income rules.)
- Transfer excess funds in the operating or professional corporation to a related corporation for investment purposes.
- Use a qualified electing fund election as a means of eliminating the punitive tax regime.
- Carefully manage the US-dollar value of distributions to US shareholders.

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Cash Dividends and Amended Subsection 55(2)

Editor's note: The recent amendments to subsection 55(2) have been the subject of ongoing commentary in this newsletter. See "Proposed Subsection 55(2.5): Is the New Definition of 'Significant Reduction' a Boon or a Bane?" (October 2015) and "Subsection 55(2): The CRA's Recent Positions" (January 2016). We welcome additional comments from readers on practical problems experienced in applying the amended rules.

The intention behind both old subsection 55(2) and related provisions (referred to collectively as "old subsection 55(2)") and the amended version ("new subsection 55(2)") that applies to dividends received after April 20, 2015 is to convert a tax-free intercorporate dividend received by a corporation resident in Canada into a capital gain when the dividend replaces what should have been a capital gain.

New subsection 55(2) has rightly attracted a good deal of attention from the tax community. Tax commentators have expressed their concern that intercompany dividends between closely held corporations that should be tax-free could attract new subsection 55(2) treatment in inappropriate circumstances, thus impeding normal business transactions.

If new subsection 55(2) applies, the dividend is deemed not to be a dividend received by the dividend recipient. Rather,

1) if the dividend is received on the redemption, acquisition, or cancellation of a share to which subsection 84(2) or 84(3) applies, the dividend is deemed to be proceeds of disposition of the share; and
2) if point 1 does not apply, the dividend is deemed to be a gain from the disposition of capital property.

By virtue of proposed subparagraph 55(2.1)(b)(i), new subsection 55(2) will come into play if one of the purposes of a dividend (or one of the results of a deemed dividend on a redemption or purchase for cancellation to which subsection 84(3) applies) is to effect a significant reduction in the capital gain that would have been realized on a disposition at FMV of any share immediately before the dividend.

New subsection 55(2) will come into play if a dividend (other than a deemed dividend on a redemption or purchase for cancellation to which subsection 84(2) or (3) applies) is received on a share that is capital property of the dividend recipient and one of the purposes of the payment or receipt of the dividend is to effect

1) a significant reduction in the FMV of any share, or
2) a significant increase in the cost of property such that the total of the tax values of all properties of the dividend recipient immediately after the dividend is significantly greater than the total of the tax values of

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all properties of the dividend recipient immediately before the dividend.

With respect to test 1 in proposed subparagraph 55(2.1)(b)(ii), it would be hard to argue that the payment of the dividend by Opco did not reduce the FMV of the shares of Opco. However, that test should apply only to shares that have a high tax value, thus allowing for an artificial reduction in FMV that could allow the potential creation of an artificial capital loss. In most closely held groups, the tax value of the shares of subsidiaries will be nominal.

With respect to test 2, it is apparent that the cost of property in Holdco (the cash received) will have been increased. But can it seriously be contended that that test should apply to an increase in the tax value of the cash received by Holdco? The answer should be no, because the FMV of cash cannot be reduced to create an artificial loss.

Nevertheless, a literal reading of those two tests raises concerns when cash dividends are paid from Opco to Holdco for normal business purposes—for example, to protect the cash from potential future creditor claims or to allow Holdco to on-lend the funds to another member of the corporate group. Paragraph 55(3)(a), which negates subsection 55(2) in many related-party transactions, should alleviate this concern. Unfortunately, paragraph 55(3)(a) has also been amended to the detriment of clarity.

Whereas paragraph 55(3)(a) used to exempt "any dividend received by a corporation" from the operation of old subsection 55(2), amended paragraph 55(3)(a) now exempts only dividends to which subsection 84(2) or (3) applies (broadly, dividends received on a windup or redemption or purchase for cancellation).

Does all of this mean that we will have to rely on the paragraph 55(2.1)(c) safe income exemption from new subsection 55(2) in connection with garden-variety cash dividends? This question appears to have spawned a safe income calculation industry, because many tax professionals have suggested that safe income calculations should be made before cash dividends are paid. Software designers are already selling safe income templates to assist in making these calculations. If such calculations are in fact necessary, compliance costs will be increased unnecessarily.

I do not believe that new subsection 55(2) will apply to most cash dividends: new subsection 55(2) will be brought into play only if "one of the purposes" behind the dividend was to reduce a capital gain, reduce the FMV of a share, or increase the cost of property. Of course, "purpose" is subjective. Therefore, an overzealous CRA auditor could try to make a case for the application of new subsection 55(2) when a garden-variety cash dividend has been paid or received. Practically speaking, however, the auditor will visit well after the dividend has been recorded. That being the case, hindsight should demonstrate that there was no nefarious intent on the part of the taxpayer.

In this regard, it must be said that proposed subparagraph 55(2.1)(b)(i) is of greater concern than subparagraph 55(2.1)(b)(ii) because the potential capital gains reduction referred to in subparagraph (i) could, theoretically, be well down the road. Nevertheless, according to the preamble to subsection 55(2.1), the artificial capital gains reduction must be "part of a transaction or event or a series of transactions or events." One can only hope that common sense will prevail and that a sale of the shares of Opco by Holdco many years after the dividend will not be considered part of a series that included the dividend.

At present, capital gains realized by an individual are cheaper than taxable dividends. When an after-tax capital gain realized by a corporation is flowed through to an individual shareholder, the shareholder will be in essentially the same after-tax position that he would have been in if he had realized the capital gain personally. I cannot help but wonder what will happen when a taxpayer relies on new subsection 55(2) to voluntarily treat an intercompany cash dividend as a capital gain.

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