

While the proposals seem deceptively simple (at least in comparison to other draft amendments such as the non-resident trust and FIE rules) their application will give rise to numerous questions, which we will explore in greater depth in the next issue of the Tax Commentary. At this point, the draft proposals are more in the nature of a talking paper, as the Department clearly anticipates that a number of submissions will be made, and the merits of the proposals to be debated at length, before coming into effect in 2005.

On the same day CCRA also released the final version of the new Interpretation Bulletin IT-533 on interest deductibility, previously released in draft form in August. CCRA's comments do not, however, reflect Finance's draft proposals. It is to be anticipated that this issue will remain a "hot topic" for the foreseeable future.

The members of the Tax Group at Fogler, Rubinoff LLP would be pleased to discuss any questions or concerns you may have.

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tax commentary

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RESTRICTIVE COVENANTS: MANRELL REVERSED

by Peter K. Guselle

We have written previously in this newsletter with respect to the decisions of the Federal Court of Appeal in the *Fortino* and *Manrell* cases, dealing with the taxation of payments received by an individual vendor of a business for granting a non-competition covenant. In *Manrell*, the Court determined that an individual's right to compete or to carry on a particular activity was not "property" in the legal sense. Accordingly, an agreement to give up or not to exercise that right could not be considered a disposition of property. It followed from this analysis that a payment received as consideration for not exercising such right could not form proceeds of disposition of a property which would otherwise be taxable as a capital gain. Since the taxpayers in *Fortino* and *Manrell* were selling the shares of their operating companies, they had not previously carried

on the business as individuals, and the payment could not be taxed in their hands as an eligible capital amount. Given that the general scheme of the *Income Tax Act* only taxes income from an office, employment, business or property (plus certain specific enumerated sources of income listed in subdivision d of Division B to Part I of the Act) and taxable capital gains from the disposition of property, there was no other category of taxable receipt in which the Crown could characterize the payment, and, as a result, the payments were received tax-free.

A similar result could have been obtained under the *Manrell* analysis, in a case of a corporation which sold all of its assets, where the shareholder negotiated a separate payment in respect of a non-competition covenant. However, where the payment was received by an employee in consideration for a covenant arising out of an agreement made with his employer prior to, during or immediately after the period of employment,

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subsection 6(3) of the *Income Tax Act* deemed such amount to be remuneration for the payee's services rendered during the period of employment, and therefore fully taxable.

Immediately upon the release of the *Manrell* decision in March of this year, tax commentators anticipated a legislative response from the Minister of Finance, to block the perceived "loophole" which permitted a vendor of a business to receive a tax-free receipt. On October 7, 2003, the Minister announced proposed amendments to the *Income Tax Act*, in response to the *Fortino* and *Manrell* decisions.

The proposed amendments will treat any amount receivable for granting a restrictive covenant as ordinary taxable income. The only exception to ordinary income treatment will apply in the case of a taxpayer who is selling shares of a corporation or a partnership interest to an arm's length purchaser, in which case the amount receivable by the taxpayer for granting a restrictive covenant will be taxable on a capital gains basis to the extent that the taxpayer's share or partnership interest has an increased value by virtue of the covenant granted by the taxpayer.

The new proposals may be seen as somewhat punitive, given that they mandate income treatment for amounts that, but for the *Manrell* decision, would likely have been

taxed on a capital gains basis, as part of the proceeds on a sale of shares. In addition, where the exception applies to permit capital gains treatment under the new proposals, and the taxpayer who has granted the covenant is not the sole shareholder, his ability to claim capital gains treatment will be limited to a pro rata amount of the increased value which has attached to all of the shares being sold, proportionate to the covenantor's shareholding in the corporation being sold, with the remainder of the payment being taxed on income account. It is difficult to see the logic of this approach (other than purely punitive). If the grant of the restrictive covenant results in an increase in the value of the shares being sold, logically the entire payment for the covenant should be treated as a capital receipt.

The new proposals are to apply to any amounts received after October 7, 2003, other than amounts received before 2005 pursuant to a written agreement made on or before October 7, 2003 between parties dealing at arm's length. Consequently, if arm's length parties negotiated a payment for a non-competition covenant, prior to the announcement of the new proposals and in reliance on the *Manrell* decision, where the payments were to be paid over a number of years, the grandfathering rules will only apply with respect to payments received up to the end of 2004. It should also be noted that the new proposals apply to any restrictive

DTC 7436) and *Taylor v. The Queen* (2000 DTC 7596). In both cases, the Tax Court had dismissed the taxpayer's appeal on the basis that the taxpayer's chief source of income was neither farming nor a combination of farming and some other source. In both of these cases, the Tax Court had based its decision on the interpretation of *Donnelly v. The Queen* (97 DTC 5499)(F.C.A.), that the taxpayer had to have a reasonable expectation of profit from the farm operation. The Federal Court of Appeal, however, allowed the taxpayer's appeal in both instances. It stated that the Tax Court had misinterpreted the *Donnelly* decision in analyzing the *Taylor* and *Kroeker* cases. The taxpayers were allowed to deduct the farming losses because the Federal Court found in both instances that the taxpayer's chief source of income was farming or a combination of farming and some other source. The CCRA affirmed that its approach to the rules in section 31 is consistent with the Federal Court's approach, as set out in these two cases. The CCRA's focus is on time spent and capital committed to the farming operation, and comparing farm income to other sources.

Tax Avoidance

In response to which areas of tax avoidance transactions are currently under review, CCRA noted that the GAAR Committee was looking at offshore spousal trusts, surplus

stripping, foreign property of deferred income plans and, in particular, treaty shopping. The CCRA is challenging all treaty shopping agreements, both under GAAR and also on the basis of the commentary on Article 1 of the OECD Model Convention which indicates that a benefit need not to be applied under a treaty if the situation is abusive. Two treaty shopping cases that are currently before the Tax Court are *Bradley Holdings* and *Kaufman Family Trust et al.*

NEW PROPOSALS ON INTEREST DEDUCTIBILITY

As promised in the February 2003 Federal Budget, the Department of Finance has released draft proposals to restrict the deductibility of interest and other expenses to counteract the "inappropriate tax results" arising from recent court decisions such as *Ludco*, *Stewart* and *Walls*. As stated in February, the Department of Finance regarded these results as neither consistent with appropriate tax policy nor in conformity with prior law and practice.

The new proposals, which will be applicable to any deductions which are relevant to computing income from a source that is a business or property, will essentially re-introduce the REOP, or reasonable expectation of profit, concept on a cumulative basis over the entire period that the business or property is expected to be carried on or held.

partnership. Examples of this include providing accounting services, equipment rental, or engineering services, if these were not the business of the partnership. In the CCRA's view, an agreement with the partnership to pay a salary to a partner is not sufficient.

Taxation of Prepaid Income

The taxpayer in *Blue Mountain Resorts Limited v. The Queen* (2002 DTC 1886)(T.C.C.) received proceeds on the sale of non-refundable season passes that entitled the holders to use the taxpayer's facilities for the season that began after the end of the taxation year. The taxpayer included the proceeds in income under paragraph 12(1)(a) and deducted a reserve of the same amount under paragraph 20(1)(m), on the basis that the services would be rendered after the end of the taxation year. The Minister included these amounts in the taxpayer's income under subsection 9(1), thus denying the reserve under paragraph 20(1)(m). The Tax Court allowed the taxpayer's appeal. The CCRA's current position on the taxation of prepaid income is that an amount will be included in income under subsection 9(1) rather than under paragraph 12(1)(a) where the inclusion under subsection 9(1) gives a more accurate picture of income. This would be the case where there has been a substantial performance of services at the time of the payment and there

are no restrictions on the taxpayer keeping the payment if future services are not provided.

Prejudgment Interest Concerning Wrongful Dismissal

Generally, prejudgment interest, which refers to interest computed for the period prior to the court order (or settlement), is taxable as interest income. However, it has been the CCRA's administrative policy not to tax prejudgment interest on awards in respect of personal injury or death (see IT-365R2) or awards for wrongful dismissal. The policy of not taxing prejudgment interest for wrongful dismissal awards is set out in CCRA technical interpretations and memoranda (See, for example, Document Nos. 2002-0121305, 9813585 and 9731957 from CCH's Tax Window Files). Paul Lynch announced on September 23, 2003 that effective after 2003, the CCRA's administrative position would change with respect to prejudgment interest on wrongful dismissal awards or settlements. Beginning in 2004, the prejudgment interest will be associated with the nature of the award and will be taxed accordingly. The CCRA policy will not change for prejudgment interest on personal injury or death amounts.

Restricted Farm Losses

The CCRA was asked to comment on the application of section 31 to farm losses in light of the cases of *Kroeker v. The Queen* (2002

covenants, and not merely non-competition covenants which were the subject of the *Fortino* and *Manrell* decisions.

From the payor's perspective, the Department's press release indicates that the amount paid for a restrictive covenant in conjunction with the acquisition of a business, or of shares or partnership interests, may be treated as an eligible capital expenditure, or as part of the cost of the shares or partnership interest, as the case may be.

BARE TRUSTS AND GST

by Ian V. MacInnis

It is common for real estate to be held by a so-called bare trustee, which is typically a corporation acting as a nominee to hold legal title in trust for the beneficial owners (i.e. the shareholders). Such corporations are usually registered on title to avoid the necessity of registering subsequent conveyances of the beneficial interest. In a true bare trust arrangement, the trustee (sometimes also called the agent or nominee) is merely vested with the legal title to the property and has no independent powers, discretion or authority with respect to the trust property. In such case, the beneficial owner retains the right to control and direct the trustee in all matters relating to the trust property. Accordingly, a trust will not be considered to be a bare trust where the trustee has other duties which

involve independent or discretionary powers and responsibilities.

The use of bare trusts gives rise to some interesting GST consequences. In the case of a bare trust, it is the position of the Canada Customs and Revenue Agency (the "CCRA") that it is the beneficial owner (and not the trustee) who is engaged in a business respecting the trust property and may, therefore, be required to register for GST purposes. See Technical Information Bulletin B-068 and Policy P-015. Unless the beneficial owner qualifies for "small supplier" status pursuant to section 148 of the *Excise Tax Act* (Canada) (the "Act"), or under one of the exceptions listed in subsection 240(1) of the Act, the beneficial owner is required to be registered for purposes of the GST.

In *Leowski v. The Queen*, 96 GTC 3151 (T.C.C.), the Court held that a bare trustee who acted as an unpaid agent for its principal was not engaged in a "commercial activity". This supports the conclusion that in a true bare trust arrangement, it is the beneficial owner (and not the trustee/agent) that carries on a commercial activity and, therefore, has the GST reporting and remittance obligations. There are numerous other decisions of the courts to the same effect. Where there is more than one beneficial owner, each beneficial owner would account for the GST on the supply to the extent of its share of the trust property.



The CCRA confirms this conclusion in Technical Information Bulletin B-068. In the case of a bare trust with several beneficial owners, it would be possible for the owners to elect one of them to be responsible for accounting for the GST in respect of the trust property pursuant to the joint venture election in section 273 of the Act.

An interesting question arises in the case of the acquisition of real estate by a bare trustee where the property acquired is for the use or supply primarily in the course of a commercial activity of the beneficiary of the bare trust. Provided the beneficiary is registered for GST purposes, the beneficiary (and not the trustee) would be required to self-assess GST payable by it in respect of the acquisition. This follows by virtue of paragraph 221(2)(b) and subsection 228(4) of the Act. As a practical matter, however, the vendor may request proof or confirmation of GST registration by the trustee (and not the beneficiary), as the vendor would likely be ignorant of the existence of the bare trust arrangement. In these circumstances, GST registration by the trustee/agent of a true bare trust is irrelevant. It would seem prudent in this case to ensure that the beneficiary of the bare trust is registered for GST purposes before the purchase, and, if necessary, that disclosure and/or confirmation of GST registration by the beneficiary be made to the vendor with an acknowledgement to the

vendor as to the true bare trust nature of the arrangement.

The transfer of legal title to a bare trustee and the distribution by a bare trustee of legal title to the beneficiary each constitute transfers that are deemed to be a supply for GST purposes. The value of the consideration for GST purposes is equal to the amount determined under the *Income Tax Act* (Canada) to be the proceeds of the disposition of the property. See sections 268 and 269 of the Act. The definition of "disposition" in subsection 248(1) of the *Income Tax Act* (Canada) indicates that the transfer of legal ownership of property held in trust, without any change in the beneficial ownership, is not a disposition of property. This provision would apply to a bare trust situation. Sections 268 and 269 of the Act provide that, for GST purposes, there is a supply of property where legal title is settled upon a trustee or distributed to the beneficial owners, even where such transaction does not constitute a "disposition" for income tax purposes. In any event, the transfer of legal title alone, where the beneficial interest is not being conveyed, would normally be a transaction of nominal monetary value. Accordingly, the settling of the legal title in a bare trust and the transfer of legal title to the beneficial owner should not have a GST implication.

Canadian Tax Foundation Conference - CCRA/ Practitioner Round Table

by Craig A. Shaw

On Tuesday, September 23, 2003, CCRA/Practitioner Round Table was held at the Canadian Tax Foundation's Conference in Montreal.

A summary of some of the issues that were discussed is set out below. As has been the case in previous years, it is expected that the complete panel discussion will be published at a later date by the Canadian Tax Foundation and by the CCRA.

Shareholder/Manager Remuneration

Questions on shareholder/manager remuneration were raised concerning recent technical interpretations and the CCRA's policy of not challenging the reasonableness of bonuses if paid by a CCPC to an active individual shareholder, resident in Canada. The CCRA's view is that the policy provides some flexibility in tax planning and the ability to take advantage of the integration that is in the system. The policy is applicable when the remuneration is paid from the normal earnings of an active business. It may not apply, however, if remuneration is paid from the sales of assets that are outside the normal business. The CCRA may still give a ruling when a corporation bonuses down out of extraordinary earnings, but it will be a question of fact if a given situation is acceptable.

Corporate Loss Utilization

On the issue of transferring losses within a corporate group where one member of the group is paying taxes and another is in a loss position, the CCRA acknowledged that this is acceptable between affiliated parties. Parties may submit a ruling request based on the consolidated tax position of the corporate group. The CCRA suggested certain information should be in the ruling request, such as a summary of losses and incomes of each member of the affiliated group for each year in question; the period of time the members have been affiliated; and a summary of the planned application of the losses to specific years. It is the CCRA's view that the transactions entered into to achieve the loss consolidation also should make some sense on a commercial level.

Partnerships - Allocation of Income

To date, CCRA's administrative policy with respect to salaries paid to individual partners is that same were not deductible in computing the income from a partnership. The CCRA was asked this year if it had reconsidered its position on the tax treatment of salaries paid to a partner. CCRA's response was that a person cannot enter into a contract to employ himself or herself. As a result, remuneration paid to a partner is generally not deductible. An exception to this general rule would occur if the partner is providing a separate service in a business that is not provided by the