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## **Tax Update – November 2003**

This newsletter will highlight several recent significant income tax developments.

### **Legislated Reasonable Expectation of Profit Test**

On October 31, 2003, the Department of Finance released for public comment draft proposals regarding the deductibility of interest and other expenses for income tax purposes. The proposals, if enacted, provide that a taxpayer will be considered to have a loss from a business or property for a taxation year only if, in that year, it is reasonable to expect that the taxpayer will realize a cumulative profit from that business or property, during the time that the taxpayer has carried on or held, or can reasonably be expected to carry on or hold, the business or the property. The proposals specifically provide that profit for this purpose does not include capital gains. These proposals are intended to have effect for taxation years beginning after 2004.

The proposals require that the taxpayer make an annual assessment of the aggregate profitability of the business or property over the entire "profitability time period", and the taxpayer would only be able to claim a loss if their expectations for a cumulative profit over the entire relevant time period were reasonable. The "profitability time period" will begin at the time the taxpayer commenced carrying on the business or acquired the property, and will end when the taxpayer ceases to carry on the business or disposes of the property. The proposals set out an example where, in each of a taxpayer's 2005 to 2007 taxation years, it is determined that it is reasonable to expect that the taxpayer will profit from a particular business over the profitability time period. The taxpayer will therefore be entitled to claim a loss in respect of the particular business for each of those years. However, when making the determination for 2008, if it is no longer reasonable to expect that the taxpayer will realize a cumulative profit over the period that the taxpayer can reasonably be expected to carry on the business in question, the loss from that business will not be deductible for the 2008 taxation year. However, the determination in 2008 will not affect the previous conclusions reached in years 2005 through 2007, and the losses for each of those years remain deductible.

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The proposals require that it must be reasonable in the circumstances of the particular taxpayer to expect to profit from the property or business. For example, a rental property that produces rental revenue in excess of directly related rental expenses might, on those facts alone, be viewed as a property that should provide a taxpayer with a reasonable expectation of profit. However, if a particular taxpayer incurs a large amount of debt in order to purchase the property, such that the amount of interest expense associated with the property means that the particular taxpayer cannot realize a profit from the rental activity, then that taxpayer would not have a reasonable expectation of profit in respect of that rental activity. As previously discussed, the proposals clarify that the term “profit” does not include a capital gain derived from the business or property. However, in the above example, if the taxpayer purchased the rental property with the specific intention of profiting from its sale, the gain or loss on the ultimate sale of the property will be treated as an ordinary gain or loss, rather than as a capital gain or loss. In such case, the anticipated income on the sale could be included in the determination of profit for the purposes of these rules.

By requiring that the profit expectation be reasonable, the Department of Finance intends that the determination will be made on an objective, rather than a subjective, basis. The proposed profitability test will not necessarily be met solely because there is no personal element to the carrying on of a business or the holding of a property. Furthermore, where a taxpayer has, or purports to have, expectations of profit that are objectively unreasonable, the subjective beliefs will not suffice and the loss will not be deductible.

To illustrate this point, the proposals contain an example of a taxpayer who borrows funds at an annual fixed rate of 8%, and uses only such borrowed funds to make an investment that has a fixed annual return of 5%. The example indicates that the investment cannot increase in value. In such case, there is no reasonable expectation of profit, regardless of whether, on a subjective basis, the misinformed investor intended to profit. Although not mentioned in the example contained in the proposals, the same conclusion would be reached if the investment could increase in value, but such increase would be a capital gain. However, it would appear that the reasonable expectation of profit test would be met if this investment were financed 50% with borrowed funds and 50% with the taxpayer’s own funds, so that overall, net income would be earned on the investment. While most taxpayers are expected to act on a commercially rational basis, the rules would enable the Canada Customs and Revenue Agency to use hindsight to second-guess a taxpayer’s business judgment.

With no reasonable expectation of profit, the taxpayer will not be considered to have realized a loss from a source that is the business or investment. However, the proposed rules provide that, although the loss will be disallowed, expenses will be allowed to the extent necessary to offset the revenue from that business or investment.

The proposed rules do not provide for a carryover of disallowed losses to future net income from the business or investment. Furthermore, the proposed rules are not symmetrical, in that income earned from a business or property from which the taxpayer does not have a reasonable expectation of profit will nevertheless be taxable.

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Simultaneous with the proposed legislation, the Canada Customs and Revenue Agency released Interpretation Bulletin IT-533, "Interest Deductibility and Related Issues". These measures reaffirm many current practices that support the deductibility of interest, including those relating to the deductibility of interest on money borrowed to purchase common shares.

### **Tax Treatment of Amounts Received for Non-Competition and Other Restrictive Covenants**

On October 7, 2003, Finance Minister John Manley announced proposed amendments to the Income Tax Act affecting the income tax treatment of amounts received or receivable by a taxpayer for granting a restrictive covenant, such as a non-competition clause.

The proposed amendments are in response to recent Federal Court of Appeal decisions, which held that, where a taxpayer sells shares of corporation, amounts receivable by the taxpayer for an agreement not to compete with the business carried on by the corporation, were generally not taxable. The proposed amendments will generally treat any amount receivable in respect of a restrictive covenant as ordinary income. If enacted, these proposals will apply to amounts received or receivable 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.

Under the proposals, amounts receivable for granting a restrictive covenant (that is not treated as a disposition of property for income tax purposes) will generally be taxable as ordinary income. However, exceptions will apply in certain circumstances to amounts receivable for a restrictive covenant granted in the context of the sale of either a business, the shares of a corporation, or an interest in a partnership.

Where a proprietor sells a business, an amount receivable by the proprietor for a restrictive covenant will generally be considered an eligible capital receipt, one-half of which is taxable. On an arm's length sale of shares, an amount receivable by a taxpayer for granting a restrictive covenant relating to a business carried on by the corporation will be treated as additional sales proceeds, to the extent that the taxpayer's shares being disposed of would increase in value (when compared to a sale in which the taxpayer does not grant a covenant) if no amount were payable for the covenant. The amount receivable in excess of that treated as proceeds of disposition will be taxable as ordinary income. Similar treatment is afforded to an amount receivable for granting a restrictive covenant on an arm's length sale of a partnership interest.

The proposed rules also clarify the treatment of amounts paid for restrictive covenants from the payer's perspective. Specifically, where an amount is paid for a restrictive covenant in conjunction with the acquisition of business assets, the payer of the amount will be allowed to treat the payment as an eligible capital expenditure. Where an amount is paid for a restrictive covenant in conjunction with the acquisition of shares of a corporation or a partnership interest, the payer will be allowed to include the payment in the cost of the shares or the partnership interest, as applicable.

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In an example provided in the proposals, two shareholders, Terence and Isabelle, each own 50% of the shares of a corporation. An arm's length person offers to acquire all of the shares for \$2 million, provided Terence (who has been closely involved in the business) agrees not to compete with the business after the sale. If no covenant is provided, the purchaser will pay \$1.8 million. The parties agree to allocate the proceeds \$1.8 million for shares, plus \$200,000 for Terence's covenant not to compete. Isabelle will receive \$900,000 for her shares, and Terence will receive \$900,000 for his shares and \$200,000 for his restrictive covenant. Under the proposed rules, Terence would include \$100,000 of the \$200,000 amount as share proceeds, since the value of his shares would increase by \$100,000 if the covenant were provided for no consideration. Therefore, Terence would report proceeds of disposition in respect of the shares of \$1,000,000 and ordinary income related to the covenant not to compete of \$100,000. Isabelle would report proceeds of disposition in respect of the shares of \$900,000.

**Technical Amendment Bill**

On December 20, 2002, the Minister of Finance released a comprehensive income tax technical amendment bill. Several significant proposed tax changes are described below.

**Reserve Not Available**

Subject to various restrictions, a taxpayer is allowed to claim a reserve in respect of its profit or gain from the sale of certain property, where all or part of the proceeds of the sale are not yet due at the end of the year.

In the case of a capital gain, no reserve may be claimed in respect of properties disposed of to a corporation that either controlled the taxpayer or was controlled by the taxpayer (or by a person or group of persons that controlled the taxpayer). However, no similar restriction applied in the case of a reserve claimed in respect of business income related to property sold by the taxpayer (referred to as an "ordinary gain"). The technical amendment bill proposes to deny a reserve against an ordinary gain where the purchaser of the property is a corporation that either controlled the taxpayer or was controlled by the taxpayer (or by a person or group of persons that controlled the taxpayer).

The proposals also deny a reserve against either an ordinary gain or a capital gain of a taxpayer, where the property is sold to a partnership, and the taxpayer is a "majority interest partner" of that partnership.

If enacted, the proposals will apply to reserves to be claimed on the dispositions of property that occur after December 20, 2002.

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### **Kiddie Tax Amendments**

Under the kiddie tax rules, children under the age of 18 at the end of a calendar year are subject to a special tax, computed at the highest marginal personal tax rate, on “split income”. Except for the dividend tax credit and the foreign tax credits, no deductions or credits are allowed in computing the minor's split income or the tax thereon.

Split income includes certain income received directly or indirectly through a trust or partnership, such as taxable dividends (other than on shares of listed public corporations), shareholder benefits and shareholder loans included in income, and income derived from the provision of goods or services to businesses which are owned by a person or persons related to the minor.

Prior to the technical amendment bill, it appeared that income derived from the “provision of goods or services” did not include income from property that was rented, or money that was loaned, by a trust or partnership. Under a proposed amendment, the definition of split income will now include income derived from the “provision of property or services” to businesses which are owned by a person or persons related to the minor. Accordingly, income from the renting of property or the lending of money by the trust or partnership to a “related business” will presumably constitute the “provision of property”.

If enacted, the proposal will apply to fiscal periods and taxation years that begin after December 20, 2002. Existing structures will not be grandfathered.

### **Foreign Affiliate Amendments**

Numerous changes are proposed to the rules dealing with the taxation of income of foreign affiliates.

The proposed amendments, if enacted, will expand the exemptions from foreign accrual property income (“FAPI”) to include certain real estate development profits earned through certain partnerships, where there are more than five full-time employees involved in the business.

Under current law, it appears that the so-called “fresh start rules” do not apply to allow a foreign affiliate to step up its share of the cost base of the property owned by a partnership of which it is a partner, for the purpose of the FAPI rules. The technical amendment bill contains a provision which, if passed into law, would address this situation.

Numerous other changes to the foreign affiliate rules are proposed. The technical amendment bill includes the ability to make certain elections, within a specified timeframe, to have selected rules apply retroactively. Please speak to your partner at Goldfarb, Shulman, Patel & Co. LLP to discuss the potential application of these rules to your situation.

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**Draft Legislation on Non-Resident Trusts and Foreign Investment Entities (“FIEs”)**

On October 30, 2003, the Department of Finance also introduced new draft legislation on non-resident trusts and FIEs. This draft legislation revises numerous previous drafts of legislation designed to ensure that Canada is able to tax investment income earned by Canadians through foreign intermediaries, as previously announced in the 1999 budget. Many of the changes now being proposed to the earlier draft legislation are in response to submissions made by taxpayers and professional advisors. The rules are to have effect for 2003 and subsequent taxation years.

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To discuss the impact of these tax matters on your business, please contact your partner at Goldfarb, Shulman, Patel & Co. LLP.