Quarterly Newsletter – Business – November 2013

Recent CRA Thinking on Topics of Interest

The Canada Revenue Agency (CRA) regularly releases its responses to queries from the general public on varying tax matters. The responses given by CRA to these queries give us an insight to CRA's approach to the law, including actual practices and policies of the government on such issues. Some recent queries and responses of interest are summarized below.

Canadian Controlled Private Corporation (CCPC) determination

The CRA was asked if a corporation would be considered a Canadian-controlled private corporation (CCPC) where 50% of the corporation's shares are owned by a resident of Canada and 50% are owned by a non-resident, and each shareholder has an option to acquire additional shares of the corporation.

The CRA stated that, in such circumstances, the corporation would not be a CCPC. A CCPC is defined to exclude a corporation that is controlled directly or indirectly by one or more non-residents. In determining CCPC status, any right to acquire shares of a corporation is treated as though the right has been exercised and the shares acquired. Accordingly, the right to acquire an additional share by the non-resident (despite the resident shareholder having an identical right) taints the CCPC status.

Manufacturing and Processing

The CRA was asked if a taxpayer's process of converting water into ice cubes and blocks for sale qualified as "manufacturing or processing" for the purposes of the manufacturing and processing profits deductions. If the process did qualify as manufacturing or processing, the CRA was also asked if the equipment used in the process would be eligible for inclusion in Class 29 or 43 and thus afforded the increased capital cost allowance associated with those classes. The CRA's answer to both questions was "maybe", because the determination was a mix of fact and law.

The taxpayer's business involves collecting treated water in ice making towers to produce ice cubes and blocks which it then packages and sells. The CRA pointed out that the definition of "manufacturing and processing" excludes several activities such as farming, fishing, logging, and construction from manufacturing or processing as well as any manufacturing or processing activity that does not generate at least 10% of the gross revenue of the business in Canada. The CRA went on to note that the Act does not indicate what activities are manufacturing or processing so it is necessary to look at the ordinary meaning of these terms in order to make a decision. The CRA commented that, in general, manufacturing

involves the creation of something whereas processing involves “a technique of preparation, handling, or other activity designed to effect a physical or chemical change in an article or substance, other than natural growth”. The CRA stated that while the taxpayer's activity could be considered to be manufacturing or processing for purposes of the M&P tax credit, a detailed review of the taxpayer's operations would have to be undertaken by the taxpayer's Tax Services Office in order to reach a definitive conclusion.

Equipment that is acquired after March 18, 2007, but before 2016, and is used directly or indirectly in primarily Canada (more than 50% according to the CRA's policy) in manufacturing or processing goods for sale or lease, can be included in Class 29 with CCA at a 50% straight-line rate. Such assets acquired after February 25, 1992, and before March 19, 2007, are included in Class 43 with a CCA rate of 30% declining balance.

Employee Benefits – Purchase of Computer Subsidized by the Employer

The CRA was asked if employees reimbursed by their employer for some or all of the cost of a computer chosen, purchased, and used by them in the course of performing their employment duties would be included in their income as a taxable benefit. In this case, the employees were reimbursed by their employer for the lesser of the actual amount paid for the computer and a stipulated maximum amount. The CRA was asked to confirm that the principles outlined in several previous CRA opinions would apply in this situation and ultimately exempt the employees from having to include the benefit in their income.

The CRA confirmed that, although the question of whether an employee received a benefit or not was one of fact, it considered that an employee received an economic benefit when reimbursed in whole or in part for the purchase of a computer of which he/she remained the owner. This opinion is valid even when the employee uses the computer for employment purposes. The amount of the benefit is the actual amount reimbursed by the employer. The earlier CRA opinions were based on the assumption that the computers would be used for employee computer literacy training and benefit the employer more than the employee. This is not the case in this situation.

The CRA also noted that the employee would not receive a benefit if the ownership of the computer was transferred to the employer and the personal use of the computer by the employee was minimal.

Non-Profit Organization – Interest Expense

The CRA was asked if when computing taxable income under the *Income Tax Act* (the “Act”), a non-profit organization could deduct interest expense incurred to renovate a building against interest income earned on GIC investments. Alternatively, the CRA was asked if the

interest expense could be netted against interest income and added to the cost of the building.

The Act provides that a club, a society, or an association (the “club”) is exempt from Part I tax if it is “organized and operated exclusively for social welfare, civic improvement, pleasure or recreation, or for any other purpose except profit”. However, if the purpose of the club is to provide dining, recreational, or sporting facilities for its members, it is taxed as a deemed trust on income from property and certain capital gains. In computing the taxable income of the deemed trust, deductions such as interest expense on monies borrowed to earn that income may be claimed.

The CRA responded that the interest income earned by the club on the GICs was income from property that is taxable under the Act. The borrowed money was not used to acquire the GICs but rather to renovate a building which is used for the club's operating activities. As a result, the interest expense does not relate to the interest income and cannot be deducted as an expense for the purpose of earning income. The CRA cautioned that if it was found that the interest expense was incurred for the purpose of earning interest income, it could be argued that the club had a profit purpose which is contrary to the conditions set out to qualify as a Non-Profit Organization.

The taxpayer's alternative claim that the interest expense should be added to the cost of building was based on a previous CRA Document that dealt with “Soft Costs” (May 22, 1990). In that situation, the CRA had stated that interest income earned by a for-profit corporation on a security deposit placed with a financial institution could be netted against interest expense incurred on funds borrowed to construct a building which was added to the cost of the building. In the current situation, the CRA confirmed its position that the interest income earned by the club was income from property which was taxable and that the interest expense was related to the renovation of the building and could be capitalized.

Sale of a Business

The CRA was asked a series of questions surrounding a hypothetical sale of a small business corporation (Aco) which was wholly owned by an individual shareholder to a taxable Canadian corporation (Bco) owned by a foreign parent. Under the purchase/sale agreement, the shareholder is to receive $5,000, and is required to repay Aco's $2,000 outstanding bank loan. There is a $200 early repayment penalty for the bank loan and a $50 financing fee related to the loan, $30 of which remains unamortized at the time of the sale. The CRA noted that Aco would have a deemed year-end immediately before control is acquired by Bco.

The CRA was asked if the $2,200 used to repay Aco's debt as well as the early repayment penalty would be treated as a reduction of the shareholder's proceeds of disposition. The

CRA confirmed that it would fall under the term “outlays and expenses” and could be deducted from the proceeds in determining the shareholder's capital gain on the disposition. If Aco had paid the $200 early repayment penalty directly, the CRA stated that Aco would be entitled to deduct it over what would have been the remaining term of the loan. However, since it was paid by the shareholder as a condition of the sale, it is a reduction of the shareholder's proceeds of disposition at the time of sale.

A financing fee is amortized over a five-year period. The CRA stated that the $30 unamortized portion of Aco's $50 financing fee could continue to be amortized and deducted by Aco. Because there is a deemed year-end just before Bco acquires control, Aco can deduct 20% of $50 multiplied by the number of days in the short taxation year prior to the change in control divided by 365.

The CRA also stated that the fact that Aco's debt was repaid by the vendor shareholder would not give rise to an income inclusion for Aco under the debt forgiveness rules. The definition of a “forgiven amount” sets out the formula A – B to determine the amount of a commercial obligation that is forgiven. In this situation, variable A is $2,000, which is the principal amount of the obligation, and variable B is $2,000, which is the amount paid by the shareholder. Since the result is zero, the CRA concluded that the debt forgiveness rules would not apply and that there would be no income inclusion for Aco in the period subsequent to the closing.