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September 16, 2016
9:00 a.m. – 12:00 p.m.
Total CPD Hours = 2.5 Substantive Hours + 0.5 Professionalism Hours

The Law Society of Upper Canada
130 Queen, Street West
Toronto, ON

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Agenda

9:00 a.m. – 9:10 a.m.  Welcome and Opening Remarks
Martin Sorensen, Bennett Jones LLP

9:10 a.m. – 9:30 a.m.  The Most Important Tax Cases of the Year
Martin Sorensen, Bennett Jones LLP

9:30 a.m. – 9:50 a.m.  New Developments in the Taxation of Inter Vivos Trusts and Testamentary Trusts
Joan Jung, Minden Gross LLP
9:50 a.m. – 10:10 a.m. Ontario and Toronto Land Transfer Tax Update
Jane Helmstadter, Bennett Jones LLP

10:10 a.m. – 10:35 a.m. Professional Corporations: Tax Benefits and Structuring Issues
Colin Smith, Thorsteinssons LLP Tax Lawyers

10:35 a.m. – 10:45 a.m. Go Ahead and Ask Us (Question and Answer Session)

10:45 a.m. – 11:00 a.m. Coffee and Networking Break

11:00 a.m. – 11:30 a.m. Professionalism: Dealing with Non-Compliant Taxpayers and Tax Evasion (30 minutes)
Christi Hunter, Heller, Rubel Professional Corporation
Adrienne Woodyard, DLA Piper (Canada) LLP

11:30 a.m. – 11:55 a.m. Spotting the Tax Issues in Business Transactions
Daniel Lang, Borden Ladner Gervais LLP

11:55 a.m. – 12:00 p.m. Go Ahead and Ask Us (Question and Answer Session)

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Daniel Lang, Borden Ladner Gervais LLP
The Most Important Tax Cases of the Year

Martin Sorensen
Bennett Jones LLP

September 16, 2016
Perhaps more than ever, tax seems to top of mind for lawyers and their clients. Domestically, many will have noticed that tax rates are going up, and increased enforcement is following. The story is much the same internationally. News organizations trumpet headlines about the global empires of large taxpayers such as Apple, Google and Starbucks, while law firms like Mossack Fonseca get unwanted attention for their role in offshore structuring. For better or worse, it is an interesting time to be an observer of, or have an interest in, the state of our tax laws.

Once again, this past year has been an interesting one for tax cases. What follows is a highly subjective list of the top 10 cases from the past year for the non-tax practitioner. In view of the time limitations inherent in such a presentation, I have paid most attention to Canadian income tax law under the *Income Tax Act* (the "ITA") and limited most of my commentary to the top three cases cited below.

**Number 10... R & S Industries v. The Queen (2016 FC 275)**

This case is a good refresher on the importance of distinguishing between tax appeals to the Tax Court (dealing with the correctness of a tax assessment by CRA) and judicial review applications to the Federal Court (dealing with the reasonableness of a discretionary determination by CRA). It is also a reminder of the importance of respecting the limitation periods associated with each.

In this case, as part of a larger fight with CRA, the taxpayer attempted to file an amended election form and the CRA declined to accept it. The taxpayer then correctly sought to bring a judicial review to the Federal Court to challenge that rejection, but not until 15 months later. The moral of the story is that the 30-day deadline for launching a judicial review is a real one, and it is not sufficient for the taxpayer to plead ignorance, particularly where represented by counsel.

**Number 9... Hall v. The Queen (2015 TCC 240)**

The appellants were the directors of an alarm company that ran into financial problems and fell behind in their remittances for employee tax, EI and CPP. They were assessed under the director’s liability provisions of the ITA in respect of amounts that should have been remitted to CRA. Among other things, the appellants argued they exercised due diligence in attempting to prevent the company's failure to remit source deductions. The Tax Court dismissed their appeals, holding that they had made a conscious choice to pay other creditors while their withholdings went into arrears. Full marks for honesty, but not a good recipe for showing due diligence. Appeal dismissed.
Number 8... 1455257 Ontario Inc. v. Her Majesty the Queen (2016 FCA 100)

Sometimes the key issues in tax cases are not really tax issues at all. Case in point: Can a dissolved OBCA corporation initiate a tax appeal? Sweeping aside some older case law, the Federal Court of Appeal said no. You better revive your corporation first if you want to appeal.

Number 7... Mariano v. The Queen (2015 TCC 244 and 2016 TCC 161)

Yet another charitable donation scheme involving the donation of cash and property with a value alleged to exceed the cost to the donor. The payoff for the taxpayer is a great big charitable receipt.

Like other recent similar cases, the taxpayer lost. But unlike most such cases, the Court did not even give the taxpayer the benefit of the cash that the donor actually paid out as part of the scheme. In the end, the Court found that the taxpayer did not have a “donative intent” to make any gifts and that the transactions were a sham. Oh, and the promoter of the scheme and the appealing taxpayers are both liable for the Crown’s costs of the appeal.

Number 6... Remtilla v. The Queen (2015 TCC 200)

Synopsis: An experienced tax accountant tried to have it both ways — income treatment for loss years and capital gains treatment for good years — and ultimately enters into a settlement with CRA to get everything treated on income account. But when it comes time to implement the settlement and he is assessed, he tries to argue that the CRA cannot reassess the good years because they are statute-barred.

Conclusion: Nice try, said the Tax Court, but no cigar. The good years are not statute-barred because the taxpayer’s T1 Adjustment Requests operated as waivers of the normal reassessment period.

Number 5... TDL Group Co. v. Her Majesty the Queen (2016 FCA 67)

Yes, interest deductibility. Again.

In this decision, the Federal Court of Appeal reviewed a controversial Tax Court decision that denied an interest deduction on a loan on loans used to invest in non-dividend-paying common shares. In its decision, the Tax Court considered the tax avoidance motive of TDL and the use of the funds by their recipient, and not to the use of the funds by the taxpayer itself. The Court of Appeal overturned the trial judgment, holding that interest on loans used to invest in non-dividend-paying common shares can be deductible if there is at least a possibility of earning dividend income. Furthermore, the Court of Appeal dismissed the lower court’s concern with any tax avoidance motivations. A welcome development in this seemingly perennial issue.
**Number 4 ... Fairmont Hotels Inc. v. A.G. (Canada) (2015 ONCA 441)**

*Fairmont* has a fairly common fact pattern for a rectification case: a taxpayer took certain steps in anticipation of a particular tax result, but didn’t achieve it due to some mistake or misunderstanding along the way. The taxpayer now faces the prospect of having to pay an unexpected tax bill. CRA would understandably like their money, but the taxpayer protests it was all a big mistake and seeks relief from a provincial superior court in the form of a rectification order. The overarching question is whether such a mistake should be rectified or whether it amounts to retroactive tax planning.

To date, the courts have generally been fairly accommodating, and the Ontario Court of Appeal continued this trend here. In short, the Court granted the relief requested by the taxpayer in reliance on the earlier case of *Juliar v. AG (Canada)*, (2000) 50 OR (3d) 728 (Ont. C.A.). In doing so, the Court rejected the CRA’s long-standing argument that *Juliar* is bad law and should be reversed.

However, the CRA had a fresh kick at this particular can on May 18, 2016, when its arguments were heard by the Supreme Court. The judgment is currently under reserve. Whatever the result, this case will be an important one for all lawyers who implement or advise on transactions that turn out to have unanticipated tax consequences. Stay tuned on this one…

**Number 3 ... McGillivray Restaurant Ltd. v. Her Majesty the Queen (2016 FCA 99)**

In *McGillivray*, the Federal Court of Appeal provided some welcome news to the Canadian tax advisors concerning the appropriate legal test for determining whether a person has "de facto control" over a corporation for tax purposes.

Control is a fundamental concept relevant to many corporate tax issues, including:

- whether the corporation will qualify as a “Canadian-controlled private corporation” (or CCPC), which has many significant implications to both the corporation and shareholders (including the availability of favourable corporate income tax rates and credits);

- whether the corporation will be “associated” with other corporations for purposes of having to share certain tax benefits; and

- the potential availability of an exemption from Canadian withholding tax on interest paid to a non-resident creditor.

Control can generally be based either in law (*de jure* control) or in fact (*de facto* control). Whereas *de jure* control is determined based on the right to appoint the majority of the board of directors of a corporation and is often a relatively straightforward analysis, *de facto* control (i.e., effective control in the absence of clear
de jure control) can be significantly more challenging to assess in practice. Prior court decisions have suggested that any number of ambiguous and subjective factual considerations relating to the day-to-day management, operations and finances of the corporation may be relevant to the determination of de facto control. In many cases this can result in a troubling level of uncertainty in understanding the applicable tax implications and planning otherwise relatively straightforward transactions.

In McGillivray, the FCA confirmed that a narrower test must be applied in assessing de facto control. In this respect, the only relevant factors are those founded on a legally enforceable right and ability to effect a change to the board of directors or its powers, or to exercise influence over the shareholder or shareholders who have that right and ability. In other words, factual operational control is irrelevant in the absence of a right to undertake actions that are otherwise within the exclusive purview of the shareholders who have legal (de jure) control the board.

This straightforward and practical clarification cuts through much of the confusion created by prior case law and should simplify the de facto control analysis in many common situations going forward.


Subsection 231.2(1) of the ITA confers a broad power on the Minister to compel any person to provide information or documents concerning any taxpayer for any purpose related to the administration or enforcement of the ITA. If the person fails to provide the information, the Minister may seek a compliance order from a court under s. 231.7 of the ITA, and the person could ultimately face severe sanctions, including imprisonment. The ITA does provide an exception for information protected by solicitor-client privilege, but the exception is subject to an exclusion for accounting records of a lawyer.

The Notaires case stemmed from demands by the CRA to require a number of notaries practising law in Quebec to disclose information regarding their clients, on the basis that such information constituted accounting records and therefore was not subject to solicitor-client privilege. The notaries complained to the Chambres des notaires du Quebec, which commenced a declaratory action against the Attorney General and the CRA for the purpose of having ss. 231.2(1) and 231.7, and the exception for accounting records in the definition of solicitor-client privilege in s. 232(1) of the ITA, declared unconstitutional. Both the Superior Court and the Court of Appeal ruled in favor of the Chambre, and the Attorney General appealed to the Supreme Court.

In Thompson, it was a lawyer who was the subject of CRA enforcement action. In response to CRA’s request for his accounts receivable, Mr. Thompson provided only an indication of the balance owing, claiming that further details (such as the names of
his clients) were protected by solicitor-client privilege. Accordingly, he filed a Notice of Constitutional Question regarding the issue with the Federal Court.

Both the Federal Court and Federal Court of Appeal rejected Thompson’s position, with the appeal court expressly declining to follow Notaires. The Court of Appeal found that although solicitor-client privilege did not generally apply to the information sought, some of Thompson’s clients’ names could potentially be protected by such privilege and the clients should have been afforded an opportunity to assert such privilege. Consequently, the matter was sent back to the Federal Court for a new hearing.

In Notaires, the Supreme Court declared ss. 231.2(1) and 231.7 of the ITA to be unconstitutional and inapplicable insofar as they apply to lawyers in their capacity as legal advisers, and went even further with respect to the exception for a lawyer’s accounting records set out in the definition of “solicitor-client privilege” in ss. 232(1) of the ITA, finding it to be unconstitutional and invalid. The Court emphasized that solicitor-client privilege is a substantive rule of law of deep significance and a principle of fundamental justice. As such, it should "remain as close to absolute as possible" and should not be interfered with unless absolutely necessary.

In Thompson, the Court found that Parliament clearly intended to abrogate the protection of solicitor-client privilege with respect to lawyers’ accounting records. However, given its finding in Notaires that it was unconstitutional to do so, the Court set aside the Court of Appeal’s order for a new hearing and dismissed the Minister’s application. The Court held that the information requested was presumptively privileged, and its disclosure could not be required unless a court first determined whether solicitor-client privilege actually applies.

Ultimately, all tax cases from the Supreme Court will be worth reading by tax practitioners, however these two cases are likely worth reading by all lawyers who have dealings with CRA on behalf of their clients. The CRA’s “requirement” powers are extremely broad and lawyers can often find themselves on the receiving ends of requirement letters. It is useful to know that there are limits on the effect of such letters and that the CRA occasionally oversteps its legal bounds. At this point, it is unclear whether the ITA will be amended or how the CRA will respond. This area is worth keeping an eye on.

**Number 1 … ARQ v. Groupe Enico Inc. (2016 QCA 76)**

Tax authorities owe a duty of care and good faith to taxpayers. They are required to use their extensive powers in a reasonable and non-abusive manner. That’s the message from the Quebec Court of Appeal in this case to the tax authorities. They didn’t in this case, and the Agence du Revenue du Québec (“ARQ”), which administers the GST in Québec, was found liable to pay $3 million to the plaintiffs, including $1 million in punitive damages. While the case arose in a civil law context, it represents
the most significant victory yet for taxpayers that are the subject of negligent or abusive behavior by tax authorities.

Both the trial and appeal decisions are available only in French, but the key facts are as follows. Jean-Yves Archambault ("Archambault") was the principal of Groupe Enico Inc. ("Enico"), a robotics company. Enico was established in 1990 and prospered. By 2007, Enico had built up annual revenues of $5.6 million and had 38 employees. It had a credit facility with a major bank, commitments for further financing and was even due a large tax refund from all its research and development activities. By all accounts, both Enico and Archambault were doing very well.

However, that began to change in 2005 when ARQ began to audit Enico for GST, QST and income tax following a tip from a disgruntled former employee that Enico had filed false sales tax returns. Following the tip, ARQ initiated an extensive audit. During the audit, ARQ was less than forthcoming or competent. For example, one experienced auditor held himself out to be an intern. Ultimately, with little or no warning, ARQ issued a series of tax assessments beginning in October 2007 that effectively ruined Enico. Internal ARQ documents revealed that ARQ knew the assessments were far too high. A number of the assessments even included gross negligence penalties. ARQ also assessed Archambault on the basis that he had appropriated funds from Enico, even though the opposite was true.

In the meantime, ARQ lost a month of Enico’s payroll remittances and assessed Enico for those amounts. Further, ARQ labeled Enico an "offender" or "delinquent taxpayer" and sought to speed up its collections against the company. Accordingly, ARQ’s collections branch then took actions to seize Enico’s assets to satisfy the company’s alleged debts. The Court found that this caused the company’s financiers to flee and its customers to stop paying it. The company ultimately failed and was forced into bankruptcy. Later, the assessments were reduced to a small fraction of the original amounts but by then it was too late.

At trial, the Quebec Superior Court found a litany of abuses by ARQ and that the reassessments resulted from malicious and intentional misconduct by the tax authority. The Court further concluded that the evidence demonstrated that ARQ’s internal policies (which, for instance, expressly linked auditor’s and collection agent’s bonuses to amounts assessed and collected) encouraged this type of conduct. The Court awarded Enico and Archambault $4 million in damages, an unprecedented amount in Canada for such a case.

ARQ appealed the decision, but the bulk of the lower court judgment was affirmed on appeal. While the Court of Appeal took issue with some aspects of the lower court’s judgment (such as the emphasis on ARQ’s use of a quota system to reward auditors), the Court largely upheld the trial decision. There were no errors of fact or law committed by the trial judge: ARQ was negligent and owed damages to Enico. The
QCA found that $1,000,000 was an appropriate amount for the punitive damages, and $1,400,000 was awarded for economic loss.

At trial, Archambault himself had also received $50,000 in “moral” damages, $50,000 in physical damages, and $1,000,000 in punitive damages. This aspect of the judgment was largely overturned, as the Court of Appeal held that both the moral and punitive damages could not be sustained. In its view, ARQ had failed to meet its standard of care owed to Enico, not Archambault. Thus, the Court upheld only the $50,000 award for physical damages to Archambault as compensation for a psychological prejudice resulting from the economic prejudice suffered as the *alter ego* of Enico.

While some may try to limit the effect of this case to civil law jurisdictions, the cat could be out of the bag. It is the most significant successful lawsuit against a tax authority in Canadian history and is likely to be carefully considered in other provinces. Indeed, common law courts have already made similar determinations regarding the existence of a duty of care (see, for example, *Leroux v. Canada Revenue Agency*, 2014 BCSC 720) and it seems likely that such a court would have little difficulty finding liability in the right circumstances. Since suing the tax authority will generally be the only recourse for aggrieved taxpayers in cases of administrative malfeasance, this is a welcome development. With great powers come great responsibility; this case confirms that adage.
Recent Developments in the Taxation of Inter Vivos and Testamentary Trusts

Joan Jung
Minden Gross LLP

September 16, 2016
There have been significant changes in the taxation of _inter vivos_ and testamentary trusts which can be traced to the 2013 Federal Budget. The 2013 Federal Budget announced a consultation on the elimination of the graduated rates of taxation then available to estates and testamentary trusts. Following the short consultation, draft legislation addressing the targeted consultation points but also including some surprises was released in the summer of 2014 and quickly enacted on December 16, 2014, generally applicable as of January 1, 2016 (the “Legislative Amendments”). The fallout from these amendments is still not final, as further draft legislation intended to have a remedial effect following comprehensive submissions from various interested professional groups, has been released but not yet enacted. The following is intended to be a non-technical summary of items of interest to the general practitioner. There have been a number of detailed technical papers/presentations on the Legislative Amendments and the interested reader may find citations to other materials in the footnotes.

**Graduated Rates of Taxation**

Before the Legislative Amendments, testamentary trusts were subject to the graduated rates of taxation. This provided income splitting opportunities. An individual could establish multiple testamentary trusts in his/her will with variations in the choice of life tenant and remainder interests; each testamentary trust’s income being taxed at graduated rates. In addition, an estate would continue well past the so-called executor’s year, holding some income producing assets, and its income would also be taxed at graduated rates. In contrast, _inter vivos_ trusts were typically taxed at the top marginal rate.

As a result of the Legislative Amendments, effective January 1, 2016, all trusts (with the exception of a “graduated rate estate” (“GRE”) and “qualified disability trust (“QDT”)) are subject to tax at the top marginal rate, sometimes colloquially referred to as flat top rate taxation. As there were no grandfathering provisions, a testamentary trust or estate in existence at the end of 2015 which could not meet the GRE requirements became subject to tax at the top marginal rate on January 1, 2016 and compelled to change to a calendar year end. It is possible that such a pre-existing testamentary trust or estate had two year ends in calendar 2015 – one being its previous “regular” year end and the second being the short year ended December 31, 2015.
What is a GRE?

GRE is a new concept and a defined term. There are six basic parameters which are set out below:

- Must be an estate that arose on and as a consequence of a person’s death.
- The estate must be a “testamentary trust” as defined in the ITA.
- No more than 36 months have passed since the date of death.
- The estate must designate itself as the GRE of the deceased individual in the first return filed after 2015. Note that there is no mechanism in the legislation for a late filed designation.
- No other estate can designate itself as the GRE of the deceased individual.
- The deceased individual’s Social Insurance Number must be provided in the estate’s return.

A GRE must be an estate. There is a distinction between an estate and a trust. An estate is generally considered to exist while the executors are administering same and have not distributed the assets in accordance with the deceased’s will to beneficiaries or testamentary trusts. An estate is a trust and may be a “testamentary trust” as defined. However, a trust is not necessarily an estate. For example, a will may create a testamentary trust but such a testamentary trust will not be a GRE. As a result, although multiple testamentary trusts can continue to be established by will and there may non-tax reasons for doing so, there is no tax planning rationale to doing so as the Legislative Amendments eliminated multiple access to graduated rates.

In the case of multiple wills, there has been a question of whether GRE designation could only apply to one will, bearing in mind that the disposition of property and choice of estate trustees might be different and in addition, property may be multi-jurisdictional. The stated position of the Canada Revenue Agency is that an individual only has one estate notwithstanding multiple wills. CRA’s view was that if there are different estate trustees for the multiple wills, then they should agree and co-operate on the single tax return for the estate with the GRE designation.

The parameters of the GRE definition mean that GRE status and therefore access to the graduated tax rates is available for a maximum of 36 months. Because of the time limitation, if estate administration extends past 36 months (e.g., complex estate; litigation), the income of the estate will thereafter be subject to tax at the top marginal rate. When GRE status ceases, there is a deemed year end for income tax purposes and the ongoing estate will thereafter have a December 31 year end. Therefore in the calendar year in which status changes from GRE to non-GRE, the estate will have two taxation year ends and two income tax returns to file.

It is possible that GRE status may be lost during the 36 month period if the estate ceases to meet the “testamentary trust” definition. Notably, “testamentary trust” status can be lost if a
beneficiary or a person non-arm’s length to a beneficiary makes a loan to the estate, subject to certain limited statutory saving provisions. One common situation where beneficiary loans may arise is the funding of estate expenses. However, if there is a beneficiary loan because the beneficiary made a payment on behalf of the estate and the estate pays full reimbursement within 12 months, then testamentary trust status is not lost. 10 It is therefore important to track payments by beneficiaries on behalf of the estate and take steps for timely reimbursement.

From a will drafting perspective, it may be prudent to direct the executors to the need to make a GRE designation and to obtain advice as needed to ensure that the estate qualifies as a GRE. In the case of multiple wills (and in particular if there are different executors under each will), it may be prudent to direct the executors of the multiple wills to consult with one another and make one GRE designation for the one estate. In addition, to permit the estate to take advantage of the graduated rates for the maximum 36 month period, consideration should be given to a clause expressly providing that estate administration may continue for 36 months.11

The reader should note that GRE status is not limited to only the availability of graduated rates of taxation. It is also relevant to a number of technical income tax measures which are not discussed in this paper.12

**Life Interest Trusts**

The term “life interest trust” refers to an *inter vivos* joint partner trust or alter ego trust, or a testamentary spousal trust. Upon the death of the life interest beneficiary, the trust is deemed to dispose of all of its property for fair market value proceeds. Until the above Legislative Amendments, the income from such deemed disposition was income of the particular trust. By way of example, common estate planning for a couple (married spouses or common-law partners as defined in the ITA) often involves wills which provide that upon the death of the first-to-die spouse, all (or certain specified property such as, notably, shares of a private corporation) property passes to a testamentary spousal trust for the benefit of the surviving spouse. Such a testamentary spousal trust must provide that the surviving spouse is entitled to receive all of the income therefrom during his/her lifetime and no person other than the surviving spouse may receive or otherwise obtain the use of any of the income or capital of the trust during the lifetime of the surviving spouse. In such circumstances, there is a so-called “roll-over” upon the death of the first-to-die spouse13; effectively the consequences of a deemed disposition of property at fair market value are deferred until the death of the second-to-die spouse. The question is who recognizes the income resulting from the deemed disposition of property upon the death of the second-to-die spouse. Prior to the Legislative Amendments, the answer in this example would have been the testamentary spousal trust (which obviously has the property).

As a result of the Legislative Amendments, two changes relevant to life interest trusts came into effect as of January 1, 2016:14
• The taxation year of the particular trust is deemed to end at the end of the day on which the life interest beneficiary dies.
• The income of the trust (including the income resulting from the deemed disposition immediately before the death of the life interest beneficiary) is deemed to have become payable to the life interest beneficiary and accordingly, subject to tax in the terminal return of the life interest beneficiary.

In the above common estate planning example, the above means that the income resulting from the deemed disposition of property upon the death of the second-to-die spouse would be recognized in the terminal income tax return of the second-to-die spouse. The imposition of tax liability pursuant to the above deeming provision clearly does not correlate with any distribution of property by the trust. The trust remains the owner of the trust property yet the estate of the deceased life interest beneficiary is liable for the tax. Issues of equity could arise. For example, imagine a blended family where each spouse had children from a prior marriage and where each spouse might provide for ultimate disposition of property to his/her biological children. Suppose the will of the first-to-die spouse provided for a testamentary spousal trust for the benefit of the surviving spouse. Upon the death of the surviving spouse (being the life interest beneficiary of the testamentary spousal trust), the capital gain from deemed disposition of property of the testamentary spousal trust would be included in the income of the estate of the surviving spouse, yet the remaining property of the testamentary spousal trust may be distributed otherwise.

The above became law as of January 1, 2016 without grandfathering. In other words, the above applied to existing estate plans and life interest trusts. For example, a testamentary spousal trust in existence on January 1, 2016 which was set up under the will of an individual who died before the coming into effect of the Legislative Amendments is subject to the new rules. In such circumstances, obviously no planning or amendments can be done to address the tax liability which will be borne by the surviving spouse upon her/his death, rather than the trust/estate which holds the assets. These concerns and others were raised in comprehensive submissions to the Department of Finance which were made by a number of professional organizations in the tax and estate planning fields.

On January 15, 2016, the Department of Finance released draft legislation (to apply to 2016 and subsequent taxation years) intended to ameliorate the situation (the “2016 Draft Legislation”). Effectively, the capital gain on the death of the life interest beneficiary is moved back to where it was before the Legislative Amendments and specifically, taxed in the trust, subject to limited circumstances where an election can be made to the contrary. In the following circumstances, the 2016 Draft Legislation provides that an election can be made to tax the gain in the hands of the estate of the life interest beneficiary:\textsuperscript{15}

• The life interest beneficiary was resident in Canada immediately before death.
• The trust is a post-1971 testamentary spousal trust created by the will of a taxpayer who dies before 2017.
• There is a joint election made by the trust and the GRE of the deceased life interest beneficiary and such election is filed with both tax returns.

Absent such election, the default rule (assuming that the 2016 Draft Legislation is enacted) has been restored to the situation before the Legislative Amendments.

It should be noted however that it will no longer be possible to make use of the deceased life interest beneficiary’s unused capital gains exemption.\textsuperscript{16}

**Qualified Disability Trusts**

A “qualified disability trust” (“QDT”) is not taxed at the top marginal tax rate, but rather is subject to tax at the graduated rates. The prerequisites for QDT status are:\textsuperscript{17}

• Must be a testamentary trust
• Must be resident in Canada
• Joint election must be made in the trust’s tax return together with one or more beneficiaries and the Social Insurance Number of each of those electing beneficiaries must be provided
• Each electing beneficiary must qualify for the disability tax credit\textsuperscript{18}
• The electing beneficiary cannot have made the joint election with any other trust.

The limit of one QDT for any particular beneficiary should be noted. It does not matter that the particular electing trust itself does not have sufficient income to reach the top marginal rate.

QDTs are subject to a complicated “recovery tax” \textsuperscript{19} in the year in which the particular trust ceases to qualify as a QDT (i.e., above prerequisites are no longer satisfied) or a capital distribution is made to a beneficiary other than the electing beneficiary. It appears that the recovery tax recognizes that the trust was subject to tax at the graduated rates and attempts to claw back the “savings” resultant from income not having been distributed to the electing beneficiary.

**Charitable Donations**

The Legislative Amendments provide for increased flexibility in the utilization of charitable donation tax credits in respect of charitable gifts made, loosely speaking, as a consequence of death.

Prior to the Legislative Amendments, the charitable donation tax credit for a gift “by will” could be claimed in the deceased’s terminal return or in certain circumstances, the return for the year preceding death. The legislation deemed such a gift to have been made by the individual immediately prior to his/her death. Because of the deeming timing of the gift, the charitable donation tax credit could be applied against the deceased’s tax liability resulting from the
deemed disposition of property immediately before death and any other income of that year. However, there was no carryforward rule and the credit could not be utilized by the estate. Further, there was a prioritizing rule. The credit had first to be applied to tax liability in the year of death and only if any amount was unused could that unused portion be applied to tax liability for the year preceding the year of death. In addition, there was some uncertainty regarding the meaning of a gift “by will” (as those words were used in the legislation) and there was a considerable body of CRA administrative positions on the interpretation of this phrase. If the “by will” requirement was not satisfied, then the credit would not be available as described above but possibly only by the estate. Therefore care had to be exercised in drafting wills to address this requirement.

As a result of the Legislative Amendments, there appears to be greater flexibility to utilize the charitable donation tax credit where an individual died after 2015 although GRE status is needed. The distinction between gifts made “by will” and those made by the estate has been eliminated by a deeming rule. The gift is deemed to be made by the estate. Also the timing of gift is statutorily specified. In particular, a gift made by an individual’s will, or gift made by an estate is deemed to be made when the property is actually transferred to the charity based on the fair market value at that time and is deemed to be made by the estate. If the estate is a GRE and the GRE makes a gift of property acquired on or as a consequence of death, the estate trustee may claim the charitable donation tax credit:

- In the deceased’s terminal return
- In the return of the deceased for the year preceding the year of death
- The taxation year of the GRE in which the donation was made
- Any earlier taxation year of the GRE

Also, the charitable donation tax credit may be carried forward for five years. The foregoing will also apply to designations of life insurance proceeds or the deceased’s RRSP, RRIF or TFSA to a “qualified donee” (i.e., registered charity).

As mentioned above, GRE status is limited to the 36 month period following death. As a result, the increased flexibility for use of the charitable donation tax credit rules requires estate trustees to make the donation within 36 months of death. This could be challenging in some estate situations for reasons of estate complexity or litigation. Some relief was proposed in the 2016 Draft Legislation extending the 36 month period for making the donation to 60 months. This only applies where the estate would have been a GRE in the period after the expiry of the 36 months to the date of donation, but for the 36 month limitation. For example, the particular estate would still have to meet the “testamentary trust” definition as explained above. In these circumstances, the 2016 Draft Legislation proposes that the charitable donation tax credit may be claimed in the deceased’s terminal return; the return of the deceased for the year preceding the year of death or the taxation year of the estate in which the donation is made.
The taxation of testamentary trusts and grandfathered inter vivos trusts at graduated rates effectively allows the beneficiaries of those trusts to access more than one set of graduated rates. This tax treatment raises questions of both tax fairness and neutrality in comparison to the treatment of beneficiaries of ordinary inter vivos trusts and taxpayers receiving equivalent income directly.

Tax planning opportunities associated with the availability of trust-level graduated rates include the use of multiple testamentary trusts, tax-motivated delays in completing the administration of estates, and avoidance of the Old Age Security Recovery Tax. The tax benefits arising from tax planning of this nature raise questions of fairness, and negatively affect government tax revenues. In addition, the extent of tax planning in this area heightens these concerns.

Economic Action Plan 2013 announced the Government’s intention to consult on possible measures to eliminate the tax benefits that arise from taxing at graduated rates grandfathered inter vivos trusts, trusts created by will, and estates (after a reasonable period of estate administration).

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1 See June 3, 2013 announcement of consultation available on the Department of Finance website https://www.fin.gc.ca/activty/consult/grt-itp-eng.asp, a portion of which is extracted below to highlight the apparent policy rationale for the review:


4 Certain inter vivos trusts were grandfathered from taxation at the top marginal rate and rather, were taxed at graduated rates. In general terms, this was a trust established before June 18, 1971; resident in Canada at that date and thereafter without interruption; did not carry on an active business; had not received any property by way of gift since June 18, 1971; had not incurred any debt to a beneficiary; had not received property on a “trust-to-trust” transfer from another inter vivos trust taxed at the top marginal rate; and not a mutual fund trust.

5 See s.122(1), Income Tax Act (Canada), R.S.C. 1985, c.1 (5th Supp.) as amended (“ITA”). The “grandfathered” inter vivos trusts described in note 4 above also became subject to tax at the top marginal rate. Reference may be made to the history of s.122(2), ITA prior to the Legislative Amendments.

6 See s.248(1), ITA.

7 The definition of the term “trust” in s.248(1), ITA expressly includes an estate.

8 See CRA Document no. 2015-0572091C6 being Question 2 of the CRA Roundtable at the 2015 National Conference of the Society of Trust and Estate Practitioners. The “one estate” concept was also in the Explanatory Notes published by the Department of Finance accompanying the August 29, 2014 draft legislation, the terms of which were substantially enacted as the Legislative Amendments as defined herein.

9 See s.249(4.1), ITA.

10 See subparagraph (iii) of paragraph (d) of the definition of “testamentary trust” in s.108(1), ITA.

For example, GRE status is necessary for certain post mortem strategies where the deceased owned private corporation shares. Pursuant to s.164(6), ITA, losses realized in the first year of the estate may be carried back to the terminal return of the deceased. The Legislative Amendments restrict this to a GRE.

See s.70(6), ITA.

See s.104(13.4), ITA.

See proposed s.104(13.4)(b.1)

Subsection 110.6(12), ITA has been repealed.

See definition in s.122(3), ITA.

As provided for in s.118.3(1)(a) to (b), ITA. Eligibility for the disability tax credit (which is technically referred to in the ITA as the “credit for mental or physical impairment” is described thus in Income Tax Folio S1-F1-C2, paragraph 2.2:

2.2 The eligibility rules for the disability tax credit are set out in subsection 118.3(1). An individual is eligible for the disability tax credit for a tax year where the following requirements are met:

a) the individual has one or more severe and prolonged impairments in physical or mental functions;

b) the effects of the impairment or impairments are such that the individual is either:

• markedly restricted in the ability to perform a basic activity of daily living or would be markedly restricted but for life-sustaining therapy; or

• significantly restricted in the ability to perform more than one basic activity of daily living and the cumulative effect of the significant restrictions is equivalent to being markedly restricted in the ability to perform a basic activity of daily living; and

c) a medical practitioner certifies that the individual meets the requirements under ¶2.2 (a) and one of the requirements under ¶2.2 (b).

See s.122(1)(c) and (2), ITA.

See s.118.1(5), ITA.

Referred to as an “eligible transfer”. See s.118.1(5.2), ITA.
Ontario and Toronto Land Transfer Tax Update – September 2016

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1. INTRODUCTION

In the current market of soaring real estate values, particularly in and around the City of Toronto (Toronto being the only Ontario municipality to levy its own additional transfer tax in addition to the provincial tax), an understanding of provincial and municipal land transfer tax has never been more important. Today, the drive to collect land transfer tax has intensified, and the government bodies responsible for collecting that tax are reviewing and revising their regulations and policies to ensure no revenues are lost. This paper provides a general overview of the land transfer tax regime in Ontario and discusses some of the key areas in which tax battles are currently being won and lost.

The legislation governing land transfer tax ("LTT") in Ontario and Toronto is the Land Transfer Tax Act (Ontario) (the "Act"), and City of Toronto By-Law No. 1423-2007 (the "Bylaw"). This paper does not address income taxes or other taxes that may be payable on or relevant to the transfer of real property in Ontario, such as the harmonized sales tax. Except where relevant to note a distinction or difference, this paper treats the Act and the Bylaw as equivalent and provides reference to the relevant provision of the Act only. The Act and the Bylaw differ in certain material respects, including in relation to objections and appeals (for example, see the general four year limitation period for assessments or reassessments by the Ministry under Section 12(4) of the Act and the general six year limitation period for assessments or reassessments under Section § 760-74 of the Bylaw). Any person making an objection or appeal should pay particular attention to Articles XII – Article XIII of the Bylaw and Sections 13 – 14.1 of the Act.

The rate of LTT payable in Ontario depends on several factors, including the location of real property within the province and the type of property being transferred. Real property located in the City of Toronto is subject to provincial tax under the Act, as well as municipal tax under the Bylaw. Real property in the rest of the Province is subject only to provincial tax. Since inputting a purchase price into a draft transfer in the Ontario land registry Teraview system will automatically calculate the LTT payable on any Ontario transfer, and because the rates are published on government websites, this paper will not discuss the tax rate calculation in great detail. Suffice to say that the rates are graduated with differing rates depending on the total value of the consideration. Once the value of the consideration is above a few million dollars, a rough guide is that the LTT will be: for commercial properties, 1.5% outside of Toronto and 3% in Toronto; and for residential properties 2% outside of Toronto and 4% in Toronto.

LTT is payable under the Act on both registered conveyances of real property and unregistered dispositions of interests in real property. Though there are similarities between each form of taxation, there are also important distinctions between the two. We start, therefore, with a brief overview of the what, who, when, and how of land transfer tax.

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2 For municipal LTT rates see: City of Toronto, online: <www1.toronto.ca/wps/portal/contentonly?vgnextoid=a690a58e82ce1410VgnVCM10000071d6089RCRD&vgnextchannel=4f90f0e43db1410VgnVCM10000071d6089RCRD>; For provincial LTT rates see: Ministry of Finance, online: <www.fin.gov.on.ca/en/tax/ltt/>. 
2. **TAX ON REGISTERED CONVEYANCES – SECTION 2 TAX**

The basic taxing provision in the Act, Section 2(1), provides that "Every person who tenders for registration in Ontario a conveyance by which any land is conveyed to or in trust for a transferee shall pay when the conveyance is tendered for registration or before it is tendered for registration, a tax computed at the rate of … of the value of the consideration".

(a) **What is the tax payable?**

The graduated tax rates are set out in detail in Section 2(1) of the Act and Section § 760-9 of the Bylaw. The introduction to this paper sets out a rough guide to estimating the tax payable, and the Teraview system will automatically calculate the tax during preparation of a draft transfer. The term "value of the consideration" is discussed later in this paper.

(b) **Who must pay the tax?**

Section 2.2 of the Act provides that:

> Every person who immediately after the registration of a conveyance has a beneficial interest in the land that was acquired or increased as a result of a conveyance or as part of an arrangement relating to the conveyance is liable for the tax payable under subsection 2(1), unless the person has previously paid tax on the acquisition of or increase in beneficial interest.

We will discuss beneficial ownership of land shortly; at this point it is enough to say that the transferee of the land is the party who bears the liability to pay the LTT.

(c) **When is the tax due?**

On a conveyance pursuant to Section 2(1) of the Act, LTT is payable on the registration of the transfer. As Section 2(1) indicates, LTT may also be pre-paid, in which case no tax will be payable when the transfer is registered. In order to pre-pay tax certain administrative steps must be taken and payment must be made in person to the Ministry of Finance (the "Ministry").

(d) **How is the tax paid?**

If the registration is made by way of electronic registration in the Teraview system, land transfer tax is automatically debited from the trust account of the registering solicitor. If the registration is made in person at a land registry office, tax must be paid by certified cheque or bank draft in order for the conveyance to be accepted.

3. **TAX ON REGISTERED UNREGISTERED DISPOSITIONS – SECTION 3 TAX**

In Ontario, as in the rest of Canada, it is common for real property to be held by one person or entity in trust for another person or entity by virtue of a declaration of trust, a nominee agreement, or some other form of contract. Where such a structure exists, the person or entity holding title is commonly referred to as a "nominee" or "trustee" and the person or entity for whom title is held is referred to as the "beneficial owner". There are a number of commercial, tax,
confidentiality, and other reasons to create such a structure, each of which is beyond the scope of this paper. For our purposes, it is sufficient to note that since July 19, 1989, the Act has taxed dispositions of beneficial interests in land and, as a result, off-title transfers of land from one beneficial owner to another are taxable. Specifically, subject to the exclusions in Section 3(1), the Act defines a disposition of a beneficial interest in land as including: "(a) a sale, transfer or assignment, however effected, of any part of a beneficial interest in land; and (b) any change in entitlement to or any accretion to a beneficial interest in land". ³

(a) **What is the tax payable?**

The tax rate applied to a disposition of a beneficial interest in land is equivalent to the tax on a registered transfer. Pursuant to Section 3(2), tax on a disposition of a beneficial interest in land is payable "at the rates otherwise determined under Section 2". ⁴

(b) **Who must pay the tax?**

Tax under Section 3 of the Act is payable "by every person who acquires a beneficial interest in land or whose beneficial interest in land is increased as a result of the disposition". ⁵ Again, this means that the transferee is liable for the LTT payment.

(c) **When is the tax due?**

Unlike registered conveyances where the tax payable must be tendered at registration, tax payable under Section 3 must be paid "on the thirtieth day after the date of the disposition". ⁶

(d) **How is the tax paid?**

Unlike registered conveyances, tax payable under Section 3 must be paid by submitting a certified cheque, hard-copy return, and supporting materials to the Ministry, rather than to the land registry office. ⁷ If the land in question is located in the City of Toronto, true copies of all documents submitted to the Ministry must also be submitted to the City of Toronto along with the municipal portion of the tax payable. ⁸ The obligation to submit a return lies with the nominee, although in practice many include in the covering letter to the Ministry enclosing the return a request that the return by the beneficial owner be accepted as the return by the nominee. ⁹

³ Act, supra note 1, at s 3(1).
⁴ Act, supra note 1, at s 3(2).
⁵ Act, supra note 1, at s 3(3).
⁶ Act, supra note 1, at s 3(2).
⁷ Act, supra note 1, at s 5(7).
⁸ Bylaw, supra note 1, at § 750-42(A).
⁹ Act, supra note 1, at s 5(8); In Ontario, Ministry of Finance, "Land Transfer Tax “De Minimis” Partnership Exemption: Clarifying Amendments for Certain Dispositions", (Published February 2016), online: <www.fin.gov.on.ca/publication/ltt-deminimis-amendments-en.pdf> [De Minimis Bulletin], the Ministry acknowledges its acceptance of this practice under the heading "Filing Returns", specifically stating: "To help facilitate compliance and in accordance with its usual practice, the ministry accepts returns and payments made by a partner on behalf of other partners, as well as by trustee(s) on behalf of beneficiaries."
The form of hard-copy return under the Act is available online, as is the form required by the Bylaw. Along with the hard-copy return, a copy of the agreement of purchase and sale pursuant to which the transfer was affected must be provided. Additionally, the Ministry will typically request the following supporting documentation: statement of adjustments for the transaction, copy of the agreement pursuant to which the beneficial interest was conveyed (if distinct from the purchase agreement), copy of the nominee agreement(s) pursuant to which the nominee holds title for the beneficial owner, copies of the partnership agreement and register of partners for any partnership beneficial owner, and forms authorizing a law firm to represent the named transferee (if the return is being submitted by a law firm). Guides to the preparation of this material are available online.

4. TAXATION OF CERTAIN TRANSACTIONS

It is obvious that LTT is payable on a conventional sale of land between vendor and purchaser, but the definition of "convey" in the Act significantly broadens the scope of transactions that may be subject to tax. The Ministry publishes a helpful guideline in respect of these transactions, entitled "Guide to the Application of the Land Transfer Tax Act to Certain Transactions" (the "Certain Transaction Guide").

(a) Purchase Agreements

Though the term "convey" is defined to include "agreeing to sell land in Ontario", since Section 2 tax is payable only when a person "tenders for registration in Ontario a conveyance by which land is conveyed", the mere signing of a purchase agreement cannot be said to crystallize an obligation to pay LTT under Section 2. Likewise, the execution of a purchase agreement alone does not trigger Section 3 tax because of the saving provision in Section 3(1)(g), which provides that the value of the consideration must change hands before there is a disposition of a beneficial interest in land.

Though the signing of a purchase agreement itself does not trigger an obligation to pay tax, the registration of that purchase agreement (should the parties wish to do so in order to protect the purchaser's right to acquire the land against third parties, or for other reasons) does. This is evident from Section 2(1) of the Act, and is confirmed by the Ministry's position in the Certain Transaction Guide, which states "an agreement of purchase and sale or any related notice or caution is a taxable conveyance when tendered for registration". Upon registration of the transfer by which title is actually conveyed, a statement can be completed in the transfer stating that tax was already paid so that tax is not paid twice.
(b) Options to purchase

The term "convey" is also defined to include "the giving of an option upon or with respect to any land in Ontario". As such, the grant of an option to purchase land is taxable under Section 2 if the conveyance document creating the option is tendered for registration. The Act is less clear regarding unregistered options (because Section 3 does not impose tax based on a "conveyance" but based on unregistered dispositions of an interest in "land"). In practice, to the knowledge of the authors, most people do not remit tax on unregistered options.

The value of the consideration for the grant of an option is determined pursuant to the definition of "value of the consideration": namely, the price paid, liabilities assumed, and benefits conferred as part of the arrangement relating to the conveyance. Since the conveyance creating the option is only a conveyance of an option, not of the underlying property, the value of the consideration is only the amount paid to acquire the option. This is confirmed by the Ministry's position in the Certain Transaction Guide, which states, "The value of the consideration is the amount of the consideration paid by the optionee to acquire the option, and not the option exercise price".14 Likewise, when an option agreement is transferred by the original holder of the option to a purchaser of the option, LTT is payable on the purchase price paid for the option rights.15

(c) Easements

An easement is a form of tenement, estate, or right to land and, as such, falls within the definition of "land" in the Act. A grant or transfer of easement is, therefore, taxable under Section 2 or Section 3 just like a freehold interest in land, with tax payable on the value of the consideration exchanged.

(d) Transfer of units in a partnership or trust

Sections 2.2 and 3(3) of the Act state that tax is payable by every "person" who obtained an interest in land. The term "person" is not defined in the Act, but can be taken to mean natural persons as well as, pursuant to Section 87 of the Legislation Act, 2006, corporations.16 Partnerships (as well as trusts), on the other hand, are not persons but rather are a collective of, or a relationship between, persons.17 The Ministry's interpretation of the Act is in line with this legal perspective, and, accordingly, the Ministry looks through all partnerships or trusts until it reaches a natural person or corporation. Specifically, the Ministry's administrative position states that "a partnership is not a legal entity and therefore a conveyance or disposition of land to a partnership, whether the partnership is a general partnership or a limited partnership, constitutes a conveyance to the partners of the partnership as tenants-in-common and in proportion to their partnership interest(s)."18 Likewise, in respect of trusts, the Ministry's published guide notes: "The [Ministry] does not consider a "trust" to be an entity and looks through the trust to the beneficiaries".19 In the case of a discretionary trust where the class of beneficiaries is not fully known (for example, "all

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15 Act, supra note 1, at s 1(1): Consider the inclusion of the words "interest of an optionee" in the definition of "land".
16 Legislation Act, 2006, SO 2006, c 21, Schedule F.
17 See, for example, Superstars Mississauga Inc. v Ambler-Courtney Ltd., [1993] OJ No 1871, 15 OR (3d) 437 at para 5.
18 Unregistered Guide, supra note 11 at part 7.
of the issue of John Smith"), the determination is somewhat more complicated. See Part 3 of the Ministry's guide "A Guide for Real Estate Practitioners - Land Transfer Tax and the Registration of Conveyances of Land in Ontario" for some assistance.  

As a result of this position, the transfer of units in a partnership that beneficially owns real property is considered a disposition of a beneficial interest in that real property for which tax is be payable under Section 3. For a discussion of the value of the consideration attributable to such disposition, see the discussion below.

5. **VALUE OF THE CONSIDERATION**

   (a) **Amount paid and benefits conferred**

The term "value of the consideration" is specifically defined in the Act to capture many forms of consideration that might be paid in connection with the sale of real property. In a typical real property purchase, the value of the consideration is the sale price and will be determined pursuant to Section (a) of the definition of such term, being:

   the gross sale price or the amount expressed in money of any consideration given or to be given for the conveyance by or on behalf of the transferee and the value expressed in money of any liability assumed or undertaken by or on behalf of the transferee as part of the arrangement relating to the conveyance and the value expressed in money of any benefit of whatsoever kind conferred directly or indirectly by the transferee on any person as part of the arrangement relating to the conveyance [emphasis added].

   This definition captures a number of potential forms of payment, including the outstanding principal amount of any mortgage assumed by the transferee. The broad definition can also include amounts paid to acquire personal property. To use the words of the Ontario Superior Court of Justice, "the definition of "value of the consideration" clearly includes consideration for benefits that are not land so long as they are related to the conveyance."  

   Management and leasing fees included in an agreement of purchase and sale have, for example, been found to be taxable, as have nursing home licenses sold together with a nursing home. To the extent there is a significant connection between the benefit being conferred and the land the courts are more likely to hold that such benefit is taxable.  

   It is critical when structuring an agreement of purchase and sale including real property that separate contractual obligations between buyer and seller are not wound into the purchase agreement such that benefits of those contractual obligations become part of the arrangement

22 Act, *supra* note 1, at s 1(1).
23 *CSH Aurora Resthaven Inc. v Ontario (Minister of Finance)*, 2012 ONSC 4376 [*CSH*] at para 13.
24 *472601 Ontario Ltd. v Ontario (Minister of Revenue)*, 1987 Carswell Ont 689, 36 DLR (4th) 738, 47 RPR 91; *CSH, supra* note 23.
25 *CSH, supra* note 23 at paras 15 and 16.
relating to the conveyance and, as such, become taxable. The court’s 1987 decision in Assaly,\(^{26}\) followed recently in OPTrust\(^{27}\) provides a cautionary tale about creating strong connections between the land and other obligations in such contracts. In Assaly, the court concluded that where a builder-vendor agreed to sell land to a purchaser and also to build a home on that land, LTT was payable on both the value of the land and the construction costs of the home. The court came to the conclusion reluctantly, making it clear that typically a purchaser of raw land would pay LTT only on the raw land and that any future construction on the land wouldn’t be taxed. In the case before the court, however, the parties had wound the construction together with the land acquisition, even making the land purchase agreement conditional on the construction contract being entered into. The court cautioned that ”with appropriate tax planning such a result could be avoided”, but in the case before the court it could not hold otherwise.

Clearly the court’s caution to use appropriate tax planning holds just as true today as it did in 1987, as the 2016 case of OPTrust indicates. In OPTrust, a purchaser again contracted with a vendor-builder to acquire land and have the vendor build on that land. In order to secure the payments that would become due to it under the agreement, the vendor registered $26 million in mortgages on title at close (no funds were ever advanced under the mortgages—they were there simply to secure payment of future construction fees). The purchaser paid LTT on the land purchase price of $16 million as well as the $26 million in anticipated building costs to be secured by the mortgages. When, however, the construction project fell apart and the development agreement was terminated, the purchaser demanded a refund of the LTT paid on the $26 million. The Ontario Minister of Finance (the ”Minister”) refused and the parties ended up in court. The court found for the Minister, holding that that the construction services were a benefit conferred as part of the arrangement relating to the conveyance. Despite objections from counsel to the purchaser, the court found that the contingent nature of the obligation to pay for the services did not matter and instead followed another 1987 case, stating that ”It is the value of the services calculated at the time of the transfers that must govern the imposition of tax”.\(^{28}\)

Interestingly, the court in OPTrust found that the purchaser should have made use of the Ministry’s administrative policy of using undertakings when the value of the consideration hinges on a contingent event.\(^{29}\) These undertakings are often requested by the Ministry when a purchase agreement provides for payment of an additional amount in the event some additional event occurs, like the acquisition of some other lands within a specified period of time.

(b) **Fair market value**

In some circumstances the value of the consideration is not the amount paid, liabilities assumed, or benefits conferred, but instead is deemed to be the fair market value of the land in question. The first important instance of this deeming occurs in respect of leasehold interests in land.

Subject to one important exception, a conveyance (which includes an initial grant) of a leasehold interest is generally taxable under the Act. The definition of ”land” under the Act includes ”tenements and hereditaments and any estate, right or interest therein”, which, of course,

\(^{26}\) Assaly v Ontario (Minister of Revenue) (1986), 41 RPR 309, 56 OR (2d) 30, 30 DLR (4th) 291.
\(^{27}\) OPTrust Amaranth 1 Inc. v Ontario (Minister of Finance), 2016 ONSC 3648 [OPtrust].
\(^{28}\) Optrust, supra note 27 at para 31.
\(^{29}\) Registration Guide, supra note 19 at s 2.
includes leasehold interests. Likewise the definition of "conveyance" includes "any instrument or writing by which land is conveyed and includes … a caution or notice of any kind in writing signifying the existence of any instrument or writing by which land is conveyed", which includes leases.\(^{30}\) The exception to this rule is Section 1(6) of the Act, which provides that no tax is payable in respect of leases where the term yet to run does not exceed 50 years (including all extensions and renewals included in any document). For leases having a term of greater than 50 years, therefore, tax is payable and paragraph (c) of the definition of "value of the consideration" states that tax is payable on "the fair market value, ascertained as at the time of the tender or submission for registration, of the land to which the lease extends or of a smaller portion of such land if only such smaller portion is conveyed".\(^{31}\)

In addition to leasehold interests in land, there are several other instances in which the value of the consideration is deemed to be the fair market value of the land:

(i) Mortgage foreclosures: when land is transferred to a mortgagee, either as part of a foreclosure or transfer by the mortgagor in satisfaction of the debt, the value of the consideration may be the fair market value of the land if such amount is less than the sale price and the amount outstanding under the charge.\(^{32}\)

(ii) Trustee to trustee transfers, where beneficial ownership has changed and consideration was paid: See the discussion regarding trustee to trustee transfers for nil consideration, below.\(^{33}\)

(iii) Transfer to a corporation, taking back shares: if land is transferred to a corporation and the payment of any part of the consideration consists of the allotment and issuance of the corporation's shares (which would include a transaction structured as a Section 85(1) rollover pursuant to the *Income Tax Act* (Canada)), the value of the consideration is deemed to be the fair market value of the land.\(^{34}\)

(iv) Transfer from a corporation to its shareholders: if land is transferred by a corporation to its shareholders, the value of the consideration is deemed to be the fair market value of the land.\(^{35}\)

6. **NIL CONSIDERATION: NO TAX PAYABLE**

In circumstances where no consideration passes between the parties to a real property related transaction, the Act recognizes that no LTT is payable. This may occur in several situations.

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\(^{30}\) Act, *supra* note 1, at s 1(1).

\(^{31}\) Act, *supra* note 1, at s 1(1), definition of "value of the consideration", para (b) and (b.1).

\(^{32}\) *Ibid*.

\(^{33}\) Act, *supra* note 1, at s 1(1), definition of "value of the consideration", para (f).

\(^{34}\) Act, *supra* note 1, at s 1(1), definition of "value of the consideration", para (g).

\(^{35}\) *Ibid*.
(a) **Registered transfers involving trustees/nominees**

In transactions involving trustees/nominees there are three circumstances where transfers for no consideration commonly occur:\(^{36}\)

(i) **Beneficial owner to trustee:** Where a party wishes to create a nominee – beneficial owner relationship and to do so wishes to effect a transfer of legal title from itself to a nominee title holder.

(ii) **Trustee to trustee:** Where a nominee title holder wishes to transfer legal title from itself to a different nominee title holder who will hold title for the same beneficial owner.

(iii) **Trustee to beneficial owner:** Where the beneficial owner wishes to take back title from the nominee title holder and so become both the legal title holder and the holder of the beneficial interest in land.

There is a specific Teraview statement that must be completed in the registered transfer for each of these situations. Additionally, the transferee or the transferor must sign and submit a supplementary affidavit that makes a number of statements about the transfer.\(^{37}\) The statements required in this affidavit are intended to prove to the Ministry that the value of the consideration is nil (and that it should not be deemed to be fair market value).

One potential problem arises in the case of trustee to trustee transfers where there has been an affiliate deferral during the time the trustee owned the land. In such a case the provisions of Section (f) of the definition of "value of the consideration" will be triggered, because there will have been a change in beneficial ownership of the land, during the time the nominee held title, for which valuable consideration was paid (the consideration that was the subject of the deferral). In these situations a transfer will not be permitted for nil consideration but will instead be deemed to be at the fair market value. The statements that are required to be made in the supplementary affidavit require the parties to disclose whether or not this is the case. Section (f) of the definition of "value of the consideration" is a holdover from an earlier iteration of the Act and represents an early attempt by the Ministry to curb off-title beneficial transfers. It now arguably produces an unintended result, but it remains nonetheless and must be considered whenever an affiliate deferral is contemplated.

(b) **No change in beneficial owner**

Following the same line of reasoning that permits a trustee to trustee (for the same beneficial owner) transfer under Section 2 of the Act without payment of tax, a disposition of a beneficial interest where the parties on each side of such disposition are the same, to the extent they are the same, will not be taxable to such extent. Situations like this may occur where

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partnerships or trusts are involved and are possible because of the view of partnerships and trusts at law and in the Ministry's eyes (see discussion above).

Given this position, it is possible that the tax payable on a disposition of a beneficial interest in land to a partnership will be reduced where the transferor is either: (a) a partner in such transferee partnership, or (b) itself a partnership possessing common partners with the transferee partnership. The tax may be reduced because the interest in land being disposed of is less than 100% of the land. Since the disposition is for less than the whole of the interest, the amount of the consideration attributable to such disposition is reduced in a like proportion.

In such situations, as with all beneficial dispositions, a complete return must be filed in hard-copy with the Ministry, together with the supporting documentation mentioned earlier in this paper. In addition to such supporting documentation the Ministry will also typically request the partnership register(s) and partnership agreement(s) of the partnership(s) involved. If there is no change in beneficial ownership, no return is required to be filed because no tax is payable.38

Relevant to this point, as well as being an interesting illustration of the difference between Section 2 tax, Section 3 tax, and of the increased flexibility that Section 3 permits to a transferee, is the 2007 Ontario Court of Appeal decision Woodbine Cachet West Inc. v. Ontario (Finance) ("Woodbine").39 In Woodbine, a nominee title holder owned land for two beneficial owners; it had also charged the land to the Bank of Nova Scotia. The nominee defaulted on the mortgage and the bank sold the land to a new nominee (Woodbine), who acquired the land in trust for one of the existing beneficial owners. The existing beneficial owner argued that it should only have to pay LTT on the percentage by which it increased its interest in the land. The Minister, and the court, disagreed. The decision turned on the fact that the sale was being completed by the bank through its power of sale. The bank was not acting as agent for anyone, and it was selling, pursuant to a registered conveyance under Section 2 of the Act, the entire interest in the property that the original nominee had mortgaged to it. Accordingly, tax was payable on the entire purchase price.

Woodbine had essentially been arguing that it should have the benefit of the flexibility afforded under Section 3 of the Act and the court, rightly in our opinion, denied it that flexibility. In this scenario, it likely wasn’t possible for Woodbine or the bank to complete an unregistered disposition under Section 3 (as the bank’s enforcement remedies likely precluded it from completing the sale through an unregistered disposition), but the case is illustrative of the differences between the two sections and how proper tax planning and structuring can have an important impact.

(c) Gifts

Gifts of real property are not specifically excepted from taxation under the Act, but if the value of the consideration passing between the parties is actually zero (absent the transaction being one in which the value of the consideration is deemed to be the fair market value of the land), no LTT will be payable. On a registered transfer, specific Teraview statements must be completed where the transaction is a result of a gift, and the relationship between the parties, as well as the

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38 Act, supra note 1, at s 5(7).
39 Woodbine Cachet West Inc. v. Ontario (Finance), 2007 ONCA 809.
reason for the conveyance, must be set out in the transfer. On an unregistered disposition, a hard-
copy return must be filed.40

7. **EXEMPTIONS AND DEFERRALS: NO SECTION 3 TAX PAYABLE**

In certain circumstances, LTT under Section 3 of the Act is either not payable, may be
defered, or is subject to an exemption of some kind. We will address the most commonly
encountered of these situations.

(a) **Sale of shares in a corporation**

As we have seen, an unregistered disposition of a beneficial interest in land is subject to
tax under Section 3 of the Act, but does this include a sale of the shares of a corporation that owns
land? The answer is no, provided that such corporation holds title to the land in its own right (not
as trustee for another person), which is consistent with both the interpretation of the term "person"
under the Act as including a corporation, and with the Ministry's view of a corporation. The
Minster’s statements in the published guide regarding unregistered dispositions clarify as follows:

The transfer of shares of a corporation which holds land in its own right does not ordinarily attract tax under the Act. The Ministry considers that it is well-established law that the property of a corporation is that of the corporation and not of the shareholders of the corporation. Accordingly, the transfer of shares of such a corporation will not affect the ownership of the property ... Care must be exercised in instances of the transfer of shares of the corporation which holds the registered or legal title to land but not the beneficial title to the land. This is because in most trust transfer cases, the transfer of shares of a trustee corporation signals a change in the underlying beneficial ownership of the land. While the transfer of shares of the trustee corporation may not be of itself a taxable matter, the change in beneficial ownership of the land, which often occurs coincident with the transfer of the shares, is taxable.41

(b) **Affiliate deferral**

The Act recognizes that in some circumstances there may be a legitimate need to transfer
land to an affiliated entity where it would be unjust to impose tax. As such, Section 3(9) and 3(11)
of the Act provide for the deferral of, and potential cancellation of, LTT that would otherwise be
payable. The rules governing the affiliate deferral mechanism are complex and must be carefully
adhered to; the points in this paper should serve as a general guide only. Also useful is the
Ministry’s published guide "Land Transfer Tax and the Treatment of Unregistered Dispositions of
a Beneficial Interest in Land" (the "Unregistered Guide").42

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In brief, the Act provides that an affiliate deferral is available for corporation to corporation transfers where the transferee corporation: (i) undertakes to remain an affiliate of the transferor corporation for three years following the transfer; (ii) undertakes that the beneficial interest in the land will continue to be owned by it or an affiliate for three years following the transfer; (iii) posts security in the amount of the tax that would otherwise be payable together with interest for three years calculated at the prescribed rate; and (iv) no conveyance or instrument or electronic document evidencing the disposition has been registered at the end of the three year period. At the end of the three year period, the Ministry will return the security posted if: (i) the undertaking has been satisfied; (ii) no conveyance or instrument evidencing the disposition of the beneficial interest in land has been registered; and (iii) no subsequent conveyance has been registered nor beneficial disposition occurred in respect of the land for which tax was paid. Parties wishing to make use of this section must also review the provisions of Section 3(15) to ensure that they meet the definition of "affiliate".

In addition to the undertaking, the Ministry will also require a hard-copy submission of a return on the acquisition of a beneficial interest in land, a copy of the agreement of purchase and sale, and other supporting documents. Prior to returning the security, the Ministry will require evidence of the satisfaction of the undertaking, which may include: an affiliation chart showing the corporations graphically, details of any name change or amalgamation in the last three years, an affidavit of a director of the corporation making statements to support the information on the chart, copies of shareholders and directors ledgers, copies of title abstracts, and copies of all registered instruments since the date of the disposition.

Completion of an affiliate deferral will eliminate the transferee corporation's ability to complete a trustee to trustee for same beneficial owner transfer at any point in the future until the beneficial ownership changes hands and tax is paid. This is because Section (f) of the definition of "value of the consideration" deems such a transfer to be at fair market value if the beneficial ownership has changed hands and consideration has been exchanged. See the discussion regarding trustee to trustee transfers for nil consideration, above.

The affiliate deferral provisions are useful for any number of restructuring purposes. A person may wish, for example to organize a new investment vehicle which will receive funds from investors and then acquire the beneficial interest to properties already owned by affiliated parties. Or a person may wish to transfer the beneficial interest in properties from one investment vehicle to another. In each instance the affiliate deferral mechanism permits these transactions on a tax-free basis. In these examples registered title could be left in the original owner or, by completing a beneficial owner to trustee (or trustee to trustee) registered transfer, registered title could be transferred to another person to be held for the new beneficial owner.

The affiliate deferral provisions can also be used when a party wishes to wind up or dissolve a corporation that holds title to real property. Through Section 3(9), the dissolving corporation can transfer its beneficial interest in real property to another corporation or a corporate shareholder and have the tax deferred and ultimately cancelled. Section 3(12) permits for such a transfer-out and subsequent dissolution of a transferor corporation, and provides that the dissolved corporation will (for affiliate deferral purposes only) be deemed to continue to be an affiliate of the transferee corporation.

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43 Act, supra note 1, at s 3(9).
44 Act, supra note 1, at s 3(11).
corporation. If a party intends to rely on Section 3(12) for this purpose, it is critical to keep in mind the following:

(i) Transfer to a nominee: The affiliate deferral cannot be used to avoid Section 2 LTT—it applies only to unregistered dispositions of a beneficial interest in land under Section 3.45 Prior to completing an affiliate deferral, a corporation that holds both legal and beneficial title to land must complete a beneficial owner to trustee transfer. Such transfer is, itself, not taxable (see the section of this paper regarding situations where Section 2 tax is not payable), but is a prerequisite to completing an affiliate deferral. If, however, the corporation already holds only a beneficial interest in land, no preliminary step is required.

(ii) Organize affiliate entities before dissolution and complete transfer before or concurrently with dissolution: Section 3(12) specifically states that the corporations claiming the deferral must be affiliates "immediately before the winding-up or dissolving" and that the deferral is available only in respect of "any disposition of a beneficial interest in land made before the winding-up or dissolution of the corporation or in the course of any distribution of property of the corporation on the winding-up or dissolution." If the dissolution occurs before the affiliate structure is organized, or if the beneficial disposition occurs post-dissolution (for example, via a power of attorney granted on dissolution), the deferral will not be available.

An additional consideration when structuring and completing an affiliate deferral is maintenance of clean title for the three year period. The Act is clear that if a "conveyance or instrument evidencing the disposition of the beneficial interest in land has been registered" the security will not be returned.46 But what exactly constitutes a conveyance or instrument evidencing the disposition of the beneficial interest in land? The registration of a conveyance of legal title to the transferee corporation is such an instrument.47 Additionally, the registration of a conveyance of legal title to a trustee/nominee for the transferee corporation is deemed to be such an instrument, underscoring the need to complete the transfer of legal title to a nominee corporation prior to completing the unregistered disposition to the transferee corporation.

In addition to these two situations, each of which is specifically enumerated in the Act, the decision in 2143569 Ontario Inc. v. Ontario (Minister of Revenue) ("214") is instructive.49 In this decision the appellant corporation and two of its affiliates, NMH and YHM, properly structured an affiliate deferral whereby: (i) YHM initially held legal and beneficial title; (ii) YHM transferred legal title to NHM; and (iii) YHM subsequently transferred beneficial title to the appellant (with NHM holding legal title for the appellant). Once the three year period had elapsed, the appellant

46 Act, supra note 1, at s 3(11).
47 Act, supra note 1, at s 3(13.1); Contrast the current legislation with the decision in 932292 Ontario Inc. v Ontario (Minister of Finance), 1997 Carswell Ont 2418, [1997] OJ No. 2276, 30 OTC 394 (affirmed at the Ontario Court of Appeal in 932292 Ontario Inc. v Ontario (Minister of Finance), 1998 Carswell Ont 3578, 82 ACWS (3d) 813), where the court permitted an affiliate deferral and tax cancellation using the nominee as the affiliate transferee through a registered transfer followed by a beneficial disposition. This decision is arguably no longer relevant given the provisions of Section 13.1 of the Act.
48 Act, supra note 1, at s 3(13.1).
49 2143569 Ontario Inc v. Ontario (Minister of Revenue), 2014 ONSC 4628, 242 ACWS (3d) 970, 44 RPR (5th) 285.
submitted the required evidence of compliance with the undertaking and requested a return of its security. The Minister refused to return the security because during the three year period a development agreement between the City of Niagara Falls and the appellant had been registered on title. The development agreement stated, in its recitals, that "the trustee holds title to the lands … as trustee for the owner", where trustee was defined as NMH and owner was defined as the appellant. The development agreement did not use the term "beneficial owner", nor did it discuss YHM, nor did it mention how the appellant came to obtain its interest in the property.

Consistent with its standard practice, the Ministry took the position that the mere mention of the appellant in a document on title constituted the development agreement an instrument evidencing the disposition of the beneficial interest in land, breaching the undertaking and permitting the Ministry to not return the security. The court disagreed, and in doing so gave useful guidance about the interpretation of this section of the Act. The court took the view that the use of the two words "the disposition" in Section 3(11) of the Act meant that an instrument must not just refer to any disposition of land, but the specific disposition that is the subject of the deferral application. According to the court, the mention of the appellant as owner "may evidence that the appellant acquired the property (that is that there has been an acquisition), but does not refer to a specific disposition" and so did not offend this provision of the Act. The court went on to say that "Evidence of "the" disposition would at the very least have to identify the entity disposing of the property … and the entity benefitting from the disposition … The recital in the development agreement with the city of Niagara Falls does not accomplish this."51

Though the 214 decision was a successful outcome for the taxpayer, clearly the safest course of action is not to refer to the beneficial owner in any registered instrument.

(c)  **De minimis exemption**

Perhaps in recognition of the fact that the administrative position by which the Ministry looks through partnerships could be unduly burdensome, Ontario Regulation 70/91 under the Act (the "Regulation") provides for an exemption from tax for on the transfer of partnership interests below a certain threshold.52 Until February 17, 2016, the Regulation provided simply that "Section 3 of the Act does not apply to a disposition of a beneficial interest in land if it is an interest of a partner in a partnership and if the person acquiring the interest would not be entitled … to a percentage of the profits of the partnership … [of] more than 5 per cent …".53

As of February 18, 2016, however, the Regulation was substantially revised, perhaps to curb what the Ministry saw as an abuse of this exemption. The revised regulation has retroactive effect, applying to any transaction back to July 19, 1989.54 In response to criticism from the legal community, however, including a joint submission from the Chair of the Ontario Bar Association Taxation Law Section, the Canadian Bar Association, and the Chartered Professional Accountants Joint Taxation Committee, the Ministry published an update to its bulletin on the amended

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50 214, supra, at para 16.
51 214, supra, at para 18.
52 “Exemptions From Tax Under Section 3 of the Act O Reg 70/91 [Regulation] at s 1(3).
53 “Exemptions From Tax Under Section 3 of the Act O Reg 70/91 as it appeared on 17 February 2016 at s 1(2).
regulation stating that it would not reassess or prosecute transactions that occurred prior to February 18, 2012 (which follows the general four year limitation period for assessments or reassessments by the Ministry under Section 12(4) of the Act), and that if disclosure is made prior to December 31, 2016, no interest would be applied to amounts payable until December 31, 2016.55

The changes to the Regulation apply equally to municipal tax under the Bylaw pursuant to Section § 760-14 of the Bylaw which states that "No tax is payable with respect to a transaction which may be exempt from time to time under the Land Transfer Tax Act or any other statute of the Province of Ontario". Likewise, if a party is entitled to a refund under the Act a refund is available under the Bylaw, and items that call for the judgment of the City under the Bylaw are deemed to be satisfied or determined in the same manner as decided by the Ministry under the Act.57 Note, however, that the City has not published a bulletin confirming that it will not reassess or prosecute transactions occurring prior to a certain date, and that the City has a general six year limitation period for assessments or reassessments under Section § 760-74 of the Bylaw.

The revised Regulation does not eliminate the exemption completely. Rather, the amended language states that the exemption is not available "if the partner who acquires the partner’s interest in the partnership is a trust or another partnership".58

As a result, the exemption may still be used, but not by ‘layered’ or 'stacked' partnerships or trusts. Where real estate investment trusts held their interest in land through a limited partnership, for example, the exemption is no longer (and is deemed never to have been) available. The retroactive nature of this regulation is of serious concern and it will be extremely important for any party who may have completed such a transfer in the last four years to complete a review of such transactions prior to the end of this year in order to determine if additional disclosure and payment is required. Additionally, great care must be taken in structuring new transactions to ensure that the revised Regulation is complied with and no more than a single trust or partnership is involved in a transaction that seeks to rely on this exemption (which may have income tax implications for property owners, depending on the structure commonly used).

Assuming that a transaction is structured properly in order to make use of the exemption, the proper analysis of the Regulation and the Act is that no return is required to be filed in respect of an acquisition of a beneficial interest in land that does not meet the de minimis 5% threshold. Because the Regulation states that Section 3 does not apply to transactions that meet the specified criteria, and because Section 5(7) of the Act provides that only persons liable to pay tax under Section 3 must file a return, a partner acquiring a less than 5% entitlement to profit in a partnership (assuming the other criteria is met) is not required to file notice of same nor a return to the Ministry.

8. CONCLUSION

Despite being a relatively short piece of legislation focused on a very specific form of taxation, the Act is not as simple as it might first appear. The provisions of the Act are at times counter-intuitive and often forego clarity in favour at affording maximum flexibility to the Ministry. It comes as a surprise to many, for example, that the Land Transfer Tax Act taxes more

56 Bylaw, supra note 1, at 760-58.
57 Bylaw, supra note 1, at 760-1.
58 Regulation, supra note 52 at s 1(3).
than just transfers of land, including transfers of chattels and interests in partnerships or trusts that happens to own Ontario real estate. Parties also frequently fail to consider the specific provisions of Section 3 of the Act and the flexibility inherent in off-title dispositions, not to mention to the specific rules for affiliate deferrals. If the recent amendments to the *de minimis* regulation are any indication, land transfer tax disputes and structures will become more complex before they become simpler. Our hope is that this paper has provided food for thought and a roadmap of things to consider when structuring transactions and preparing to comply with the Act and its many rules.
Tax Planning for Professional Corporations

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TAX PLANNING FOR PROFESSIONAL CORPORATIONS

A. **INTRODUCTION**

Legislation in Ontario specifically permits certain professionals, including doctors, accountants, dentists and lawyers, to practise their profession in corporate form, provided that certain conditions are met and the written consent of the appropriate governing body of the profession is obtained. The legislation essentially permits a professional to practise as an employee of a professional corporation.

Under the *Income Tax Act*\(^1\) (Canada) (the “Act”) significant tax advantages may be available to a professional who practices through a corporation, of which he or she is both a shareholder and an employee, rather than directly from a practice operated in his or her name.

This paper discusses how the two main tax advantages of incorporation, being tax deferral and income splitting, apply to professional corporations. It also reviews current tax planning structures for partnerships, and compares those structures with the professional corporation model. Finally, consideration is given to several recent proposed amendments to the specified partnership rules and the proposed introduction of the specified corporate income rules in s. 125(7) of the Act. These amendments were introduced in the March 2016 Budget.

B. **REVIEW OF LEGISLATION**

In Ontario, the legislative framework for professional corporations is shared between the *Business Corporations Act*\(^2\) (the “OBCA”) and the relevant statutes, regulations and by-laws governing a specific profession.

The OBCA permits a professional corporation to practice a profession if it “holds a valid certificate of authorization or other authorizing document issued under an Act governing the profession.” Since this paper focuses on the tax aspects of incorporating a professional practice, it will not review in detail the rules in the OBCA governing the incorporation of a professional practice or the mechanics of obtaining a certificate of authorization.\(^3\) The important point to note for the purposes of this paper is that a professional incorporation is only effective for tax purposes if it is done in accordance with the rules of the professional’s governing body.

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1. R.S.C. 1985, c. 1 (5th Supp.) (the “Act”). All statutory references in this paper are to the Act unless otherwise noted.
2. R.S.O. 1990, c. B-16 (the “OBCA”).
3. The relevant provisions of the OBCA accompany this paper as Appendix A.
Another key point to note from a tax perspective is that the OBCA only permits professionals to be shareholders of a professional corporation. Subsection 3.2(2) of the OBCA provides that “all of the issued and outstanding shares of [a professional] corporation shall be legally and beneficially owned, directly or indirectly, by one or more members of the same profession”. This restriction generally precludes income splitting through a professional corporation, which is one of the primary benefits of incorporation.

The OBCA permits physicians and dentists to share ownership of their corporations with non-professionals. The *Health Profession Corporations Regulation*[^4] under the OBCA allows family members and trusts held for minor children who are family members to hold non-voting shares of a physician professional corporation or a dentist professional corporation. Lawyers and accountants however continue to be excluded from this benefit and cannot have non-professionals hold shares of their corporation.

In addition, professional governing bodies may hold different views on whether subsection 3.2(2) of the OBCA prevents a holding company or family trust from being a shareholder of a professional corporation. For example, the Law Society of Upper Canada ("LSUC") has taken the position that neither the *Law Society Act*[^5] nor the LSUC’s by-laws specifically prohibit the ownership of a professional corporation by a holding company, as long as the shares in the holding company are wholly owned by the practising lawyer. In contrast, the College of Veterinarians of Ontario regulations do not permit veterinarians to hold shares of a professional corporation through holding companies. The shares must be held directly by the licensed veterinarian. It is important therefore to contact one’s own professional governing body when planning to incorporate.

Although physician professional corporations and dentist professional corporations are permitted to have trusts as shareholders, the use of trusts is restricted to trusts that hold shares for minor children. Such trusts are not overly helpful from a tax planning perspective. (This will be discussed in greater detail below).

[^4]: O. Reg. 665/05.
[^5]: R.S.O. 1990, c. L.8, section 62(0.1)(28.1)
C. TAX ADVANTAGES OF INCORPORATION

The two main tax benefits available to a professional who incorporates are tax deferral and income splitting. Both advantages derive from the fact that a professional corporation pays tax at a preferential rate on its active business income earned in Canada each year up to a maximum amount of $500,000. A professional corporation’s entitlement to this $500,000 “small business limit” is absolutely crucial to the viability of incorporation.

The examples that follow use 2016 Ontario tax rates.

1. TAX DEFERRAL

The tax deferral advantage is available to a professional corporation that is repaying debt or that is retaining its after-tax income for investment because the professional corporation will be subject to a tax rate of 15% on the first $500,000 of taxable practice income earned by it in each fiscal year.

The tax deferral advantage arises because the corporation pays tax at a lower tax rate than the professional would pay personally. In contrast to the corporate rate of 15%, the top individual marginal tax rate for 2016 for an individual resident in Ontario with a taxable income of over $220,000 is 53.53%. Therefore, if a professional will otherwise pay tax at the top marginal rate, he or she can legitimately defer the payment of tax of about $.40 on each dollar of taxable income by leaving money in the professional corporation for investment or the repayment of practice related debt.

There is a common misconception that accumulating income-producing assets in a professional corporation ultimately results in higher aggregate tax on the investment income because the corporation pays tax on the investment income and the professional pays tax on the same income again when the corporation pays the professional a dividend. This concern is unfounded. Generally speaking, passive investment income (rents, interest, and royalties), capital gains and portfolio dividends will be taxed at approximately the same tax rate regardless of whether the income is received by a corporation and distributed to a shareholder or received by the individual directly.

Unincorporated professionals who have personal investments outside of an RRSP or TFSA and are only now planning to incorporate should consider transferring personally-owned investments to the professional corporation. The transfer can

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6 Such debt may have been incurred to buy assets used in the professional practice or investment assets and might be payable to the professional, third parties or a combination thereof.

7 Query whether paragraph 3.1(2)(5) of the OBCA renders such a transfer ultra vires because the professional corporation would acquire investments other than by using “surplus funds earned by the corporation”. The better view would appear to be that the paragraph does not have this effect.
usually be done on a tax-free basis (although there may be a savings by creating a capital gain on a transfer of investments to a professional corporation)\(^8\) and the result is usually that a large amount will be owing to the professional that can be withdrawn tax-free after the professional corporation has only paid tax at the small business rate.\(^9\)

For example, if an unincorporated professional had a portfolio with a fair market value of $150,000 and a tax cost of $100,000, the professional could transfer the portfolio to the professional corporation on a tax-free basis for a $100,000 shareholder loan and $50,000 of shares. The professional could then withdraw $100,000 from the professional corporation after it paid tax of approximately $15,000. The professional would otherwise pay tax of approximately $55,000 at the top marginal tax rate on the $100,000 of income. Therefore a tax deferral of approximately $40,000 will arise that will be lost when the portfolio is liquidated and the proceeds are paid to the professional in the form of a dividend.

Consideration should also be given to triggering the accrued gain in the portfolio from the example highlighted above. If the professional does not transfer the portfolio to the professional corporation on a tax-deferred basis, and instead chooses to realize a gain on the transfer, the professional would be subject to a tax rate of 26.76% on the capital gain of $50,000 ($150,000 - $100,000). This would result in taxes payable of $13,380. If the portfolio is subsequently liquidated in the professional corporation, the proceeds could be paid out to the professional or a family member as an eligible dividend at an effective tax rate of 39.34%. If a family member does not have any other significant source of income, he or she could receive an eligible dividend of up to $51,474 on a tax-free basis. Therefore triggering a capital gain may be an effective way to minimize taxes payable if a professional needs to liquidate a portfolio or requires funds from the professional corporation.

Finally it should be noted that there are two types of tax deferral:

1) the money now, tax later type of deferral; and

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8 Dividends are taxed at a higher rate than capital gains. Therefore some professionals transfer investments to a professional corporation on a taxable basis in consideration for a promissory note. The professional can then remove funds from the corporation tax-free by receiving payment for the note. The result is that funds can be extracted from a company at capital gain tax rates rather than dividend tax rates. Currently in Ontario the savings is approximately 13%.

9 The superficial loss rule must be considered whenever investments with accrued losses are transferred to a corporation.
2) the money later, tax later type of deferral.

Tax deferrals which permit taxpayers to spend money now but result in a tax bill later, such as a film tax shelter, are very effective but must be used with great caution because the taxpayer needs to plan ahead to pay the tax liability that may arise when the taxpayer has no cash to pay the tax. The tax deferral associated with saving corporately is preferable because the taxpayer will generally only have to pay tax if and when funds are removed from the professional corporation.

2. INCOME SPLITTING

As discussed above, Ontario permits non-voting participating shares of a medical or dental professional corporation to be held by a professional’s spouse, child or parent. This permits family members who are not active in the professional practice to share a portion of the professional corporation’s after-tax income by receiving dividends on shares that they directly or indirectly own. If these family members are 18 years of age or older, are in a low tax bracket and the corporation is properly structured, then the family, as a whole, will pay less tax than if the professional had earned all the income personally. Income splitting with children under 18 is severally restricted under the Act as a result of what is commonly referred to as “kiddie tax”. Kiddie tax, which is discussed further below, restricts the ability to split corporate income with a person under 18 years of age.

Currently an individual resident in Ontario, without any other source of income, can receive about $33,000 of non-eligible dividends tax-free by virtue of his or her basic personal tax credit and the dividend tax credit for non-eligible dividends.10 If dividends are paid to such an individual, that individual can use the funds to pay for certain family household expenses that the professional would otherwise pay for resulting in a tax savings of up to $.45 for each dollar of taxable income. If the professional corporation is earning income in excess of the small business deduction, the tax-free dividend increases to $51,000 for an Ontario resident individual that is not earning significant income.11

The advantage of paying dividends to family members rather than salary is that salary is subject to a reasonableness test. If the amount of any salary paid to a family member is more than what would be paid to a stranger, then the excess may not be deductible to the payor even though it is still income to the payee. It is not unusual for the Canada Revenue Agency (“CRA”) to assess penalties when lump sum amounts of salary are paid to minors. There is strong evidence that the CRA is currently taking a much more aggressive position with respect to the payment of

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10 Essentially a non-eligible dividend is a dividend that has been paid out of a professional corporation’s retained earnings that have benefited from the small business deduction. The difference between the tax treatment of eligible dividends and non-eligible dividends is discussed in detail below.

11 This is a result of the enhanced gross-up and enhanced dividend tax credit for eligible dividends.
unreasonable salaries to family members. There is no reasonableness test with respect to the payment of dividends.

(i) Trust Structure

A trust structure is often used to realize the full benefit of the savings that can be generated by income splitting since a trust structure can utilize a dependant’s low tax rates without giving up control over the money paid to them. Therefore, it may be preferable to issue the non-voting participating shares of the professional corporation to a discretionary trust whose beneficiaries are the professional’s spouse and children rather than issue the shares directly to the professional’s spouse and children.

Dividends and capital gains realized by a trust will retain their character for income tax purposes as the income is distributed to the beneficiaries of the trust, (provided the appropriate designations are made). Such a structure may be preferable for the following reasons:

(a) the professional’s spouse and children will not have a direct interest in the shares individually, thereby isolating the shares from both the beneficiaries themselves and their creditors; and

(b) the trust can easily be dissolved by transferring its assets to one or more of the beneficiaries (for example, to the spouse) on a tax deferred basis and this might solve the problem of getting “rid of the kids” once they become self-sufficient.

The disadvantage of using a trust is that it is more complex to administer and there are annual costs associated with accounting for its transactions and filing its tax return. Furthermore as outlined earlier, some professional governing bodies severely restrict or do not permit the shares of a professional corporation to be held by a trust. For example, the non-voting participating shares of a medical professional corporation or dental professional corporation in Ontario can only be held by a trust if the beneficiaries of the trust are minor children (the trust must be dissolved when the children turn 18 years old). As such, a trust structure may not always be helpful from a tax planning perspective.

(ii) Dividend Sprinkling Shares

An alternative to the use of a trust is the use of dividend sprinkling shares. Dividend sprinkling shares consist of numerous classes of common shares of which a separate class is issued to each family member and there is a specific power that permits dividends to be paid on any one class of shares to the exclusion of the others. While the CRA previously attacked the use of dividend sprinkling share structures, the validity of these structures has now been specifically sanctioned by the Supreme
Court of Canada. Such a structure should be considered, instead of a trust, in cases where:

(a) the professional’s children are very young. A trust generally distributes its assets every 21 years to avoid a deemed realization of its assets. To anticipate the effect of this distribution add 21 to the current age of each of the professional’s children and assess whether it is likely that the professional would be comfortable distributing shares to his or her children at that time; and

(b) it is unlikely that the professional will be able to accumulate significant assets in the corporation to pass on to the next generation. The real advantage of a trust over a dividend sprinkling structure is the ability to pass on future growth to the next generation. If there is no future growth, there would be no need for a trust structure.

Although there is a substantial loss of corporate control associated with issuing shares directly to family members, many dividend sprinkling share structures provide for a special class of redeemable shares to be issued to the children so that the professional corporation can redeem the shares at a subsequent time with or without the children’s cooperation.  

3. Attribution Rules

The Act contains a number of rules which are intended to prevent a high rate taxpayer from arranging his or her affairs in such a way that his or her income is decreased and the income of certain low rate individuals to whom he or she is related (usually his or her spouse and/or minor children) is increased with the result that their combined tax liability is reduced. The attribution rules do not preclude the opportunity to income split, as there are legitimate ways of ensuring that they will not apply.

The rules are complex, however, and must be carefully thought out as there is generally no simple solution to bringing a transaction that is subject to the attribution rules back on side. Further, it is important when establishing an income splitting structure that the relevant documentation be prepared and retained so that, in the

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12 The issue of shares of a professional corporation to a minor can create special problems under the attribution rules unless the corporation remains a “small business corporation” throughout the child’s minority. A “small business corporation”, among other things, must ensure that 90% or more of the fair market value of its assets are used in an active business. This is a stringent test, and trying to meet it will hamper a professional’s ability to take maximum advantage of the tax deferral because investments acquired with retained earnings will generally not be considered to be used in the business. The alternative, however, is also unpalatable: an attribution rule could apply to reduce the tax benefits associated with the professional corporation.
event of an enquiry by the CRA, it can be clearly demonstrated that the attribution rules have no application.

Without careful planning, the attribution rules could arise at two points in the incorporation process: first, when shares of the professional corporation are acquired by the professional’s spouse and/or children or by a trust established for their benefit and, second, on an ongoing basis as the corporation accumulates assets which are not necessary to the operation of the professional practice.

Avoiding the attribution rules is particularly important because not only will their application negate any intended tax advantage but in some cases may actually result in a substantially increased tax liability.

**4. Kiddie Tax**

After 1999, tax is imposed at the top marginal rate on “split income” distributed to a person under the age of 18 years. This tax is commonly referred to as “kiddie tax” and was introduced to eliminate a tax savings associated with splitting certain forms of passive income with minor children.

Kiddie tax will generally apply to taxable dividends and other shareholder benefits from private (not public) Canadian and foreign companies to a person under 18 years of age during the year (received directly or through a trust or partnership). The only deductions available from this tax are the dividend tax credit and foreign tax credit that are in respect of amounts included in split income. This effectively negates the tax savings which once were available from splitting income earned in a professional corporation by paying dividends to minor dependants. For dependants 18 years of age or older however, kiddie tax will not apply and dividends distributed to them will be taxed according to their marginal rates. For a professional with a dependant spouse, parents or a dependant child 18 years of age or older, the tax savings discussed above will be available.

**5. Miscellaneous Advantages**

In addition to the two main tax benefits of incorporation, there are a number of miscellaneous advantages that may be available to incorporated professionals.

(i) **Cheaper Non-Deductibility**

As long as incurring an expense will not result in a shareholder benefit, certain expenses which would be non-deductible to either the professional or the professional corporation should be incurred by the professional corporation. The cost of non-deductibility is less in the professional corporation because the corporation pays tax at a lower tax rate than the professional. Such expenses include life insurance
premiums, entertainment expenses and certain insurance premiums and social or sports club fees or dues, provided the membership creates a reasonable probability of generating business so that the dues and fees are not shareholder benefits to the professional.

(ii) **Retiring Allowances and Death Benefits**

A professional corporation may be able to arrange to pay retirement allowances or death benefits upon the retirement or death of an employee.

(iii) **Health and Welfare Trusts**

Certain contributions to private dental or professional plans for the employees of a corporation are not taxable to the employee and should therefore be paid by a corporation, where they are deductible.

(iv) **Individual Pension Plan**

It may be possible for an incorporated professional to arrange to have a pension plan established for his or her benefit by the professional corporation. The contributions to the individual pension plan would be made in lieu of contributions to a registered retirement savings plan and an advantage may arise depending on the particular professional’s circumstances. Some of the factors in determining whether it is more advantageous to establish an individual pension plan rather than use a RRSP is the age of the professional and the age of his or her spouse. Individual pension plans will have a significant cost in connection with establishing and administering them and therefore the advantage must be significant before it makes sense to pursue.

(v) **Loss Companies**

Family companies that have suffered non-capital losses might be changed into a professional corporation or wound up into a professional corporation so that the non-capital losses can then be used to shelter income from the professional practice. Careful scrutiny of the debt forgiveness rules and the acquisition of control rules is required when implementing this type of plan.

(vi) **Capital Gains Exemption**

While the basic $100,000 lifetime capital gains exemption was extremely important for incorporating professionals between 1988
and 1994, it is now rarely of importance. The $824,176 qualified small business corporation share (QSBCS) exemption is often not useful or cannot be used. A professional can obtain the benefit of the exemption only if he or she sells the shares of the corporation that operates the professional practice. A family physician, however, will often find that there are no buyers for such a practice. Even where there is a buyer, if the professional has taken maximum advantage of the deferral and invested large amounts in investments, the shares of the corporation might not qualify as QSBCSs so that the exemption will be unavailable. Rarely a large benefit is achieved by using the $1,000,000 qualified farm property exemption in respect of farm or fishing property owned continuously since June 17, 1987 (no 1994 capital gain exemption can be used) on the transfer of farm property to a professional corporation (or related corporation). This can permit the professional to remove $1,000,000 tax-free from the professional corporation.

D. ELIGIBLE DIVIDENDS

An eligible dividend is a taxable dividend that is received by a person resident in Canada, paid after 2005 by a corporation resident in Canada and designated in writing by the corporation to be an eligible dividend.

Generally speaking, eligible dividends may be paid to the extent that a professional corporation has a positive balance in its general rate income pool (“GRIP”) at the end of the taxation year. The calculation of GRIP is relatively complex; however, the intent of the calculation is to determine the professional corporation’s retained earnings that have been subject to tax at the general corporate tax rate. Therefore distributions from a profession corporation’s underlying earnings that have benefited from the small business deduction would not qualify as eligible dividends.

An eligible dividend that is received by a shareholder of a professional corporation will be subject to an enhanced gross-up of 38% and an enhanced federal dividend tax credit (“DTC”) of $1/11ths of the gross-up. As such, the tax treatment of eligible

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13 The $100,000 basic exemption would still be valuable if a professional filed an election in 1994 to increase the tax cost of the professional’s goodwill and the professional’s goodwill has maintained its value. This would permit the professional corporation to increase the amount that it can pay to the professional on a tax-free basis in consideration for the practice assets.

14 A professional corporation that pays an excess eligible dividend in a year may be liable under Part III.1 of the Act (for 20% of the excessive eligible dividend designation). In certain situations, a non-arm’s length shareholder may also be jointly and severally liable with the professional corporation for any amounts owing under Part III.1.
dividends is distinguished from the tax treatment of other taxable dividends (i.e. non-eligible dividends) which are subject to a 17% gross-up and federal DTC of 21/29ths of the gross-up.

There is also an enhanced provincial DTC which for 2016 and subsequent years is 36.3158% of the gross-up. This is in contrast to the provincial DTC of 29.50% of gross up on other taxable dividends. These amounts result in effective tax rates applicable to eligible and non-eligible dividends received by an individual in Ontario as follows:

<table>
<thead>
<tr>
<th></th>
<th>Eligible Dividends</th>
<th>Non-eligible Dividends</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Federal</strong></td>
<td>24.81%</td>
<td>26.30%</td>
</tr>
<tr>
<td><strong>Ontario</strong></td>
<td>14.53%</td>
<td>19.00%</td>
</tr>
<tr>
<td><strong>Combined</strong></td>
<td><strong>39.34%</strong></td>
<td><strong>45.30%</strong></td>
</tr>
</tbody>
</table>

Professional corporations that earn taxable income in excess of the small business deduction limit typically bonus down at the end of the year. This was a result of the fact that it was more advantageous to pay tax on the bonus at the top marginal rate for individuals than it was to pay tax at the corporate level and then again at the shareholder level when a dividend was paid out in the future. For example in 2006, the top marginal rate for an individual in Ontario was 46.41% and the integrated Ontario-federal corporate rate without the small business deduction was 55.63%. Therefore even though a professional corporation could benefit from the ability to invest an additional 10.3%\(^\text{15}\) by keeping the high-rate income in the corporation, this benefit was offset by the aggregate tax that would be paid by the professional corporation and the shareholder once the dividend was paid out.

However, reductions to the federal corporate tax rate combined with the creation of the GRIP and the decrease in the personal tax rate on eligible dividends have lowered the “cost” of keeping income in excess of the small business deduction in the professional corporation. For example, in 2016 the top marginal rate for an individual in Ontario is 53.53% and the integrated Ontario-federal corporate rate

\(^{15}\) This number is calculated by taking the Ontario personal rate of 46.41% and subtracting the combined Federal-Ontario 2006 general corporate rate of 36.1%.
without the small business deduction is 55.42%, resulting in savings of less than 2% when paying out a bonus. In comparison, keeping the high-rate income in the corporation would result in the ability to invest an additional 27%.

Therefore a professional that earns more than $500,000 a year may now benefit from a deferral in the corporation.

Table 3 outlines the deferral rates available in 2016 in respect of active business income that is subject to the general corporate tax rate:

<table>
<thead>
<tr>
<th></th>
<th>$500,000+ ABI</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Corporate Tax Rate</td>
<td>26.5%</td>
</tr>
<tr>
<td>Tax Rate on Eligible Dividend</td>
<td>39.34%</td>
</tr>
<tr>
<td>Effective Tax Rate after Eligible Dividend</td>
<td>55.42%</td>
</tr>
<tr>
<td>Personal Tax Rate</td>
<td>53.53%</td>
</tr>
<tr>
<td>Potential Deferral</td>
<td>27.03%</td>
</tr>
<tr>
<td>Savings (Cost)</td>
<td>(1.9%)</td>
</tr>
</tbody>
</table>

### E. PARTNERSHIPS

#### 1. INCORPORATING A PARTNERSHIP

Where a professional corporation is a member of a partnership, additional steps must be taken in order to preserve the tax benefits of incorporation; in particular, the professional corporation’s ability to claim the small business deduction. The specified partnership income rules in the Act require members of a partnership to share the small business deduction based on each corporate partner’s participating interest in the partnership. For example, a professional corporation that is a 10% partner in a partnership can only claim the small business deduction in respect of

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16 This number is calculated by taking the Ontario personal rate of 53.53% and subtracting the combined Federal-Ontario 2016 general corporate rate of 26.5%.
$50,000 of its allocated partnership income (10% x $500,000). Therefore if additional steps are not taken, there may be very limited benefits, if any, generated from incorporation for a professional that is practicing in a partnership.

It should be noted that amendments to the small business deduction rules have been proposed to limit the benefit that can be obtained through a partnership or central professional corporation. These new rules specifically address the structures detailed below and if enacted, will come into effect for taxation years beginning after March 21, 2016. Therefore care should be taken when considering implementing these structures as the benefits may be severely limited by the new legislation.

There are four ways the problem created by the specified partnership income rules have traditionally been remedied; (i) establish a cost-sharing arrangement; (ii) create a central professional corporation; (iii) allow the partnership to enter into a fee-for-service arrangement with professional corporations; and (iv) amend the partnership agreement to allow partners to establish a two-tier corporate partnership structure. Each of these structures are briefly described below.

(i) Cost-Sharing Arrangement

A cost-sharing arrangement relates to the sharing of costs and not of revenue. The partnership is wound up and each professional enters into a cost-sharing arrangement whereby each professional (incorporated or not) carries on his or her own practice. The costs associated with running the various practices are allocated amongst the members of the arrangement. Since the costs do not need to be allocated equally, it is often possible to achieve the same economic result that would arise under a partnership structure. The specified partnership income rules do not apply since the underlying entity is no longer a partnership and therefore each incorporated professional in the arrangement is entitled to claim the full $500,000 small business deduction. There is a risk, however, that the arrangement may still be construed as a *de facto* partnership if the members attempt to share expenses in a manner which reflects the sharing of profits. Furthermore, there is also a concern that the professional corporations in the arrangement would be associated with one another for the purposes of the Act and as such, required to share a single small business deduction limit.

(ii) Central Professional Corporation

In this structure, the partnership is wound up and a central professional corporation is incorporated. The former partners directly (as independent contractors) or indirectly (through professional corporations) provide professional services to the central professional corporation for a fee. The central professional corporation then provides professional services to the clients. The fees received by the professional corporations are not specified partnership income and therefore each professional corporation is entitled to claim its own small business deduction. The concern in this
structure is the possibility that the contracting professional corporations may be earning personal service business income, which is not eligible for the small business deduction.

As previously noted, amendments to the specified partnership rules were introduced in the 2016 Budget. Among these proposals is an amendment to the small business deduction rule which would introduce the term “specified corporate income” which may exclude income earned from corporations such as the central professional corporation from eligibility for the small business deduction. This exclusion may apply where a corporation provides services to another corporation in which it, a shareholder, or a non-arm’s length party holds a direct or indirect interest.

(iii) Fee-for-Service Arrangement

The partnership is not wound up in a fee-for-service arrangement. The professional becomes an employee of his or her own professional corporation and the professional corporation renders services to the partnership on a fee-for-service basis. These fees are not partnership allocations and therefore there is no requirement for the professional corporations to share the small business deduction limit. The professional also continues to carry out duties in his or her capacity as a partner, generally in areas relating to the administration and management of the partnership. The primary drawback of this structure is that it does not allow a professional to transfer his or her partnership capital to a professional corporation and thereby obtain the benefits of funding the partnership capital with corporate retained earnings.

The proposed amendments may also affect the fee for service arrangements. The proposed legislation introduces the concept of a “designated member”, meaning a corporation (more specifically a Canadian-controlled private corporation or “CCPC”) that while not a member of a particular partnership, provides services to that partnership in which either a shareholder has an interest or the corporation is not at arm’s length with a person who does. The specified partnership rules, as proposed, are expanded to include a designated member. These amendments may deem the designated member’s small business limit in circumstances such as those described above as nil, but allows for an actual member of the partnership to assign its portion of the $500,000 limit to the designated member.

(iv) Two-Tier Corporate Partnership Structure

The two-tier corporate partnership structure also does not require the partnership to be wound up. The professional transfers his or her partnership interest into a professional corporation (“corporate partner”) and the shares of the corporate partner are held by a second-tier corporation (which is ultimately owned by the professional). The professional enters into an employment agreement with the second-tier corporation, which enters into a contract for services with the corporate
partner. The corporate partner receives an income allocation from the partnership and is entitled to deduct the fees paid to the second-tier corporation. The second-tier corporation is not a partner and the fees it receives therefore would arguably not be subject to the specified partnership income rules. Unlike the fee-for-services arrangement, this structure allows a professional to fund partnership capital with corporate retained earnings since the professional is able to transfer his or her partnership capital to the corporate partner.

Since the proposed small business deduction rules discussed above apply where a shareholder or a non-arm’s length party holds either a direct or indirect interest in the partnership, the new rules may prevent income of a corporation in the two-tier structure from being eligible for the full $500,000 limit. As indicated above, these structures must be reconsidered in light of the proposed amendments and renewed attention must be paid when considering their potential benefit.

2. MANAGEMENT CORPORATIONS

In addition to reorganizing a partnership structure to ensure that the specified partnership income rules do not apply, a professional that practises in a partnership should also give consideration to the use of a management corporation or a management partnership in order to obtain certain income-splitting benefits. These benefits and a basic outline of the management corporation and management partnership structure are outlined below.

A management corporation is a corporation that provides management and administrative services. It may also own or lease the office premises, furniture and other business assets relating to the professional partnership. The shares of the management corporation are generally held by the professional’s spouse or a family trust in order to achieve income-splitting benefits.

The professional partnership pays the management corporation a reasonable fee (typically with a 15% mark-up) for the administrative services. The management corporation is entitled to claim the full $500,000 small business deduction in respect of the fees since the management corporation is not a member of the partnership. As noted above, the proposed changes to the specified partnership income rules would have to be reviewed prior to implementing these structures.

One drawback of this structure is the potential application of the harmonized sales tax (“HST”) on the fees paid from the partnership to the management corporation.

The transfer of the physical assets from the professional partnership to the management corporation can be done on a tax-deferred basis. However, the Harmonized Sales Tax (“HST”) may be payable on subsequent lease payments made by the professional partnership to the management corporation.
Certain professionals, such as doctors, dentists and others in the health services are not entitled to a refund of HST charged by the management corporation since they are not engaged in a “commercial activity” as defined by the *Excise Tax Act*. Therefore there may be an additional 13% cost to this structure for certain professionals.

3. MANAGEMENT PARTNERSHIPS

A management partnership is generally the preferred structure for a professional partnership because, unlike a management corporation, which must pay tax at the corporate level (and can only claim the small business rate on the first $500,000 of active income), no taxes are payable at the partnership level.

Similar to a management corporation, a management partnership provides administrative and non-professional services to the professional partnership for a fee (and a mark-up). The units of the management partnership may be owned by the professional directly, by his or her spouse or by a family trust. At the end of each year the net income of the management partnership is allocated amongst the partners based on the partnership agreement and taxes are payable by each partner based on his or her respective tax rate. Therefore considerable income-splitting benefits can be achieved where the units of the management partnership are held by family members or a trust for the benefit of family members that do not earn significant income.
APPENDIX A

Business Corporations Act

R.S.O. 1990, Chapter B.16

Professional corporations

3.1 (1) In this section and in sections 3.2, 3.3 and 3.4,

“member” means a member of a profession governed by an Act that permits the profession to be practised through a professional corporation; (“membre”)

“professional corporation” means a corporation incorporated or continued under this Act that holds a valid certificate of authorization or other authorizing document issued under an Act governing a profession. (“société professionnelle”) 2000, c. 42, Sched., s. 2.

Professions

(2) Where the practice of a profession is governed by an Act, a professional corporation may practise the profession if,

(a) that Act expressly permits the practice of the profession by a corporation and subject to the provisions of that Act; or

(b) the profession is governed by an Act named in Schedule 1 of the Regulated Health Professions Act, 1991, one of the following Acts or a prescribed Act:

5. Veterinarians Act. 2000, c. 42, Sched., s. 2; 2010, c. 6, Sched. A, s. 69; 2010, c. 6, Sched. C, s. 67.
Regulations

(3) The Lieutenant Governor in Council may make regulations prescribing Acts for the purposes of clause (2) (b). 2000, c. 42, Sched., s. 2.

Application of Act to professional corporations

3.2 (1) This Act and the regulations apply with respect to a professional corporation except as otherwise set out in this section and sections 3.1, 3.3 and 3.4 and the regulations. 2000, c. 42, Sched., s. 2.

Conditions for professional corporations

(2) Despite any other provision of this Act but subject to subsection (6), a professional corporation shall satisfy all of the following conditions:

1. All of the issued and outstanding shares of the corporation shall be legally and beneficially owned, directly or indirectly, by one or more members of the same profession.

2. All officers and directors of the corporation shall be shareholders of the corporation.

3. The name of the corporation shall include the words “Professional Corporation” or “Société professionnelle” and shall comply with the rules respecting the names of professional corporations set out in the regulations and with the rules respecting names set out in the regulations or by-laws made under the Act governing the profession.

4. The corporation shall not have a number name.

5. The articles of incorporation of a professional corporation shall provide that the corporation may not carry on a business other than the practice of the profession but this paragraph shall not be construed to prevent the corporation from carrying on activities related to or ancillary to the practice of the profession, including the investment of surplus funds earned by the corporation. 2000, c. 42, Sched., s. 2; 2002, c. 22, s. 8; 2005, c. 28, Sched. B, s. 1 (1).

Deemed Compliance

(2.1) A professional corporation that has a name that includes the words “société professionnelle” shall be deemed to have complied with the requirements of subsection 10 (1). 2004, c. 19, s. 3 (1).
Corporate acts not invalid

(3) No act done by or on behalf of a professional corporation is invalid merely because it contravenes this Act. 2000, c. 42, Sched., s. 2.

Voting agreements void

(4) An agreement or proxy that vests in a person other than a shareholder of a professional corporation the right to vote the rights attached to a share of the corporation is void. 2000, c. 42, Sched., s. 2.

Unanimous shareholder agreements void

(5) Subject to subsection (6), a unanimous shareholder agreement in respect of a professional corporation is void unless each shareholder of the corporation is a member of the professional corporation. 2000, c. 42, Sched., s. 2; 2005, c. 28, Sched. B, s. 1 (2).

Special rules, health profession corporations

(6) The Lieutenant Governor in Council may make regulations,

(a) exempting classes of health profession corporations, as defined in section 1 (1) of the Regulated Health Professions Act, 1991, from the application of subsections (1) and (5) and such other provisions of this Act and the regulations as may be specified and prescribing terms and conditions that apply with respect to the health profession corporations in lieu of the provisions from which they are exempted;

(b) exempting classes of the shareholders of those health profession corporations from the application of subsections 3.4 (2), (4) and (6) and such other provisions of this Act and the regulations as may be specified and prescribing rules that apply with respect to the shareholders in lieu of the provisions from which they are exempted; 2005, c. 28, Sched. B, s. 1 (3).

(c) exempting directors and officers of those health profession corporations from the application of such provisions of this Act and the regulations as may be specified and prescribing rules that apply with respect to the directors and officers in lieu of the provisions from which they are exempted.
Consequences of occurrence of certain events

3.3 (1) Despite any other Act, a professional corporation’s certificate of authorization or other authorizing document remains valid and the corporation does not cease to be a professional corporation despite,

(a) the death of a shareholder;
(b) the divorce of a shareholder;
(c) the bankruptcy or insolvency of the corporation;
(d) the suspension of the corporation’s certificate of authorization or other authorizing document; or
(e) the occurrence of such other event or the existence of such other circumstance as may be prescribed. 2000, c. 42, Sched., s. 2; 2001, c. 8, s. 1 (1); 2001, c. 23, s. 6 (1).

Invalidity of certificate

(2) Subject to the regulations, a certificate of authorization or other authorizing document becomes invalid and the corporation ceases to be a professional corporation on the revocation of the certificate. 2000, c. 42, Sched., s. 2; 2001, c. 8, s. 1 (2).

Regulations

(3) For the purposes of subsection (1), the Lieutenant Governor in Council may make regulations,

(a) prescribing events and circumstances for the purposes of clause (1) (e);

(a.1) providing that, despite clause (1) (a), (b), (c), (d) or (e), whichever applies, a professional corporation’s certificate of authorization or other authorizing document ceases to be valid and the corporation ceases to be a professional corporation because of a failure to meet the terms and conditions described in the regulation;

(a.2) prescribing terms and conditions that apply with respect to the events and circumstances referred to in clauses (1) (a), (b), (c), (d) and (e);
(a.3) prescribing exceptions to the events and circumstances referred to in clauses (1) (a), (b), (c), (d) and (e);

(b) prescribing the manner in which shares of a shareholder are to be dealt with on the occurrence of any event mentioned in clauses (1) (a) to (e), the time within which they are to be dealt with and any other matter related to dealing with the shares.

2000, c. 42, Sched., s. 2; 2001, c. 23, s. 6 (2).

No limit on professional liability

3.4 (1) Subsection 92 (1) shall not be construed as limiting the professional liability of a shareholder of a professional corporation under an Act governing the profession for acts of the shareholder or acts of employees or agents of the corporation. 2000, c. 42, Sched., s. 2.

Deemed acts

(2) For the purposes of professional liability, the acts of a professional corporation shall be deemed to be the acts of the shareholders, employees or agents of the corporation, as the case may be. 2000, c. 42, Sched., s. 2.

Professional liability

(3) The liability of a member for a professional liability claim is not affected by the fact that the member is practising the profession through a professional corporation. 2000, c. 42, Sched., s. 2.

Joint and several liability

(4) A person is jointly and severally liable with a professional corporation for all professional liability claims made against the corporation in respect of errors and omissions that were made or occurred while the person was a shareholder of the corporation. 2000, c. 42, Sched., s. 2.

Same

(5) The liability of a member under subsection (4) cannot be greater than his or her liability would be in the circumstances if he or she were not practising through the professional corporation. 2001, c. 8, s. 2.

Same, partnerships and limited liability partnerships

(6) If a professional corporation is a partner in a partnership or limited liability partnership, the shareholders of the corporation have the same liability in
respect of the partnership or limited liability partnership as they would have if the shareholders themselves were the partners. 2001, c. 8, s. 2.
Professionalism: Dealing with Non-Compliant Taxpayers
Income Tax Act Search Warrants & Ethical Considerations to Avoid Pitfalls

Christi Hunter
Heller, Rubel Professional Corporation

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Professionalism: Dealing with Non-Compliant Taxpayers
Income Tax Act Search Warrants & Ethical Considerations to Avoid Pitfalls

Christi Hunter, Assisted by Stephanie Polgar (HELLER, RUBEL)

Someone’s Knocking at the Door… Let ‘Em In?

Are you competent/insured to deal with this issue?

Relevant Rules of Professional Conduct and Commentary

Competence
3.1-1 In this rule, “competent lawyer” means a lawyer who has and applies relevant knowledge, skills, and attributes in a manner appropriate to each matter undertaken on behalf of a client including:

(a) Knowing general legal principles and procedures and the substantive law and procedure for the areas of law in which the lawyer practises;

(h) Recognize limitations in one’s ability to handle a matter or some aspect of it, and taking steps accordingly to ensure the client is appropriately served;

Commentary
[6] A lawyer must recognize a task for which the lawyer lacks competence and the disservice that would be done to the client by undertaking that task. If consulted about such a task, the lawyer should:

(a) Decline to act;

(b) Obtain the client’s instructions to retain, consult, or collaborate with a licensee who is competent for that task; or

(c) Obtain the client’s consent for the lawyer to become competent without undue delay, risk or expense to the client.

- Often clients will be aware that there is an investigation by the Canada Revenue Agency (CRA) prior to a search warrant being executed. For example, they may receive a letter notifying them that their matter has been referred out of audit into special investigations, or an investigator from the special investigations divisions of the CRA may have contacted them or someone else about the matter.
As soon as you are aware there is a criminal investigation, or suspect there may be one forthcoming, a lawyer must assess if they are competent to deal with the issues. If not, the client should be referred to criminal counsel for advice. Counsel, upon instruction from the client, should work together to tackle the different issues and problems arising with a non-complaint taxpayer.

Client’s Charter rights are engaged once they are being criminally investigated:

- Section 7 – Everyone has the right to life, liberty and security of the person and the right not to be deprived therof except in accordance with the principles of fundamental justice. The right to remain silent is a principle of fundamental justice.

- Section 8 – Everyone has the right to be secure against unreasonable search or seizure.

Show Me the Search Warrant

A search warrant may be issued pursuant to Section 231.3(1) of the *Income Tax Act*, RSC 1985, c 1 (5th Supp).:

Search Warrant

231.3(1) A judge may, on ex parte application by the Minister, issue a warrant in writing authorizing any person named therein to enter and search any building, receptacle or place for any document or thing that may afford evidence as to the commission of an offence under this Act and to seize the document or thing and, as soon as practicable, bring it before, or make a report in respect of it to, the judge or, where the judge is unable to act, another judge of the same court to be dealt with by the judge in accordance with this section.

(2) An application under subsection 231.3(1) shall be supported by information on oath establishing the facts on which the application is based.

(3) A judge may issue the warrant referred to in subsection 231.3(1) where the judge is satisfied that there are reasonable grounds to believe that:

(a) An offence under this Act was committed;
(b) A document or thing that may afford evidence of the commission of the offence is likely to be found; and
(c) The building, receptacle or place specified in the application is likely to contain such a document or thing.

(4) A warrant issued under subsection 231.3(1) shall refer to the offence for which it is issued, identify the building, receptacle or place to be searched and the person alleged to have committed the offence and it shall be reasonably specific as to any document or thing to be searched for and seized.

(5) Any person who executes a warrant under subsection 231.3(1) may seize, in addition to the document or thing referred to in that subsection, any other document or thing that the person believes on reasonable grounds affords evidence of the commission of an offence under this Act and shall as soon as practicable bring the document or thing before, or make a report in respect thereof to, the judge who issued the warrant or, where the judge is unable to act, another judge of the same court to be dealt with by the judge in accordance with this section.

(6) Subject to subsection 231.3(7), where any document or thing seized under subsection 231.3(1) or 231.3(5) is brought before a judge or a report in respect thereof is made to a judge, the judge shall, unless the Minister waives retention, order that it be retained by the Minister, who shall take reasonable care to ensure that it is preserved until the conclusion of any investigation into the offence in relation to which the document or thing was seized or until it is required to be produced for the purposes of a criminal proceeding.

(a) Will not be required for an investigation or a criminal proceeding; or
(b) Was not seized in accordance with the warrant or this section

(7) Where any document or thing seized under subsection 231.3(1) or 231.3(5) is brought before a judge or a report in respect thereof is made to a judge, the judge may, of the judge’s own motion or on summary application by a person with an interest in the document or thing on three clear days notice of application to the Deputy Attorney General of Canada, order that the document or thing to be returned to the person from whom it was seized or the person who is otherwise legally entitled thereto if the judge is satisfied that the document or thing

(8) The person from whom any document or thing is seized pursuant to this section is entitled, at all reasonable times and subject to such reasonable conditions as may be imposed by the Minister, to inspect the document or thing and to obtain one copy of the document at the expense of the Minister.

A search warrant may also be issued pursuant to section 487 of the *Criminal Code of Canada*, RSC 1985, c C-46.
Review the Warrant

Get a copy of the warrant as quickly as possible. Read the warrant to determine the search perimeters:

- Who is allowed to search the premises? (The searching officers must be specified)
- What are they allowed to search for? (For example, what years are specified in the warrant, for which documents?)
- What address, building, storage facility, etc. is specified in the search warrant? (If it is not specified, the officers cannot enter and search.)
- Make contact with the officer in charge of the search warrant
- A client cannot interfere with the lawful execution of the search

Advising the Client – Who Else Needs Advice?

- Special investigations, and/or other law enforcement agencies may seek to question individuals on site while conducting the warrant
- Know who your client is and if there are any possible conflicts
- Encourages others to seek independent legal advice (ILA)

Relevant Rules of Professional Conduct and Commentary

When Client an Organization
3.2-3 Notwithstanding that the instructions may be received from an officer, employee, agent or representative, when a lawyer is employed or retained by an organization, including a corporation, in exercising the lawyer’s duties and in providing professional services, the lawyer shall act for the organization.

Commentary

[1] A lawyer acting for an organization should keep in mind that the organization, as such, is the client and that a corporation client has a legal personality distinct from its shareholders, officers, directors, and employees. While the organization or corporation will act and give instructions through its officers, directors, employees, members, agents, or representatives, the lawyer should ensure that it is the interests of the organization that are to be served and protected. Further, given that an organization depends upon persons to give instructions, the lawyer should ensure that the person giving instructions for the organization is acting within that person’s actual or ostensible authority.

[2] In addition to acting for the organization, the lawyer may also accept a joint retainer and act for a person associated with the organization. An example might be a lawyer advising about liability insurance for an officer of an organization. In such cases the lawyer acting for an
organization should be alert to the prospects of conflicts of interest and should comply with the rules about the avoidance of conflicts of interest. (Section 3.4)

Duty to Avoid Conflicts of Interest
3.4-1 A lawyer shall not act or continue to act for a client where there is a conflict of interest, except as permitted under the rules in this Section.

You Have the Right to Remain Silent... or Tell the Truth

Obstructing Justice
- Client must be advised that they do not have to answer any questions by the investigators (and may properly be advised not to answer questions), but if they do, they must be truthful or risk being charged with “obstructing justice” contrary to section 139 of the Criminal Code.
- Additionally, client must be advised not to dissuade others by “threats, bribes, or other corrupt means from giving evidence” or risk being charged with obstructing justice
- Client may be advised to tell others that they are under no obligations to speak with investigators, but should speak with counsel before making a decision
- Others should seek ILA to avoid any conflicts of interests

Protecting That Privilege

Solicitor-Client Privilege Issues
- Ask client immediately if there are documents on site which may be subject to solicitor-client privilege
- Section 232(1) of the Income Tax Act excludes “accounting records” of a lawyer, and any supporting cheque or voucher
- Are there documents that in-house counsel has in their office?
- Err on the side of caution in making a claim to ensure that privilege is not unduly lost
- Section 232 of the Income Tax Act governs the procedure to claim solicitor-client privilege on documents about to be seized by CRA pursuant to a warrant:
  - Notify officer that documents they are about to seize are subject to solicitor-client privilege
- Officer shall place document(s) in a package without inspecting, examining, or making copies of the documents
- The package will be sealed, and placed in the custody of the sheriff, or on another person that the officer and lawyer agree will act as custodian
- An application can be made to a judge to determine the issue
Spotting the Tax Issues in Business Transactions

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1. Structure of Transaction

The transfer of a business, whether by way of an asset or a share transaction, must be carefully structured and documented so as to give full effect to the intentions of the contracting parties and properly allocate the risk. Company management typically initiate the transaction, and the tax advisors are subsequently involved to review their client’s intentions and advise the proper documentation to implement the tax objectives.

A fundamental matter to be determined is whether the transaction is to be achieved by way of a sale of shares or a sale of assets. The general rule of thumb is that vendors prefer to sell shares and purchasers prefer to acquire assets.¹

The advantages and disadvantages of each approach are as follows:

<table>
<thead>
<tr>
<th>Why Share Transaction:</th>
<th>Why Asset Transaction:</th>
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<tbody>
<tr>
<td>For vendor, offers a potential deferral of immediate taxation e.g., safe income election or capital gains exemption for QSBC shares.</td>
<td>Full tax basis in acquired assets (including goodwill) results in higher base for future deductions (or for future disposition), but forgoes access to vendor’s tax loss carryforwards and other tax pools. However, a tax shield calculation could be the solution to bridge the tax leakage between a share and asset transaction.</td>
</tr>
<tr>
<td>Potential tax exemption for non-Canadian vendors if shares are not Taxable Canadian Property or are treaty-exempt.</td>
<td>Purchaser acquires only the assets it wants or needs to carry on the business. Therefore, does not become responsible for the historical tax liabilities of the company, and does not assume general responsibility for liabilities except for those specifically assumed under the Purchase and Sale Agreement (the “PSA”).</td>
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Minimizes transaction taxes e.g., land transfer tax, possibly provincial Retail Sales Taxes.

Reduces the need to complete income tax due diligence and to draft extensive tax representations in the PSA.

Key non-tax factor – Share transaction may be only viable transaction structure (e.g., public company target; reduces need to obtain 3rd party consents on transfer of contractual rights to a new legal entity; retains customer loyalty to existing legal entity).

A transaction structure that has sometimes been used to bridge the differences between an asset sale and a share sale has been a “hybrid transaction”, whereby both shares and assets are sold as part of the transaction structure. This transaction structure has typically been tax efficient for both the vendor (who obtains a lower effective tax rate) and the purchaser (who acquires most of the assets at a stepped up tax cost). However, changes to the tax treatment of eligible capital property, which will be effective on January 1, 2017, will result in the hybrid transaction structure losing much of its tax efficiency to the vendor. As such, there may be reduced motivation to the vendor of implementing a hybrid sale transaction structure subsequent to December 31, 2016. However, it should be recognized that even under an asset purchase, a vendor may be highly motivated to structure at least a portion of the transaction as a share purchase in order to benefit form the capital gains exemption.

2. Purchase Price Considerations

The manner in which the purchase price is to be paid must be considered. First, will the purchase price be paid in cash, shares, an assumption of liabilities or some combination thereof? Second, will there be any purchase price adjustments? Finally, will the purchase price to be paid in full on the closing of the transaction, or will a portion be deferred until a future date?

In general, the purchase price payable in a transaction will exclude sales taxes unless the parties specify that the price is to be inclusive of such. In share transactions, sales taxes are generally irrelevant as shares are not subject to sales taxes. However, given that the purchaser would be

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3 Excise Tax Act (“ETA”) section 223 provides for the collection of GST/ HST on a tax-extra or tax included basis. ETA section 224 provides the right of the vendor to enforce collection of the GST provided that the invoicing satisfied the specified requirements. See also CRA GST Policy Statement P-116 “Collection of GST, by a Supplier, where the Invoice is Silent on the Tax Payable” (dated January 27, 1994). With respect to provincial sales taxes, the sales tax is generally required to be identified as an extra charge payable by the purchaser: Provincial Sales Tax Regulation (BC) B.C. Reg. 96/2013 at section 85; Revenue Collection Administration Regulations (Saskatchewan) c.22.01 Reg. 2 at section 12; and Retail Sales Tax Act (Manitoba), Regulation 75/88R at section 9(1).

4 See ETA subsection 123(1) "financial instrument" (a); subsection 123(1) "financial service" (d); ETA Schedule V, Part VII. With respect to the provincial sales taxes levied by British Columbia, Manitoba and Saskatchewan, the
assuming all of the liabilities of the legal entity, it would still be necessary to obtain a general representation that all taxes, including sales taxes, have been remitted on a timely basis.

Assumption of Liabilities

Generally, where the purchase price is satisfied by the assumption of liabilities, the amount of the assumed liabilities is considered proceeds to the vendor. The liabilities assumed become part of the cost of the assets or shares acquired by the purchaser.

In circumstances where the amount of liabilities assumed exceeds the tax basis of the assets or shares transferred on a tax-deferred basis under either subsection 85(1) or 97(2) of the Income Tax Act (the “Act”), an income inclusion to the vendor may arise. For example, the Canada Revenue Agency (the “CRA”) considered this issue when reviewing a situation involving mortgages that exceeded the tax value of the real estate being transferred under subsection 97(2). The CRA concluded that the assumption of the excess mortgages would be considered consideration on the rollover and would therefore result in an income inclusion. This position is consistent the CRA’s position in respect of subsection 85(1) as noted in Interpretation Bulletin IT-291R3.6

Price Adjustment Clauses

Generally, on the transfer of a business, the purchase price would be determined at the time of negotiation on the basis of the most recent financial information available, which will differ from the financial information available on closing. Purchase price adjustments clauses are included in PSAs in order to reflect these changes in arriving at the final purchase price. A common post-closing adjustment is a working capital adjustment which is intended to reflect any changes in current assets and current liabilities. Typically, post-closing adjustment clauses adjust the purchase price either upwards or downwards to reflect fluctuations in working capital. Since the working capital amount can only be calculated with certainty after the transaction closes, it would be estimated as at the time of closing.

Drafting Considerations:

The PSA should address the following issues with respect to price adjustment clauses:

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sales tax is imposed only the “tangible personal property” and enumerated taxable services. The definition of “personal property” generally includes “personal property that can be seen, weighed, measured, felt or touched, or that is in any other way perceptible to the senses, and includes natural or manufactured gas, electricity, heat, and affixed machinery”; see for example Provincial Sales Tax Act (BC) SBC 2012, C. 35 (the “BC Act”) at section 1.


7 As a practical matter, working capital adjustments are a common source of post-closing disputes.
• Specify a clear accounting methodology and consistent application, (such as international financial reporting standards (IFRS) or accounting standards for private enterprise (ASPE)), but that it must also reflect the vendor’s past accounting practices; and
• Determine how any adjustments will be settled, e.g., use of escrow funds.

Purchase Price Adjustment Clauses in Non-Arm’s Length Transactions

A purchase price adjustment clause, whether incorporated into a share sale agreement or asset sale agreement, would typically be used where the transaction is between related parties and they wish to avoid adverse tax consequences should the CRA or other tax authorities subsequently determine that the sale price was not reflective of fair market values.8 Adverse tax consequences could be imposed under several sections of the Act. The primary focus of such tax consequences is often section 69, where a one-sided adjustment could result in the vendor’s sale proceeds being increased without an offsetting adjustment to the purchaser’s tax cost. This would create the potential for double taxation. Other adjustments could arise under attribution and indirect benefit provisions such as section 15, sections 74 to 74.3, paragraph 85(1)(e.2), and subsection 86(2) of the Act. A price adjustment clause – apart from conventional working capital adjustments – is not typically used in an arm’s length sale. The reason is that the arm’s length transaction would serve to validate the value of the consideration being paid.

If a price adjustment clause is invoked, the relevant purchase price will be adjusted by the difference between the fair market value of the property (as finally determined) and the price otherwise determined under the PSA.

The Canada Revenue Agency has revised its policies on price adjustments clauses in Income Tax Folio S4-F3-C1 and cancelled the provisions that were formerly reflected in Interpretation Bulletin IT-169 (“Price Adjustment Clauses”). The Income Tax Folio states that the following four requirements must be satisfied in order to implement a valid price adjustment clause:

• The agreement reflects a bona fide intention of the parties to transfer the property at FMV.
• The FMV for the purposes of the price adjustment clause must be determined by a fair and reasonable method. The taxpayer’s reliance on a different valuation method than the one chosen by the CRA and the relative inaccuracy of a FMV determination performed in good faith will not, in and of itself, compromise the effectiveness of the price adjustment clause.
• The parties agree that if the FMV of the transferred property determined by the CRA or a Court of law differs from their valuation, they will use the value determined by the CRA or the Court.
• The excess or shortfall in price is actually refunded or paid, or a legal liability therefor is adjusted.

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The Income Tax Folio at paragraphs 1.6 and 1.7 consider how the price adjustment clause could be implemented

1.6 Where the price adjustment clause relates to the issuance of shares in consideration for the transfer of a property, the price adjustment may be implemented in a number of ways, including through a change in the redemption value of the shares, the issuance of a note or a change in the principal amount of the note issued with the shares.

The price adjustment may also be implemented by issuing additional shares or by cancelling issued shares without payment such that the FMV of the shares reflects the adjusted FMV of the property transferred. However, a price adjustment clause providing for the issuance of additional shares or cancellation of issued shares without payment in order to adjust the value of the consideration received carries with it a number of legal and technical difficulties that are best avoided from the perspective of both taxpayers involved and the CRA. For instance, events like the winding–up, reorganization or amalgamation of the issuer of the share might make the future exercise of the price adjustment clause difficult or impossible.

1.7 Where the price adjustment clause relates to the issuance of a note or property other than shares in consideration for the transfer of a property, the adjustment to the price may be implemented in a number of ways, including through a change to the principal amount of the note, the issuance of additional non–share consideration, the cancellation of the note or the return of all or part of the non–share consideration.

Drafting Considerations

From a drafting perspective, the PSA should address the following issues:

- The price adjustment should be considered to be effective as of the date of the original transaction;
- The price adjustment clause should address how the consideration is to be adjusted in the event that an adjustment is required to be made. For example, any additional consideration to be paid or received could be treated as a non-interest bearing loan; and
- The triggering events for the price adjustment clause should be broadly drafted, and not limited to the circumstances whereby the CRA (or a relevant tax authority) determines that the purchase price was not reflective of fair market value. For example, the triggering events should be broadly drafted and include proposed assessments and reassessments.

Contingent Consideration – Earnout Provisions

An earnout provision refers to an arrangement whereby the purchase price is adjusted as a result of the subsequent earnings generated by underlying business assets of the business. The theory is that the purchaser is prepared to pay more for the business, but wants some assurances that the business will actually generate the expected value. Two types of earnouts are contemplated for tax purposes. Under a “traditional” earnout, the purchaser agrees to pay a stated amount at the time of the closing and to pay an additional amount (the “Earnout Amount”) over an agreed-upon post-closing period based upon stated milestones or performance criteria. Under a “reverse” earnout transaction, a maximum price is established and that maximum price would be subsequently reduced if specified thresholds or benchmarks are not achieved. In this regard, the grossed-up purchase price under the reverse earnout would be paid on closing in the form of cash (or shares of the purchaser) and a form of debt instrument. The future payment obligation of the
principal amount owing under the debt instrument is to be adjusted downwards in the event of non-achievement of the intended earnout targets.

Absent any Canadian tax planning, there is a significant risk that the Earnout Amount subsequently paid pursuant to a traditional earnout should be taxable to the vendor under paragraph 12(1)(g) as representing the receipt of ordinary income and would not be eligible for capital gains treatment. In particular, paragraph 12(1)(g) provides that any amount received by the taxpayer that was “dependent on the use of or production from property” is included in taxable as an ordinary income receipt. Since an Earnout Amount is dependent on the future revenues of the target company, it should be caught by this provision. The CRA agrees with such conclusion and has stated that “[a]ny amounts received pursuant to the earnout agreement will be … included in computing the income of the taxpayer in the year received pursuant to paragraph 12(1)(g) of the Act”.9 Understandably, the vendor may not want to be exposed to taxation pursuant to the provisions of paragraph 12(1)(g). Moreover, if the vendor has accumulated capital losses, then the sale proceeds subject to the provisions of paragraph 12(1)(g) cannot be reduced by these capital losses.

Fortunately, the CRA has adopted an administrative position known as the “cost recovery method” in order to mitigate some of the negative effects of paragraph 12(1)(g).10 Under this policy, all amounts received by a vendor are treated as a reduction in the vendor’s tax cost basis in the shares that have been sold. As such, no capital gain is realized until the aggregate amount of the sale price exceeds the vendor’s tax cost basis in those shares. For this purpose, the sale price represents the proceeds that can be calculated with certainty and to which the vendor has an absolute (although not necessarily immediate) right to payment.

The CRA’s administrative policy with respect to the cost recovery method requires that the following six conditions be satisfied:

1. The vendor deals at arm’s length with the purchaser;
2. The gain or loss in question must be “clearly of a capital nature”. This means that any vendor who holds the target shares on an inventory account cannot benefit from the cost recovery method;
3. The earnout feature relates to the underlying goodwill of the target, the value of which cannot reasonably be expected to be agreed upon by the parties at the date of sale;
4. All contingent amounts under the earnout must become payable within 5 years of the end of the target’s taxation year that includes the date of sale;
5. The vendor submits a formal request to use the cost-recovery method with its tax return for the year of sale and attaches a copy of the sale agreement to its tax return. As an aside, there may be a reluctance on the part of the vendor in having to disclose to the CRA this information in advance of any formal audit undertaken by the CRA; and,
6. The vendor is a resident of Canada.11

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10 Interpretation Bulletin IT-426R, “Shares Sold Subject to an Earnout Agreement” (September 28, 2004).
11 Ibid.
With respect to the third condition, being the difficulty in valuing the goodwill of the target, the CRA provides the following three transaction examples that do not satisfy this condition:

1. The amount paid at the closing for the target shares is reduced by the amount of the accounts receivable, and such portion of the purchase price relating to accounts receivable will be paid to the vendor only when the accounts receivable are collected;
2. A corporation whose shares are sold holds an asset for which the value is difficult to determine. The parties agree to a mechanism for adjusting the purchase price of the shares of the target so that the amount paid for the shares at the time of the sale does not take into consideration the value of this asset. However, it is agreed that as soon as the target will sell the asset to a third party, the purchaser will pay the vendor an additional amount for the shares. The additional amount will be based on the selling price of the asset; and,
3. The parties agree on a price for the shares. However, in order to guarantee the vendor's representations (e.g., valid legal title to the assets, liabilities fully declared, no lawsuits), a portion of the share purchase price will be paid to the vendor only after a limitation period for making a claim has expired.

In mechanically applying the calculation of the cost recovery method, any amounts received in respect of the sale price reduce the vendor's ACB of the shares. Once the cumulative proceeds reduce the tax cost base to zero, any excess proceeds are treated as a capital gain. A capital loss can be recognized when the maximum amount payable to the vendor is irrevocably established to be less than the vendor’s tax cost base of the shares.

The CRA takes the position that the cost recovery method is not available in asset sales. Further, the cost recovery must be based on an earnout formula attributable to the earning of the target company, and not the earnings of any other corporation.\(^\text{12}\)

If a seller selected a particular method for reporting proceeds of an Earnout Amount, can the method be subsequently changed?\(^\text{13}\) In the circumstances presented by the CRA, the taxpayer decided to declare the capital gain based on an estimate of the proceeds. However, amounts received under the earnout differed significantly from the amount that had been estimated. The taxpayer asked the CRA whether there can be a retroactive change in the cost recovery method. The CRA said that retroactive change is not possible, as there is no provision under the ITA that permits this, and thus the taxpayer’s request was denied.

The key tax motivation behind the use of a reverse earn-out is to ensure that the vendor is eligible for capital gains treatment on the sale proceeds, and that these proceeds do not become taxable pursuant to paragraph 12(1)(g).\(^\text{14}\) A reverse earnout is particularly helpful in circumstances where the structure of the transaction would not otherwise meet the CRA’s conditions for the cost recovery method including asset sales. Nonetheless, the ability to avoid the application of the paragraph 12(1)(g) is subject to an overriding requirement that the initial

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13 This was precisely the question in Views# 2014-0529221E5, “Change of method for reporting a gain”, (August 27, 2014).
14 Consider IT-462, “Payments Based on Production or Use”, (October 27, 1980) at paragraph 9.
price payable be set at a price that would realistically be paid. From the perspective of the CRA, if the maximum sale price is not identified in the sale agreement or if the maximum sale price is not reasonable, then paragraph 12(1)(g) might still become applicable.\footnote{Ibid. at paragraph 10.}

It follows that all the proceeds of disposition recorded on the sale agreement, even if a portion of those proceeds would be subject to a subsequent price reduction under the reverse earnout parameters of the sale agreement, should be included in income of the vendor pursuant to subparagraph 40(1)(a)(i).\footnote{Views #9403435, “Earnout rights re sale of shares”, (August 4, 1994), provides that the seller is to “include in his proceeds of disposition the amount actually received or receivable plus the fair market value … of the earn-out rights at the date of disposition”.} The issue then arises whether a capital gains reserve pursuant to subparagraph 40(1)(iii) would be available to immediately offset the unpaid portion of those sale proceeds.

The CRA recently considered this issue and held that a capital gains reserve is not available in a reverse earnout sales transaction.\footnote{View# 2013-0505391E5, “Clause de earnout renversé”, (February 24, 2014).} The reasoning of the CRA is that at the time of sale it is not known which portion of the proceeds of disposition would ultimately be paid, and, as such, paragraph 40(1)(iii) is inapplicable as there is no “amount determined”. The result is that the maximum sale proceeds reasonably expected to be paid would become immediately taxable to the vendor without the ability to claim any offsetting reserve for the unpaid portion of the proceeds. By taking the above position, the CRA is suggesting that the amount of the earnout is sufficiently determinable for inclusion of the capital into the vendor’s income inclusion but is not sufficiently determinable for the capital gains reserve. The CRA interpretation does not offer much support to justify its conclusions.

Based on this CRA position, it follows that if the earnout portion of the proceeds under the reverse earnout is not subsequently paid (i.e., the sale proceeds actually received by the vendor is less than the maximum proceeds), then the vendor could claim a capital loss. Should the capital loss be recognized within the three taxation years after the year in which the capital gain was recognized, then the capital loss can be carried back to offset the initial gain. Conversely, if the earnout portion of the proceeds is only forgiven after the three-year carryback period, then any reduction in the sale price would generate a capital loss that cannot be applied against the gain attributable to the original sale transaction.

It is submitted that the CRA’s position regarding the inapplicability of the capital gains reserve pursuant to a reverse earnout sale transaction is not persuasive for a number of reasons. Consider, for example, the CRA’s comments in IT-436R at paragraphs 3 – 6 thereto:

3. Where a promissory note has been accepted as absolute payment, no amount is due in respect of the disposition, since the debt is considered to have been paid or satisfied by the receipt of the promissory note, and therefore no reserve is available. However, where the note is received as conditional payment only, the availability of the reserve must be determined in accordance with the following paragraphs. Normally the Department will assume that the promissory note is received as conditional payment unless the sales agreement clearly indicates that the note has been accepted as absolute payment. A reference hereinafter to
“promissory note” refers to one accepted as conditional payment unless a contrary interpretation is stipulated.

4. It is the Department's opinion that a promissory note which is due and payable on demand, without restriction as to when payment can be demanded, is due and payable as soon as the note is issued. Therefore, the holder of such a note is not entitled to a reserve because the note does not meet the qualification, “... not due... until a day that is after the end of the taxation year...”.

5. In certain circumstances, however, promissory notes have restrictions relative to payment or demand. Examples of the restrictive conditions attached to promissory notes are as follows:
   (a) demand for payment can only be made at certain times or upon the occurrence of some event,
   (b) demand for payment can be made at any time but payment is not due until the expiration of a specified time after demand has been made, or
   (c) a combination of the above.

6. It is the Department's opinion that where payment of a promissory note is not due at the end of a taxation year for which a reserve is being considered, by reason of the restrictions outlined in 5 above, the holder of such a note is entitled to claim a reserve under the appropriate provision of the Act because, at that time, the note is not due. This comment applies only to that portion of the note which is not then due. If a portion of the note is due, a reserve may not be claimed on that portion. 18

Pursuant to the Bills of Exchange Act, a promissory note cannot be conditional. 19 However, it would be possible for a debt obligation to be entered into between the parties and mutually agreed to represent a conditional promise to pay money in the future, provided that the specified conditions were satisfied. Presumably, the focus of paragraph 3 of T-436R should extend to both promissory notes and other types of debt obligations mutually entered into by the parties. Under this perspective, the conditional portion of the sale proceeds represented by the reverse earnout should then be eligible to qualify for capital gains reserve as specified under paragraph 5 thereto. It necessarily follows that a reverse earnout should be eligible for the capital gains reserve.

3. **Purchase Price Allocation on an Asset Purchase**

In an asset transaction, it is necessary to allocate the purchase price amongst the various assets acquired. There may be some tension between the parties in determining this allocation.

The vendor would typically prefer to allocate a higher value to non-depreciable assets such as land and share investments, both of which are taxed at capital gains rates (assuming a capital transaction) and those depreciable assets which would be subject to the least amount of recapture. The purchaser would be interested in allocating a higher value to depreciable assets with the highest CCA rates.

The purchase price allocation is also relevant on a share transaction for the write-downs that arise under subsections 111(4), 111(5) and 111(5.2) of the Act on capital property, depreciable

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18 IT-436R, “Reserves —Where Promissory Notes Are Included in Disposal Proceeds”, (November 24, 1983), [Cancelled].

19 Bills of Exchange Act, R.S.C. 1985, c. B-4 at section 176: “A promissory note is an unconditional promise in writing made by one person to another person, signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money to, or to the order of, a specified person or to bearer”.
property and cumulative eligible capital, respectively. The allocation might also be relevant in
determining how much debt may be pushed down to subsidiaries.

Case law has traditionally held that the amount agreed upon between arm’s length parties is an
acceptable purchase price, provided that such allocation is not wholly unreasonable.20

Section 68 of the Act provides for a reallocation of the purchase price if the consideration is
unreasonably allocated between the respective assets. Such reallocation will be made
irrespective of the legal form or effect of the contract between the parties. Unlike section 69,
section 68 applies to both arm’s length and non-arm’s length transactions.

The allocation of purchase price was considered by the TCC in TransAlta Corp v. R.21. This case
involved the allocation of purchase price among assets in the sale of a regulated business by
Transalta to an arm's length partnership. The parties had agreed to allocate $190 million of the
$818 million purchase price to goodwill. The remainder of the purchase price was allocated to
tangible assets. The Minister reassessed Transalta under section 68 of the Act to reallocate the
entire purchase price to tangible assets on the basis that there was no goodwill being sold since
the business was subject to regulations, which set the amount of profits that could be earned.

The FCA considered the reasonableness test under section 68 and concluded that an amount can
be regarded as being consideration for the disposition of a particular property if a reasonable
business person, with business considerations in mind, would have allocated that amount to that
particular property.22 The court further noted that while the negotiated allocation between arm’s
length parties is an important factor to consider, it “does not trump the reasonableness test under
section 68 of the Act”.23 Applying this test, the FCA concluded that the agreed upon allocation
was reasonable because it complied with long standing regulatory and industry practices and was
consistent with auditing and valuation standards and practices applied in such industries. In its
view, the TCC did not apply the reasonableness test and instead substituted its own subjective
purchase price allocation for the goodwill.24

Drafting Considerations:

The PSA should address the following matters relating to the purchase price allocation:

- The allocation of the purchase price to the various assets should be explicitly addressed. This
  issue is usually resolved by way of a schedule appended to the PSA evidencing the allocation
  of purchase price to the assets.

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20 In Golden v. R., [1986] 1 CTC 274 (SCC), for example, Madam Justice Wilson stated: “It seems to me that if the
statute has failed to provide a means whereby a figure can be allocated to the depreciable property in a transaction
such as the one before us, then the figure agreed upon by the parties in an arm's length transaction, given, of course,
that it is not a sham or subterfuge … must govern.”
21 2012 FCA 20.
22 Ibid., paragraphs 7 and 75.
23 Ibid., paragraph 78.
24 Ibid., paragraphs 81 and 82.
It is common for a clause to be inserted into the PSA requiring the vendor and purchaser to use the same allocation when each of the parties records the respective asset dispositions and acquisitions on their tax returns.

Appendix 3 contains a sample purchase price allocation clause.

4. **Beyond the Boilerplate – Drafting Tax Provisions of a PSA**

The key issue in the preparation of the documentation is whether the agreement represents the intention of the parties.

The structure of a typical PSA is as follows:

- Article I – Definitions and Interpretation
- Article II – Identification of the assets being purchased (e.g., shares of the target company if the transaction is a share purchase, or otherwise the specific target assets being purchased), the consideration being paid and any liabilities that may be assumed.
- Articles III and IV– listing of the representations, including the tax representations, being provided by each of the vendor and the purchaser.
- There is also typically an indemnity article, to account for a breach of representations and damages that may be suffered by the parties.
- Finally, there may be a separate article covering tax matters that isolates the indemnity that may be suffered by the parties as a consequence of a breach of the tax representations. This section may also address post-closing tax obligations, such as the responsibility to prepare the tax returns that become due as a consequence of an acquisition of control, and certain other covenants such as the filing of tax elections.

The overall focus of tax representations, warranties, indemnities and covenants is to identify and allocate the tax risks between the vendor and the purchaser. A number of papers have extensively canvassed the issues arising from these clauses.25

**Drafting Considerations:**

Appendix 1 to this article presents a standard share PSA and Appendix 2 presents a standard asset PSA. Some of the typical tax issues encountered in drafting the PSA are discussed below. Except as specifically noted, the tax representations and covenants that are identified would apply only to a share purchase agreement and not to an asset purchase.

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Definitions and Interpretations

Definition of “Taxes”.

The taxes at issue must refer to more than the applicable federal and provincial corporate taxes. Numerous other taxes may also be relevant to the PSA, such as withholding taxes, sales taxes, payroll taxes, and business and property taxes. As a consequence, the definition of taxes should be expansive, although the vendor may try to suggest a more narrow definition. An often overlooked tax is one imposed by a foreign tax authority. For example, if a Canadian company at some point carried on sales activities in the United States, it could have been subject to possible U.S. federal and state taxes.

Definition of “Tax Returns” and Filing Requirements Related Thereto

Much like the definition of taxes, the definition of tax returns can have significant implications to the scope of the tax representation made by the vendor. Business lawyers working on the transaction might erroneously assume that the definition should focus on the corporate tax returns that are filed at the end of each taxation year. However, there are numerous types of tax returns (e.g., payroll or sales tax, withholding tax) that could be relevant to the particular transaction and target company. A representation will be made that all tax returns (or all material tax returns – one’s perspective depends on whether one represents the vendor or the purchaser) have been filed, and that they were complete and correct in all material respects except as disclosed in a schedule to the PSA.

Financial Statements and Working Capital Calculation

An associated representation that is often included is that there are no unpaid taxes except for amounts that have been accrued in the financial statements.

As part of the calculation of the working capital adjustment, it would be prudent to explicitly state whether current taxes recoverable and current taxes payable are to increase or decrease the working capital calculation. Sometimes, the working capital calculation simply provides for “current assets less current liabilities”. While accountants might suggest that such calculation methodology could include sales taxes receivable (payable) and payroll taxes payable, this result is not obvious to lawyers. An explicit description of the working capital calculation would minimize future disputes.

Tax Representations

It is critical that the both the purchaser’s tax accountants and tax lawyers interact in the drafting of the tax clauses, to ensure that all tax due diligence has been fully reflected in the PSA representations.

There is often limited scope to suggest alternative wording for tax representations, since the wording has typically become standardized. However, there may be pressure to develop a bare-bones agreement, particularly if the vendor and the purchaser are both private companies.
Accordingly, the tax advisors will be required to prioritize which tax clauses are important to the transaction at hand.

Some of the more critical tax representations and warranties are identified below:

**Tax Attributes of Target Company**

If certain tax attributes are critical to the transaction, such as the quantum of tax loss carryforwards or UCC balances, then a specific representation regarding the relevant attribute should be obtained. The prudent purchaser should not address this issue by indirectly relying on the representation that the tax returns are correct in all material respects. However, there is usually much reluctance on the part of the vendor to provide specific representations regarding the balance of tax attributes.

**Residency of the Vendor**

If property is taxable Canadian property (other than excluded property), 26 withholding tax requirements on the part of a purchaser would generally arise if the vendor is a non-resident of Canada. However, no withholding tax obligation would arise if the purchaser has a reasonable belief (after reasonable inquiry) that the vendor is a resident of Canada. It therefore follows that if the vendor is not a non-resident of Canada (i.e., in other words, the vendor is a resident of Canada), then a representation should be obtained in this regard. Given that vendors are often Canadian residents, the default representation would be that the “vendor is not a non-resident of Canada”. The residency of the vendor is relevant for both share purchase and asset purchase agreements.

**Tax payments.**

There should be a representation that all required tax instalments as well as withholdings taxes and source deductions have been made, except for taxes not yet due or that are currently under objection. Similarly, there is usually representation that there are no unpaid taxes owing by the company except for amounts that have been accrued on the financial statements.

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26 Taxable Canadian property is defined in subsection 248(1) of the Act and generally includes, among others, real property situated in Canada and certain shares or partnership or trust interests which derive their value from real property, Canadian resource property or timber resource properties. Excluded property is defined in subsection 116(6) and includes, among others, shares listed on a recognized stock exchange and treaty exempt property. Treaty exempt property is defined in subsection 116(6.1) as property that is treaty-protected property and, where the purchaser and the non-resident person are related, the purchaser provides notice under subsection 116(5.02) in respect of the disposition. Treaty protected property is defined in subsection 248(1) to mean property any income or gain from the disposition of which would, because of a tax treaty, be exempt from tax under Part I of the Act.
Covenants

The roles and responsibilities of the vendor and the purchaser should be clearly set out in the agreement. If the activities enumerated in the covenant section of the PSA are not performed, then the indemnity clause under that PSA may be triggered.

The preparation of the corporate tax returns for all pre-closing tax periods may require some negotiation. The vendor has the best knowledge as to the historical corporate tax filing positions of the target company, and it follows that it may be efficient to permit the vendor to prepare these corporate tax returns. However, a purchaser is often reluctant to cede control of the tax return preparation process to the vendor, and may want to limit the vendor’s input to that of a review function. The issue becomes more complicated if the tax balance due on the pre-closing tax returns affects not only the tax representation (i.e., that there are no taxes owing), but also any working capital adjustments to the purchase price. If the vendor is required to satisfy any working capital shortfalls, the vendor would want to ensure that the corporate tax deductions are not inappropriately shifted from the pre-acquisition period to a later period.

Once it is determined which party would be preparing each of the affected the tax returns, that party should be required to claim “all reasonable tax deductions”. Further, the tax filing positions should not be inconsistent with previously filing positions of the company and with issued CRA audit assessments made against the target company, all of which would be governed by an overriding requirement that the returns be prepared in accordance with the applicable law.

Additional covenants that are frequently provided in the PSA are the following:

- Tax elections: The parties should mutually agree to execute and file the tax election forms specified in the PSA. Moreover, this covenant should impose time limitations to ensure that the tax filings deadlines are met.
- Allocation of purchase price: The purchaser and vendor may explicitly agree to reflect the sale using the allocation schedule specified in the agreement.

Date of the Transaction

The solution to multiple tax year ends is to either forego the signing date and rely solely on the closing date to the PSA, or to pursue the election not to be a CCPC under subsection 89(11).

Under subsection 249(4) of the Act, a new taxation year arises upon an acquisition of control.27 Subsection 256(9) of the Act requires this new taxation year to commence at the beginning of that day, unless the corporation elects not to have this subsection apply. If the election were filed, then the new taxation year is deemed to happen at the specified time later in the day.

\[27\] An acquisition of control generally refers to the right to vote more than 50% of the shares; see *Buckerfields Ltd. v. MNR* 64 DTC 5301 (Ex. Ct.).
In an amalgamation transaction, if no time is specified in the articles of amalgamation or the amalgamation agreement, the taxation year of the amalgamated corporation will begin on the earliest moment of the date that the certificate is issued.\footnote{Income Tax Folio S4-F7-C1 “Amalgamations of Canadian Corporations”, at paragraph 1.15.} As a result, the tax year will be deemed to end on the day before the amalgamation.\footnote{See paragraph 87(2)(a) of the Act and CRA document no. 2002-0156725, dated October 11, 2002.} Such result may be beneficial where the both an acquisition of the target company is immediately followed by an amalgamation with the purchaser corporation, thereby minimizing the creation of multiple tax year ends.\footnote{Income Tax Folio S4-F7-C1 “Amalgamations of Canadian Corporations”, at paragraph 1.19.} This position of the CRA has been reiterated in many published documents. However, the CRA has also stated that if there is a series of transactions during that day, then the time of the amalgamation for tax purposes (even if no time is specified on the articles of amalgamation or the amalgamation agreement) would be time at which the transaction logically occurs (e.g., as specified by the closing agenda).\footnote{CRA document no. 2004-0086741C6, dated October 8, 2004.}

**Drafting Suggestions**

If pre-closing transactions are to be completed on the same day as the acquisition of control, consider the following drafting suggestions to the sale and purchase agreement:

- There should be a definition of both a “closing date” and a “closing time”.
- There should be a covenant to address the filing of a subsection 256(9) election. Such an election must be made in the corporation's tax return for its taxation year ending immediately before the change of control.
- The definition of “taxes” should explicitly include pre-closing transactions that are completed on the closing date.

5. **Management of Risk**

Once the major elements of the transaction have been set, the focus shifts to determining how the vendor will compensate, if at all, the purchaser for a breach of the tax representations and other tax clauses.

**Escrow Arrangements**

A portion of the purchase price payable on closing may be held back in escrow in order to secure against a breach of the representations by the vendor. An escrow arrangement will be particularly important if there is doubt as to whether the vendor will have the financial capability to satisfy future damage claims arising under the PSA.

**Drafting Considerations for Escrow Provisions**

If an escrow provision is inserted into the agreement, the following matters should be considered in drafting the terms of the escrow arrangement:
How long will the escrow arrangement be in place? Typically, the escrow arrangement will not extend to the full period of time for which the purchaser may claim against the vendor pursuant to the indemnity provisions. For example, the indemnification for a breach of a tax representation under the PSA would typically extend until all possible reassessments against the target company have become statute-barred. It is unlikely that the vendor would accept that a portion of the purchase price be held in escrow for such an extended period of time.

Will a section 116 clearance certificate be required? Where a section 116 withholding requirement may be applicable, the escrow arrangement should contemplate the risks to the purchaser until a clearance certificate is obtained from the CRA.

Who will pay tax on the investment income earned within the escrow account? This would be an issue if the escrow arrangement were to continue for more than one taxation year. The typical approach is for the interest earned in the escrow account to be allocable on an annual basis to the vendor and taxable in its hands. However, poorly drafted escrow arrangements have resulted in the annual income generated in the escrow account being taxable as if the escrow arrangement were in fact a trust. This is usually not a desirable result, since a trust is taxable at the highest marginal rates on all income that is not distributed to the beneficiaries.

How would the escrow funds be invested? The objective for the purchaser would be to ensure that the principal amount of the escrow fund would always be available to satisfy an indemnity claim. Hence, it would want low risk investments in the escrow fund. On the other hand, the vendor may be interested in riskier investments in order to enhance its potential earn investment income.

Tax Indemnification Drafting Considerations

An indemnity provision would compensate the purchaser in the event of a breach of the representations and warranties by the vendor. As previously noted, one issue is whether the indemnification should be paid only if the breach created a material tax liability. The vendor may try to establish a high materiality threshold while the purchaser may want taxes to be paid from the first dollar. The justification for the purchaser’s position is that the preparation of the historic tax returns – and any aggressive tax filing positions, as well as the timely payment of taxes then owing - was entirely within the control of the vendor and/or the target company.

An issue to consider in drafting a tax indemnification clause is whether the indemnity should compensate for the gross amount of damages, or whether it should be reduced for all consequential tax deductions created by the occurrence of the damage itself. The difficulty with including an offset for future tax deductions is that they are difficult to quantify. If the target company or the purchaser is experiencing tax losses, what assurances exist that any incremental tax losses attributable to the damages suffered would actually be used and, thus, should be factored into reduction of the indemnification amount payable. A compromise position may be that any tax deductions created as a consequence of the damages would be taken into account, provided that these related tax deduction have been actually used by the end of the year in which the indemnification claim is made.

32 Section 116 of the Act. A certificate may be issued under subsection 116(2), (4) or (5.2), depending on the circumstances and the property being transferred.
Another issue that should be addressed in the design of the indemnification clause is whether all indemnity payments are to be grossed up to reflect incremental taxes payable on the receipt of the indemnity payment. In this regard, it should be noted that if the amount is included in income under paragraph 12(1)(x) of the Act, then an election under subsection 12(2.2) may be available to offset this deduction.33

The indemnification clause should also contemplate the management and control of the tax reassessment process. One overriding question for consideration is whether the vendor must concede that it will pay in full the indemnity claim submitted by the purchaser, should the vendor wish to be given the sole right to contest the tax reassessment.

6. **Tax Filings**

The purchaser should consider whether transaction costs are deductible in its tax return or the tax return of the target company. The recent case of *Rio Tinto Alcan v. The Queen*34 provides guidance on the deductibility of the costs. In particular, the Tax Court segregated the fees that had been incurred by the company into two pools: “oversight expenses” and “execution costs” and held that the former were deductible but not the latter. Oversight expenses were generally fees for services that assist the board in the decision-making process and in the fulfilment of its oversight function” whereas execution costs were “fees for services that facilitate the execution of a capital transaction”.

The roles and responsibilities that each of the vendor and the purchaser would undertake in connection with the preparation and filing of tax elections should be clearly set out in the agreement. Typically, one party would bear responsibility for preparing and filing the tax election with the relevant tax authority, and the other party would merely agree to review and execute the election.

Some of the most common post-closing tax elections that are prepared, and which are relevant to both share purchases and asset purchases, are identified below. Appendix 4 provides sample tax election and covenants.

**Section 85 Election– Transfers to Taxable Canadian Corporations**

Section 85 is the basic provision addressing a tax-deferred transfer of assets or shares to a corporation in exchange for shares of the “purchaser” corporation. The PSA should provide a covenant that the parties will file the joint election form in a timely manner. The elected amount is sometimes specified in the PSA, but this is not required. However, which party can determine the elected amount should be specified in the PSA.

As described above, if the transferor and transferee do not deal at arm’s length, a purchase price adjustment clause will generally be included in the PSA, which would typically adjust the value of the share.

33 CRA document no. 2010-0371461R3.
34 2016 TCC 172.
Eligible Dividend Payments

A CCPC (or a deposit insurance corporation) may designate a dividend paid by it to be an eligible dividend to the extent of the balance in its “general rate income pool” (“GRIP”),35 or, in the case of a corporation that is not a Canadian-controlled private corporation (nor a deposit insurance corporation), to the extent that it does not have a balance in its “low rate income pool” (LRIP”).36 Eligible dividends are desired because they are subject to lower rates of income tax than non-eligible dividends in the hands of a Canadian-resident individual. The amount of the GRIP or LRIP of a corporation is determined by formulas contained in subsection 89(1).

Corporations have to designate each eligible dividend that they pay, before or at the time the dividends are paid, and notify shareholders in writing that the dividend is eligible, as required by subsection 89(14) of the Act.

Where a dividend paid has been designated as an eligible dividend and it is subsequently determined that some, or all, of the dividend is in excess of the amount that could be designated as an eligible dividend, the corporation will be subject to tax under Part III.1 of 20% of the excess eligible dividend designation (“EEDD”).37 The rate of tax increases to 30% of the entire dividend where certain transactions artificially maintain the GRIP or LRIP.38 As an alternative to the payment of Part III.1 tax in respect of an excessive amount, the corporation, with the concurrence of every shareholder who received or was entitled to receive all or any portion of the original dividend and whose address was known to the corporation, may elect under subsection 185.1(2) of the Act39 to have the portion of the dividend that does not qualify as an eligible dividend to be treated as a separate ordinary (non-eligible) dividend to the shareholder. The CRA’s position is that this election must be filed within the prescribed deadlines and is not one of the elections specified under Regulation 600 which permits an election to be late-filed. The CRA’s position could be particularly adverse to a taxpayer if it were to object to the application of the Part III.1 tax and did not file the election during the period when its objection was being reviewed.40

Because the elections outlined above require the concurrence of every shareholder who received or was entitled to receive the dividend (the vendor shareholders of the target corporation, for example), it is crucial that the vendor shareholders covenant in the PSA that they will concur to the filing of the election, if necessary. Note that if such concurrence is provided, it should be

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35 Defined in subsections 248(1) and 89(1) of the Act
36 Defined in subsection 89(1) of the Act.
37 See subsection 185.1(1) of the Act
38 Refer to paragraph 185.1(1)(b) and paragraph (c) of the definition “excessive eligible dividend” in subsection 89(1) of the Act.
39 A prescribed form has not been specified. The CRA has provided instructions on its website as to the manner in which the election should be filed on their website.
40 Views#2010-0383801E5, “Deadline to file a subsection 185.1(2) election” dated December 23 2010. In the CRA Views, the taxpayer was assessed for Part III.1 tax and the taxpayer filed a notice of objection. No election under 185.1(2) was filed while the matter was being reviewed by the CRA. If the taxpayer were to be unsuccessful in its objection, in the CRA’s interpretation the taxpayer would be unable to subsequently file the election since it had not been filed during the required statutory filing period (i.e., within 90 days from the mailing of the Notice of Assessment that imposed the Part III.1 tax).
made in respect of a specific dividend of known date and amount. In the absence of such a covenant (as would be the case if there were a large number of minority vendor shareholders), the purchaser may look to the main vendor to indemnify for damages arising from Part III.1 tax.

Subsection 97(2) – Transfers to Partnership

Subsection 97(2) of the Act provides for a tax-deferred transfer of assets or shares to a Canadian partnership in exchange for a partnership interest. The rules are very similar to those in subsection 85(1). One notable exception is the fact that real estate inventory can be transferred to a partnership on a tax-deferred basis under subsection 97(2).

Income Tax Elections Specifically Applicable to an Asset Purchase

Section 22 – Accounts Receivable

Where trade accounts receivable are transferred as part of a sale of business assets, the parties may wish to jointly file a section 22 election. To the extent that the sale price of the receivable is less than its original face amount, the election preserves for the vendor a bad debt expense deduction. Effectively, the election provides for a transfer of the reserve for doubtful debts from the vendor to the purchaser. Absent the section 22 election, the vendor would be required to include previously claimed reserves into income and may only be entitled to a capital loss. As well, absent the election, the eventual collection of the receivables at an amount that is greater or less than the price paid to purchase the receivables from the vendor could cause the purchaser to realize a capital gain or loss.

If the parties wish to file a section 22 election, all or substantially all of the assets used in carrying on the business must be sold to the purchaser. The CRA considers that “all or substantially all” means 90% or more. This requirement can be problematic when only a portion or a division of a business is sold.

If the section 22 election is not available, the receivables could be left with the vendor for collection post-closing, although there are obvious business advantages to having a single entity dealing with customers.

Subsection 20(24) – Undertaking Future Obligations

Subsection 20(24) governs the assumption of contractual liabilities by the purchaser. For example, the vendor may have received cash from a customer in advance of the delivery of goods or performance of services. For accounting purposes, the vendor would record such amounts as deferred revenue. From a tax perspective, the advances are included in business income pursuant to paragraph 12(1)(a) of the Act, and paragraph 20(1)(m) then provides for a deduction to the extent that such amounts relate to goods which are to be delivered or services which are to be rendered after the year-end. Absent a subsection 20(24) election, the vendor would be required to include the paragraph 20(1)(m) reserve into income with no offsetting deduction. The election provides the vendor with a deduction for a reasonable amount paid to the purchaser as consideration for its assumption of the obligation to deliver the goods or render
the services. In turn, the purchaser would report the amount received as income, but could then claim its own reserve if the liability remains outstanding at the end of the year.

From a business standpoint, the use of a subsection 20(24) election depends on who should reasonably pay tax on the profit attributable to the deferred revenue once it is recognized for income tax purposes. Because this is a joint election, the asset purchase agreement should specify if it is to be made.

**GST Elections**

An election is available under section 167 of the Excise Tax Act when there is a transfer of a business or part of a business and the purchaser acquires ownership, possession or use of all or substantially (typically interpreted as 90%) all of the assets necessary for it to be capable of carrying on the business. The election would eliminate the need for the purchaser to pay GST on the acquired assets. The limitation of such election is that if all or substantially all of the business is not being purchased, there may be an exposure for the vendor for failure to collect the appropriate tax plus penalty.

Typical clauses to include in an asset purchase agreement in connection with a section 167 election include:

- A representation that the purchaser is registered for GST/HST.
- Potentially a representation that section 167 of the ETA applies to the transaction. Sometimes both parties will acknowledge and agree in the purchase and sale agreement that the requirements of subsection 167 of the ETA are met. If there is uncertainty whether the transaction is eligible for a section 167 election, it may be better for the purchaser to pay the tax and claim the input tax credits on its GST/HST return.
- The section 167 election requires the purchaser to file prescribed CRA form GST44. A covenant should be obtained from the purchaser to file the GST44 election form within the required time limit.
- Potentially, an indemnity for penalties and interest if the election is rejected by the CRA. It is the vendor that is liable for tax, interest and penalty for non-collection of GST/HST if the election is not applicable, not filed, or not filed on time.

Section 156 of the ETA provides an election to members of a related group to make inter-group supplies without applying GST/HST. This election is generally only available if the recipient could otherwise claim a full input tax credit for the transaction to which the exemption applies. The election must be made using CRA Form GST25. The validity of a Section 156 election would be a relevant due diligence consideration affecting the acquisition of the target company, and could also be relevant in implementing inter-company agreements that would apply subsequent to the completion of the acquisition.
APPENDIX 1
SAMPLE TAX PROVISIONS OF A SHARE PURCHASE AGREEMENT

1 Interpretation

1.1 Definitions in this Agreement

1.1.1 “Closing Date” means •

1.1.2 “Closing Time” means •am on the Closing Date

1.1.3 “Governmental Authority” includes any government, agency, commission, body, service, bureau, or other entity entitled under Applicable Law to impose, assess or collect Taxes, including without limitation the Canada Revenue Agency and the Ministry of Finance (Ontario).

1.1.4 “HST” means all Taxes payable under Part IX of the Excise Tax Act (including where applicable both the federal and provincial portion of those Taxes) or under any provincial legislation imposing a similar value added or multi-staged tax.


1.1.6 “Post-Closing Tax Period” means any Tax period beginning on or after the Closing Date, and, with respect to a Straddle Period, the portion of such Tax period beginning on the Closing Date.

1.1.7 “Pre-Closing Tax Period” means any Tax period ending on or before the day prior to the Closing Date, and, with respect to a Straddle Period, the portion of such Tax period ending on the day prior to the Closing Date.

1.1.8 “Pre-Closing Taxes” means any Taxes of the Corporation required to be paid, collected or remitted by the Corporation for a Pre-Closing Tax Period, other than any Taxes or amounts in respect of Taxes reflected in the calculation of Working Capital on Closing. For purposes of determining Pre-Closing Taxes in respect of a Straddle Period, Taxes shall be allocated in accordance with Section •.

1.1.9 “Pre Closing Period” means any taxation period that is not a Post-Closing Period.

1.1.10 “Purchaser Tax Returns” has the meaning set out in Section •.

1.1.11 “Tax” or “Taxes” means taxes, duties, fees, premiums, assessments, imposts, levies and other charges of any kind whatsoever imposed by any Governmental Authority, including all interest, penalties, fines, additions to tax or other additional amounts imposed in respect thereof (including those levied on, or measured by, or referred to as, income, gross receipts, profits, capital, transfer, land transfer, gains, capital stock, production, gift, wealth, environment, net worth, utility, sales, goods and services, harmonized sales, use, consumption, valued-added, excise, stamp, withholding, premium, business, franchising, property, employer health, payroll, employment, health, social services, education and social security taxes, surtaxes, customs duties and import and export taxes, development, occupancy, social services, licence, franchise and registration fees and employment insurance, health insurance and Canada, Québec and other government pension plan premiums or contributions), and “Tax” has a corresponding meaning.

1.1.12 “Tax Claim” has the meaning set forth in Section •.
1.1.13 “Tax Representation” means each representation and warranty contained in each of Article 3;

1.1.14 “Tax Returns” means all returns, declarations, designations, forms, schedules, reports, elections, notices, filings, statements (including withholding tax returns and reports and information returns and reports) and other documents of every nature whatsoever filed or required to be filed with any Governmental Authority with respect to any Taxes together with all amendments and supplements thereto

1.1.15 “Straddle Period” means any Tax period that includes the Closing Date, but does not begin on the Closing Date or end on the day prior to the Closing Date.

1.2 Accounting Principles. Whenever in this Agreement reference is made to generally accepted accounting principles, or to “GAAP”, such reference shall be deemed to be to the generally accepted accounting principles as set out in the Chartered Professional Accountant Canada Handbook – Accounting for an entity that prepares its financial statements in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board, [Alternative Version: Accounting Standards for Private Enterprises included in Part II of the Chartered Professional Accountant Handbook - Accounting] at the relevant time, applied on a consistent basis (and includes, as applicable and as the context requires, any predecessor policies thereto

2 PURCHASE OF SHARES

2.1 Purchase and Sale. At the Closing Time, on and subject to the terms and conditions of this Agreement, each Vendor shall sell, assign, transfer and convey to the Purchaser, and the Purchaser shall purchase and acquire from each Vendor, all of the [Shares owned by such Vendor as set forth opposite such Vendor’s name on Schedule ●], free and clear of all Liens.

2.2 Amount of Purchase Price. The aggregate purchase price payable by the Purchaser to the Vendors for the Shares (the “Purchase Price”) is the sum of: (i) ● ($●); (ii) minus the amount of the Debt; and (iii) minus the amount, if any, by which the Closing Date Working Capital as finally determined in accordance with Section ● is less than the Minimum Target Working Capital, or plus the amount, if any, by which the Closing Date Working Capital exceeds the Maximum Target Working Capital.

3 REPRESENTATIONS AND WARRANTIES

3.1 Representations and Warranties relating to the Vendors. As a material inducement to the Purchaser entering into this Agreement and completing the transactions contemplated by this Agreement and acknowledging that the Purchaser is entering into this Agreement in reliance upon the representations and warranties of the Vendors set out in this Section, each Vendor, represents and warrants to the as follows:

3.1.1 Residence of Vendor. Save and except for ●, no Vendor is a non-resident of Canada for purposes of section 116 of the Income Tax Act.

3.2 Representations and Warranties relating to the Corporation and the Subsidiaries. As a material inducement to the Purchaser entering into this Agreement and completing the transactions contemplated by this Agreement and acknowledging that the Purchaser is entering into this Agreement in reliance upon the representations and warranties in respect of the Corporation and the Subsidiaries set out in this Section, the Vendors, represent and warrant to the Purchaser as follows:

3.2.1 Financial Statements. The Financial Statements, copies of which are annexed hereto in Schedule ●, have been prepared in accordance with GAAP consistently applied throughout the periods to which they relate, subject, in the case of the Interim Financial Statements, to usual year-end adjustments and the exclusion of footnotes. The balance sheets contained in the Financial Statements fairly present in all material respects the financial position of the Corporation and the
Subsidiaries as of their respective dates and the statements of earnings and retained earnings contained in the Financial Statements fairly present in all material respects the revenues, earnings and results of operations for the periods indicated. There are no assets, obligations or liabilities of the Corporation or any Subsidiary other than assets, obligations and liabilities relating to the Business.

3.2.2 Tax Filings. Except as set forth in Schedule ●, the Corporation and each Subsidiary has prepared and filed when due with each applicable Governmental Authority all Tax Returns required to be filed by or on behalf of the Corporation and each such Subsidiary in respect of all Taxes for all fiscal periods ending prior to the date hereof. All such Tax Returns are correct and complete in all material respects, and no material fact has been omitted therefrom. Except as described in Schedule ●, neither the Corporation nor any Subsidiary has ever been required to file any Tax Returns with, or been liable to pay or remit Taxes to, any Governmental Authority outside Canada or any Canadian provincial or territorial governmental authority outside the Provinces of ●, ● and ●.

3.2.3 Taxes Paid. The Corporation and each Subsidiary has paid in full and when due all Taxes and instalments on account of Taxes required to be paid by it on or prior to the date hereof. There are no Liens (other than Permitted Liens) for unpaid Taxes on any of the Corporation’s Assets or any Subsidiary’s Assets. Without restricting the generality of the foregoing, all Taxes shown on all Tax Returns referred to in Section ● or on any assessments or reassessments in respect of any such Tax Returns have been paid in full when due. The provision for Taxes in the Interim Financial Statements constitutes an adequate provision for the payment of all unpaid Taxes in respect of all periods up to and including the period to which the Interim Financial Statements relate.

3.2.4 Reassessments of Taxes. No reassessments of the Corporation’s Taxes or the Taxes of any Subsidiary have been issued and are outstanding and there are no outstanding issues which have been raised and communicated in writing to the Corporation or any Subsidiary by any Governmental Authority for any fiscal period in respect of which a Tax Return of the Corporation or any Subsidiary has been audited. Neither the Corporation nor any Subsidiary has received any indication in writing from any Governmental Authority that a reassessment of the Corporation or any Subsidiary is proposed in respect of any Taxes, regardless of its merits. Neither the Corporation nor any Subsidiary has executed or filed with any Governmental Authority any agreement or waiver extending the period for assessment, reassessment or collection of any Taxes.

3.2.5 Withholdings and Remittances. The Corporation and each Subsidiary has deducted, withheld, collected and remitted, when due to each applicable Governmental Authority, all Taxes which it is required to deduct, withhold, collect and remit. Without restricting the generality of the foregoing, the Corporation and each Subsidiary has withheld from each amount paid or credited or deemed to have been paid or credited to, and each taxable benefit conferred upon or dividend or distribution paid or deemed to have been paid to any of its present or former Employees, shareholders, officers and directors, and to all Persons who are or are deemed to be non-residents of Canada for purposes of the Income Tax Act all amounts required by Applicable Law to be withheld, and has remitted such withheld amounts within the prescribed periods to each appropriate Governmental Authority. Neither the Corporation nor any Subsidiary has received any requirement, demand or request from any Governmental Authority pursuant to section 224 of the Income Tax Act or any similar provision of an Applicable Law that remains unsatisfied in any respect.

3.2.6 Future Income Inclusion. There are no circumstances existing prior to the date hereof which could result in the application to the Corporation or any Subsidiary of any of sections 80, 80.01, 80.02, 80.03 or 80.04 of the Income Tax Act or any analogous provision of any comparable Law of any province or territory of Canada. Neither the Corporation nor any Subsidiary has any unpaid amounts that may be required to be included in the Corporation or such Subsidiary’s income for Canadian income tax purposes for any Post-Closing Period under section 78 of the Income Tax Act (Canada) or a corresponding provincial provision. Neither the Corporation nor any Subsidiary has
acquired property from a Person in circumstances that would result in the Corporation or Subsidiary, as the case may be, becoming liable to pay Taxes of such Person under subsection 160(1) of the *Income Tax Act* or a corresponding provincial provision.

3.2.7 *HST, GST and PST.* The Corporation and each Subsidiary is duly registered under subdivision (d) of Division V of Part IX of the *Excise Tax Act* (Canada) with respect to the goods and services tax and harmonized sales tax, and under applicable provincial Tax statutes in respect of all provincial Taxes which it is or has been required to collect. The registration numbers of each such Subsidiary are as set out in Schedule ●. All material input tax credits claimed by the Corporation and each Subsidiary pursuant to the *Excise Tax Act* (Canada) have been proper, correctly calculated and documented in accordance with the requirements of that Act and the regulations thereto.

3.2.8 *Transfer Pricing.* Transactions between the Corporation, each Subsidiary and any such non-resident person or partnership were priced in a manner so as not to give rise to any material adjustments pursuant to section 247 of the *Income Tax Act*.

3.2.9 *Non-Arm’s Length Transactions.* The value of the consideration paid or received by the Corporation and each Subsidiary for the acquisition, sale, transfer or provision of property (including intangibles) or the provision of services (including financial transactions) from or to any person or partnership with which it was not dealing at Arm’s Length at the relevant time was the fair market value of such property acquired, provided or sold or services purchased or provided.

3.2.10 *Stock Options Deduction.* The benefit in respect of each option exercised on the day prior to the Closing Date qualifies for the deduction under paragraph 110(1)(d) of the *Income Tax Act*. [NTD: alternate language: Neither the Corporation, the Vendors or any of the Corporation’s or Vendors Representatives, has made, directly or indirectly, any legally binding or enforceable agreement, representation, promise or guarantee, whether written or oral, that the benefit in respect of any option exercised by an Optionholder Vendor qualifies for the deduction under paragraph 110(1)(d) of the Income Tax Act.]

4

**TAX MATTERS**

4.1 **Preparation and Filing of Tax Returns**

Following the Closing, the Purchaser shall cause to be prepared and timely filed all Tax Returns required to be filed by the Corporation after the Closing Date other than Tax Returns that relate to or include a Pre-Closing Tax Period. For any Tax Return that relates to or includes a Pre-Closing Tax Period, the Vendor will prepare such Tax Return in accordance with Applicable Law and in a manner consistent with past practice of the Corporation. For greater certainty, Tax Returns that relate to or include any Straddle Period are Tax Returns that relate to or include a Pre-Closing Tax Period and shall be prepared by the Vendor. The Purchaser shall, and shall cause the Corporation to, fully cooperate with and assist the Vendor (including allowing access to the Vendor and its Representatives to the Corporation’s Books and Records and allowing the Vendor (and its Representatives) to make copies thereof) in connection with the preparation of any such Tax Returns, and the Vendor (and its Representatives) shall not be charged with any cost or expense for the assistance rendered by the Purchaser or the Corporation in connection therewith. The Vendor shall provide the Purchaser with a copy of each such Tax Return that relates to or includes a Pre-Closing Tax Period at least thirty (30) days (or, in the case of source deductions or HST, ten (10) days) prior to the last date for timely filing such Tax Return. The Vendor shall permit the Purchaser to review, comment on and suggest changes and corrections to each such Tax Return that relates to a Pre-Closing Tax Period (and, for greater certainty, includes any Straddle Period). The Vendor shall reasonably and in good faith consider such revisions to such Tax Returns as are requested. In the event of any dispute regarding the matters set forth in this Section, the Purchaser shall provide the Vendor with written notice thereof within fourteen (14) days (or, in the case of an HST Tax return or source deductions Tax Return, five (5) days) of its access to such Tax Returns, and the Parties shall act in good faith to resolve such dispute. If the Parties cannot resolve such dispute within fourteen (14) days (or in the
case of an HST Tax return or source deductions Tax Return, five (5) days) of notice thereof, the Purchaser may file such Tax Return with the appropriate Governmental Authority in such form determined by the Purchaser in its discretion, provided that such filing shall be without prejudice to the Vendor’s right to contest any Claim made by the Purchaser for the payment of Pre-Closing Taxes with respect to such Tax Return under this Section or [the section dealing with Indemnification]. The Purchaser shall timely file all Tax Returns that relate to or include a Pre-Closing Tax Period that are prepared by the Vendor. The Vendor shall pay or cause to be paid any Pre-Closing Taxes shown as being payable on such Tax Returns, and the Purchaser shall pay or cause to be paid all other Taxes shown as being payable on such Tax Returns. The Vendor shall have no liability for any Taxes, interest or penalties arising solely as a result of such Tax Returns not being filed by the due date.

4.2 Allocation of Taxes for Straddle Periods.
All Taxes and Tax liabilities with respect to the Corporation that relate to a Straddle Period shall be apportioned between the Pre-Closing Tax Period and the Post-Closing Tax Period on the basis that the Straddle Period consisted of two (2) taxable periods, one that ended at the close of business on the day immediately before the Closing Date and the other that began on the Closing Date, and such Taxes shall be allocated between such two (2) periods in the following manner: (a) in the case of Taxes imposed on a periodic basis (such as real or personal property Taxes), the amount of Tax allocable to a portion of the Straddle Period shall be the total amount of such Tax for the entire Straddle Period multiplied by a fraction, the numerator of which is the number of days in such portion of such Straddle Period and the denominator of which is the total number of days in such Straddle Period, and (b) in the case of any other Taxes (such as Taxes based upon or measured by net income or gain, activities, events, transfers or supplies), the amount of such Tax that is allocable to the portion of such Straddle Period that ends on the day immediately before the Closing Date shall be deemed to be equal to the amount that would be payable if the relevant Straddle Period had ended at the close of business on the day immediately before the Closing Date. [To Negotiate by the parties: For greater certainty, the Tax benefit of all items described in the definition of Transaction Expenses, whether relating to a Pre-Closing Tax Period or a Post-Closing Tax Period, shall be for the sole benefit of the Vendor.] Notwithstanding the preceding as it pertains to the allocation of Taxes and Tax liabilities of the Corporation, any interest and penalties levied on the Corporation due to the late filing of Tax Returns required in respect of a Straddle Period, the late remittance of a Tax payment required in respect of a Straddle Period or the remittance of an insufficient Tax installment amount in respect of a Straddle Period shall be reasonably allocated (i) to the Pre-Closing Tax Period to the extent that such amount is attributable to an action or omission of the Corporation that occurred prior to the Closing Date, and (ii) otherwise to the Post-Closing Tax Period. All Tax Returns relating to a Pre-Closing Tax Period contemplated by Section and all determinations necessary to give effect to or relevant to this Section or the foregoing allocations (including amortization and depreciation deductions) will be made in a manner consistent with prior practice of the Corporation and Applicable Law.

4.3 Refunds of Taxes.
If a refund of Taxes (to the extent not reflected in the calculation of the Working Capital on Closing) (the “Refund”) is received by or credited to the account of the Corporation in respect of any Pre-Closing Tax Period (other than in respect of any Tax losses carried back from any period commencing on or after the Closing Date), the Purchaser shall, or shall cause the Corporation to, pay the amount of the Refund to the Vendor. For purposes of this Section, “Refund” shall include actual receipt of a refund or interest, as well as a credit or offset of or against any other actual Tax liability or any interest or penalties on such Tax liability. The Purchaser shall promptly inform the Vendor of any such refunds or credits to which the Vendor may be entitled hereunder and shall pay to the Vendor an amount equal to the amount of any such refunds or credits within thirty calendar days following the date such refunds or credits were paid or credited by the relevant Governmental Authority to the Corporation (or its successors or assigns). If the Corporation receives a reassessment notice or other correspondence issued by a Governmental Authority to repay the Refund, then, subject to the Vendor exercising its contest rights under [Indemnification Section], the Vendor shall forthwith repay or reimburse to the Corporation the affected amount. Any amounts payable under this Section shall constitute an adjustment in the Purchase Price.

4.4 Actions after Closing.
The Purchaser shall not, and shall cause the Corporation (and its successors and assigns) not to (except with the prior written consent of the Vendor, which consent shall not be unreasonably withheld, conditioned or delayed), change any method of Tax accounting, make or change any material Tax election, file any materially amended Tax
Return, settle or compromise any material Tax liability, agree to an extension or waiver of the statute of limitations with respect to the assessment or determination of Taxes, enter into any agreement with respect to any Tax or surrender any right to claim a material Refund or otherwise take any action after the Closing Date which may result in an increase in any Pre-Closing Taxes or reduction in the amount of any Refund.

4.5 Notification Requirements.
The Purchaser shall promptly forward to the Vendor all written notifications and other written communications from any Governmental Authority received by the Purchaser or the Corporation relating to Taxes of the Corporation for all Pre-Closing Tax Periods, and shall promptly inform the Vendor of any audit proposed to be undertaken and any adjustment proposed in writing to be made by any Governmental Authority in respect of a Pre-Closing Tax Period. Notwithstanding the obligation of the Purchaser to give prompt notice as required above, the failure of the Purchaser to give that prompt notice does not relieve the Vendor of its obligations except to the extent (if any) that the Vendor has been prejudiced thereby.

4.6 Co-operation on Tax Matters
The Vendor and the Purchaser shall cooperate fully with each other (and following Closing, the Purchaser shall cause the Corporation to cooperate fully with the Vendor) and shall make available to each other in a timely fashion such data and other information as may reasonably be required for the preparation and filing of all Tax Returns, in connection with any Tax audit and in order to contest any Tax Contest or to pursue any refund, objection or appeal. Such cooperation shall include the retention and (upon the other Party’s request) the provision of records and information that are reasonably relevant to any such audit, litigation or other proceeding and making employees available on a mutually convenient basis to provide additional information and explanation of any material provided hereunder.

4.7 Tax Claims. If a notice of deficiency, proposed adjustment, assessment, reassessment, audit, examination or other Legal Proceeding or other claim in respect of Taxes of the Corporation for a Pre-Closing Period (a “Tax Claim”) shall be delivered, sent, commenced, or initiated to or against the Purchaser, or the Corporation by any Governmental Authority that results in or may result in a loss for which indemnification may be claimed from the Vendors under this Agreement, the Purchaser shall promptly notify the Vendors’ Designated Representative in writing of such Tax Claim (failing which, for greater certainty, the Purchaser’s claim for loss may be reduced in accordance with Section ●). The Vendors’ Designated Representative shall have the sole right to represent the Corporation’s and the Subsidiaries’ interests, if it provides the Purchaser with reasonable evidence that the Vendors have the financial resources to defend such Tax Claim and to fulfill their indemnification obligations under this Agreement, and to employ counsel of its choice at its expense with respect to any such Tax Claim; and the Purchaser shall cause the Corporation and each of its Subsidiaries to execute any powers of attorney necessary in order to allow the Vendors’ Designated Representative to control such contest and to settle any such Tax Claim; provided, that the Vendors’ Designated Representative shall afford the Purchaser the opportunity to participate, at its own expense, as may reasonably be requested by the Purchaser; and provided, further, that the Vendors’ Designated Representative shall not settle or otherwise compromise any Tax Claim without the Purchaser’s prior written consent (which consent shall not be unreasonably withheld, delayed or conditioned).

5 INDEMNIFICATION

5.1 Indemnity by the Vendors. The Vendors shall severally indemnify the Purchaser’s and save them harmless against, and will severally reimburse them for, any Damages arising from, in connection with or related in any manner whatsoever to:

a) any breach of any representation or warranty of the Vendors contained in this Agreement or in any other agreement, certificate or instrument executed and delivered pursuant to this Agreement;

b) any breach or any non-fulfilment of any covenant or agreement on the part of the Vendors contained in this Agreement or in any other agreement, certificate or instrument executed and delivered pursuant to this Agreement; and
c) all Taxes imposed on the Corporation with respect to any tax period or portion thereof ending on or before the Closing Date (to the extent the Closing Date Working Capital has not been reduced by a specifically identified amount of such Taxes.)

Any amount payable under this section shall constitute an adjustment to the Purchase Price.
APPENDIX 2
SAMPLE TAX REPRESENTATIONS FOR ASSET PURCHASE AGREEMENT

Representations and Warranties

1. The Vendor is not a non-resident of Canada for purposes of the Income Tax Act.

2. There are no outstanding liabilities for Taxes payable, collectible or remittable by the Vendor, whether assessed or not, which may result in an Encumbrance on or other claim against or seizure of all or any part of the Purchased Assets or which would otherwise adversely affect the Business or would result in the Purchaser becoming liable or responsible for those liabilities. The Vendor has withheld and has duly and timely remitted, or shall duly and timely remit, to the appropriate Governmental Authority all Taxes required by Applicable Law to be withheld or deducted.

3. The Vendor is duly registered under Subdivision (d) of Division V of the Excise Tax Act and its registration number is ● [and under Division I of Chapter VIII of Title I of the Québec Sales Tax Act, and its registration numbers is ● ]

4. The Vendor has not made any election or designation for purposes of any Applicable Law relating to Taxes that would affect the Business or any of the Purchased Assets after the Effective Time.

Books and Records

At the Closing Time, the Vendor will cause to be released to the Purchaser all of the Books and Records of and related to the Business. The Purchaser agrees that it will preserve, in a responsible manner consistent with the manner in which the Purchaser preserves its own books and records, the Books and Records so delivered to it for a period of seven years from the Effective Time, or for any longer period as is required by any Applicable Law, and will permit the Vendor, and the Shareholder or their authorized representatives reasonable access to them in connection with the affairs of the Vendor.

\[41\] Certain provisions from the Share Purchase Agreement in Appendix 1 would typically be included in an Asset Purchase Agreement, such as those under Representations and Warranties, Indemnification, Covenants. A tax advisor would determine the appropriate provisions based on the specific circumstances of the transaction in question.
The Purchase Price shall be allocated among the Purchased Assets as set forth in Exhibit [●] attached hereto, provided that such allocation shall be adjusted to correspond to any adjustments to the Purchase Price pursuant to Section [●] hereof. The Vendor and the Purchaser covenant and agree to use and report such allocation in their applicable Tax Returns.

[NTD: An alternative provision is as follows-
The Purchaser and the Vendor shall agree upon an allocation of the Purchase Price among the Purchased Assets and an allocation of the Assumed Liabilities and Obligations. If the Purchaser and the Vendor cannot agree on any such allocation, such dispute shall be resolved in accordance with the dispute resolution mechanism of this Agreement. The allocations required by this section shall, if required, be revised based on the Post-Closing Adjustment to the Purchase Price. Each of the Purchaser and the Vendor agree to file all Tax Returns in accordance with this Agreement. The Purchaser and the Vendor shall not take any position in any Tax Return, Tax proceeding or audit that is inconsistent with such allocations.]

If any Governmental Entity does not agree with that allocation, the Purchaser and the Vendor shall use their best efforts and good faith (which is not to be construed as requiring the Purchaser or the Vendor to commence or participate in any litigation or administrative process challenging the determination of any Governmental Entity) to agree on a different allocation acceptable to that Governmental Entity, and the Purchaser and the Vendor shall amend the original allocation and the relevant Tax Returns accordingly.
Section 85 Election. The Issued Shares shall be allocated among the [Assets] so as to ensure that the consideration received by the Vendor for each of the [Assets] shall include at least one of the Issued Shares or a fraction thereof, for purposes of subsection 85(1) of the Income Tax Act. In connection with the sale, transfer or assignment by the vendor to the Purchaser of the [Assets], the Purchaser shall execute a joint election with the Vendor pursuant to subsection 85(1) of the Income Tax Act and the corresponding provisions of any applicable provincial or territorial tax legislation. In such election the Vendor will be entitled to elect the amount which shall be the Vendor’s proceeds of disposition and the Purchaser’s cost of the [Assets] (the “Elected Amount”) for purposes of the Income Tax Act and applicable provincial income tax legislation, provided that such amount is within the limits prescribed by the Income Tax Act. The Vendor shall submit to the Purchaser, on or before the 90th day following the date of this Agreement, duly completed and executed election forms together with any required supporting documentation (the “Purchaser Election”). For purposes of completing the Purchaser Election, the Purchaser shall provide the Vendor with the information relating to the Purchaser that is required to be included in the Purchaser Election. The Purchaser shall return the Purchaser Election to the Vendor within 20 business days following receipt by the Purchaser of the completed and executed Purchaser Election. The Vendor shall be solely responsible for duly and timely filing the Purchaser Election. The Purchaser agrees to reasonably consider executing any amended Purchaser Election subsequently submitted by the Vendor to the Purchaser within 90 business days following receipt thereof.

GST Election. The Purchaser and the Vendor acknowledge and agree that the Purchase Price does not include any GST nor any tax imposed under any provision of any applicable provincial legislation imposing a similar value added or multi-staged tax. The Purchaser and the Vendor acknowledge and agree that the Purchaser is acquiring ownership, possession and use of substantially all of the assets reasonably necessary for the Purchaser to carry on the Business and that the sale and purchase of the Purchased Assets shall be completed on the basis that no GST (and no tax imposed under any provision of any applicable provincial legislation imposing a similar value added or multi-staged tax) will be payable by the Purchaser in respect of the sale and purchase of the Purchased Assets. The Purchaser and the Vendor shall jointly elect under subsection 167(1) of the Excise Income Tax Act (and under any provision of any applicable provincial legislation imposing a similar value added or multi-staged tax), that no tax payable with respect to the •. However, in the event that any GST (and any tax imposed under any provision of any applicable provincial legislation imposing a similar value added or multi-staged tax) is payable in respect of the sale and purchase of the Purchased Assets, the Purchaser agrees to pay to the Vendor, immediately upon demand, such amounts and the Vendor agrees to remit on a timely basis such payment to the Canada Revenue Agency (and to any provincial taxation authority as appropriate), and in such case, the Vendor agrees to deliver to the Purchaser written evidence of such remittance. The Vendor agrees to be responsible and pay for any applicable interest or penalties payable as a result of any late payment of such GST (and any tax imposed under any provision of any applicable provincial legislation imposing a similar value added or multi-staged tax).

Accounts Receivable Election. If requested by the Purchaser, the Purchaser and the Vendor shall elect jointly in the prescribed form under Section 22 of the Income Tax Act and under any similar provision of any other applicable provincial legislation as to the sale of the Accounts Receivable forming part of the Purchased Assets and described in Section 22 of the Income Tax Act and shall in that election allocate an amount equal to the portion of the Purchase Price allocated to those assets pursuant to Schedule • as the consideration paid by the Purchaser for those assets. The Parties shall file such election forms, along with any documentation necessary or desirable to give effect
to such election, with the Canada Revenue Agency and any other appropriate taxation authority within the
prescribed time limits.

**Subsection 20(24) Election.** The Purchaser and the Vendor acknowledge that the Purchaser has agreed to assume
the Assumed Liabilities. To the extent that the Vendor has received amounts in respect of services not rendered or
goods not delivered, in each case prior to the Closing Time, the Purchased Assets having a fair market value equal to
those amounts are transferred to the Purchaser as payment for the Purchaser’s agreement to assume a corresponding
amount of the Assumed Liabilities relating to those services or goods and, if requested by the Purchaser, the
Purchaser and the Vendor shall jointly elect pursuant to subsection 20(24) of the *Income Tax Act* and under any
similar provision of any applicable provincial legislation. The Parties shall file such election, along with any
documentation necessary or desirable to give effect to such election, with CRA and any other appropriate taxation
authority within the prescribed time periods.

**Capital Dividend Election.** In connection with the declaration and
payment of Pre-Closing Dividends that are designated to be capital dividends (as provided pursuant to subsection
83(2) of the *Income Tax Act*), then (i) all of the capital dividends so designated were recorded on Form T2054 (as
prescribed under the regulations to the *Income Tax Act*) and which Form T2054 was filed with the Canada Revenue
Agency (and any applicable provincial Taxation authority) in the prescribed manner on or before the particular time
on which any part of the dividend was paid; and (ii) as a consequence of the declaration of such capital dividend and
the filing of the Form T2054, the corporation is not subject to any Tax pursuant to the provisions of Part III of the
*Income Tax Act*. If by virtue of the designation of the Pre-Closing Dividends as capital dividend as provided
pursuant to Section • of this Agreement and the Corporation becomes liable for Taxes imposed pursuant to Part III
of the *Income Tax Act*, Purchaser shall cause the Corporation to make the election provided for in subsection 184(3)
of the *Income Tax Act* in respect of any excessive capital dividend designation so as to treat any excess amount as a
separate taxable dividend. Each Vendor hereby concurs with the making of such election, and shall, forthwith upon
the written request the Purchaser, take all steps and do all things required to make the election.

**Non-Competition Tax Election.** At the request of any Vendor and provided that the contents of the Tax election
are satisfactory to the Purchaser, acting reasonably, the Purchaser agrees to duly and timely make and file any Tax
elections or amended Tax elections in prescribed or other acceptable form and within the prescribed time limits so as
to ensure that no amount in respect of a Non-Solicitation Agreement or a Non-Competition Agreement will be
required to be included in the income of a particular Vendor pursuant to section 56.4 of the *Income Tax Act* as it
reads as of the date of this Agreement or any amended or successor provision thereto, and any analogous provision
of provincial or territorial tax legislation.

**Taxable Canadian Property Purchaser Notification.** Prior to Closing, the Purchaser shall prepare Form T2062C
in respect of its acquisition of the Shares owned by ● (the “Notification Form”), such Notification Form to be in
substantially similar form to Schedule •. On Closing, the Purchaser shall execute Part C and the Vendor shall
execute Part D of the Notification Form. The Parties agree that a letter addressed to the Canada Revenue Agency
will be submitted along with the Notification Form to the Canada Revenue Agency, which letter will be in
substantially similar form to Schedule •. The Purchaser shall file the Notification Form (together with the letter)
with the Canada Revenue Agency within the time prescribed in the *Income Tax Act*. 