Advocis™ COMMENT

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INTEREST AND OTHER EXPENSES, AND REASONABLE EXPECTATION OF PROFIT

In a press release dated October 31, 2003, the Department of Finance proposed legislation on the deductibility of interest and other expenses, and the reasonable expectation of profit (REOP). This announcement was not a complete surprise, since draft legislation was promised in the February 2003 budget. The scope of these proposals, however, is much broader than anticipated. They deal with not only interest, but also with the more general question of the deductibility of losses from a business or property.

The proposed legislation links the deductibility of interest and other expenses to the taxpayer's prospects for making a profit, not only in the current year, but over a number of years. Thus the proposals introduce the phrase "cumulative profit." This term will be used, in conjunction with the concept of reasonable expectation of profit, to create a subjective test to determine whether expenses and/or losses will be tax deductible. Under the proposals, a taxpayer will be allowed to claim a loss on income account only where there is a reasonable expectation of cumulative profit from the business or property.

The proposals also clarify that "profit" does not include a capital gain. This means that any potential return on investment in the form of a capital gain is not included in determining whether there is a reasonable expectation of a cumulative profit.

For example, consider the purchase of a rental property. An investor may buy a property using borrowed funds, knowing that the total return will include any gain on the appreciated value of the property. However, the new rules will disallow the deductibility of losses if the property has no reasonable expectation of showing a cumulative profit on an operational basis (i.e., excluding the capital gain).

The cumulative profit test will be applied on an annual basis to determine if the losses of that particular year are deductible. Each year, the taxpayer must determine if it is reasonable to expect a profit over the lifetime of the business or property. If the answer is "yes," then the losses for that year can be deducted. If not, the losses for that particular year are not deductible (but with no impact on losses deducted in prior years). This annual evaluation permits taxpayers to realize losses in certain years (such as the start-up phase of a business) provided there is a reasonable expectation of cumulative profit at that time.

As proposed, these new rules will apply to tax years beginning after 2004. Note that they do not provide grandparenting provisions to exempt existing arrangements from their application.

The Department of Finance has provided a public consultation period on this draft legislation (submissions can be made until

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December 31, 2003). Given the wide-ranging effects of these proposals, they may well be revised before their implementation.

Also note that the Supreme Court heard the appeal of the Gifford decision in November 2003. One of the issues of the Gifford case is whether interest expense is deductible under a specific exception of the Income Tax Act, or under the general rules for the deduction of business and property expenses (essentially, whether interest is on capital or income account). When the Court's decision is released, it may ultimately impact Finance's proposed new rules.

In tandem with Finance's October 31st press release of the proposed rules, the Canada Customs and Revenue Agency (CCRA) issued new Interpretation Bulletin IT-533, *Interest deductibility and related issues*. This bulletin is substantially the same as their draft interpretation bulletin dated August 14, 2003. It provides an extensive review of the Income Tax Act rules and numerous court cases that have considered the application of the rules.

I/R 7400.00

NON-COMPETITION COVENANTS – THE NEW RULES

As noted in the last issue of Comment (November/December 2003, issue #222), the Department of Finance responded to the Federal Court of Appeal's decision in the Manrell case, which relates to the income tax treatment of non-competition payments. Rather than appeal the case to the Supreme Court of Canada, Finance has proposed a change in the law. On October 7, 2003, Finance Minister John Manley announced amendments to the Income Tax Act affecting the treatment of amounts received by a taxpayer for granting a "restrictive covenant."

The proposed rules will tax, as ordinary income, an amount received by a taxpayer for granting a restrictive covenant. An exception to income treatment will be allowed where there is an arm's-length disposition of corporate shares. In that case, all or a portion of the amount received for the covenant will be treated as proceeds of disposition of the shares. The taxpayer will have to determine how much the value of those shares increased as a result of the restrictive covenant. An amount equal to that increase can be added to the proceeds of disposition and will thus be taxed on capital account. Any remaining portion of the amount received for the covenant will be taxed as income.

The proposed provision may be best explained by an example.

Sam and Shelley are the owners of a private company that they want to sell to Taylor, whom they deal with at arm's-length. Sam actively manages the business and owns two-thirds of the shares. Shelley, who is not involved in the corporation's management, owns the remaining one-third.

Taylor offers to pay $3 million for the company if Sam will sign a restrictive covenant not to compete with Taylor after the sale. Without that covenant, Taylor would be willing to pay only $2.4 million for the shares. Sam agrees to the restrictive covenant and accepts $2.2 million ($1.6 million for his shares, plus $600,000 for granting the covenant). Shelley will receive $800,000 for her shares.

Under the proposed legislation, Sam would be deemed to have disposed of his shares for proceeds of $2 million. This is the amount he actually received for the shares ($1.6 million), plus the increase in the value of his shares because the covenant was granted ($400,000, or 2/3 of ($3 million – $2.4 million)). Thus, $400,000 of the amount he received for agreeing not to compete would be taxed on capital account. The remaining $200,000 of the covenant proceeds would be fully taxable in his hands on income account. Since Shelley is not a party to the restrictive covenant, she is not affected by the proposed rules and the proceeds of disposition for her shares would simply be $800,000.

These new proposals will apply to amounts received or receivable after October 7, 2003. Grandparenting is allowed for amounts received before 2005 under a written agreement made on or before October 7, 2003. The Department of Finance has not yet released detailed draft legislation to enact this proposal.

I/R 7401.04

CHARITABLE GIFT ANNUITIES

Planning a charitable gift can be very rewarding for the donor and the charity. The donor knows that he or she has provided valuable financial support to the charity. And the charity knows that additional financial resources are being made available. A charitable gift annuity is one way to benefit both the donor and the charity.

Under a charitable gift annuity, the donor makes a gift of capital to the charity. However, the gift is subject to a condition – in exchange for the gift, the charity promises to pay the donor an income, which usually involves a payment stream for the donor's lifetime. When the charity receives the monetary gift, it could set aside some of the capital to meet its ongoing financial commitment to the donor. Commonly, though, the charity will fully "hedge" its commitment by purchasing an annuity on the life of the donor.

In the past, the tax consequences to the donor were not set out in the Income Tax Act, but rather were determined based on the administrative practices of the CCRA as described in an interpretation bulletin. The donor was deemed to have made a gift, and the amount of the gift was calculated as the capital transferred to the charity less the total of the expected income to be paid by the charity to the donor during his or her lifetime. Amounts paid to the donor by the charity were treated as tax-free because they were considered a return of capital.

Draft legislation introduced December 20, 2002, proposed new tax rules for "split receipting" of charitable gifts where the donor receives a benefit from the charity. As a result of these changes, the CCRA will no longer rely on past administrative practice as their guide for the tax treatment of charitable gift annuities. The proposed rules state that a donor is eligible for a charitable receipt equal to the capital transferred to the charity, less the fair market value of the property acquired by the donor (i.e., the annuity stream). The CCRA has released guidelines on determining the fair market value of the annuity, saying they will look at the cost of acquiring a similar annuity from an arm's-length third party. The income paid to the donor by the charity will be treated as a combination of interest income and a return of capital, with the interest portion reported on the donor's annual tax return. The proposed rules apply to all charitable annuities issued after December 20, 2002.

Consider the example of a 75-year-old non-smoker who plans to transfer $200,000 to her favourite charity upon her passing. The endowment officer of the charity proposes a charitable annuity instead. The donor would transfer the funds now and receive a monthly income from the charity for the remainder of her lifetime. Let's assume that based on her income needs, the donor arranges with the charity to pay her $1,000 each month for her remaining lifetime. This strategy allows the donor to complete her joint objectives of supporting the charity while still maintaining sufficient income to support her ongoing lifestyle. The charity benefits because it receives the funds immediately rather than at an indeterminate time in the future.

The tax results of the gift would be as follows under the old and new tax regimes:

	Old Rules ($)	New Rules ($)
Amount transferred	200,000	200,000
Monthly income	1,000	1,000
Expected lifetime receipts (1)	168,000	
Approximate cost of an annuity		120,092
Amount of the gift (i.e., tax receipt)	32,000	79,908
Taxable portion of monthly income (2)	zero	185

Notes (1) Based on a 14-year life expectancy as prescribed by Archived IT-111R2, *Annuities Purchased from Charitable Organizations*.

(2) Estimate under the new rules. The monthly income reported will depend on whether the annuity qualifies as a "prescribed annuity contract."

The old and new approaches provide significantly different patterns of income and tax credits.

- The new approach generates a much larger charitable gift, which will allow the donor a greater tax shield. If she is unable to fully utilize the receipt in the year the donation is made, the unclaimed portion can be carried forward for up to five years.
- The new approach leaves the donor with tax payable on a portion of the monthly income.

Note that while this strategy has appeal to some, a similar outcome could be achieved through a slight variation. For example, a donor could simply use a portion of her funds to buy an annuity and donate the remaining capital to the charity. This could be much simpler and more flexible than attempting to arrange the annuity directly with the charity.

The new regime is not necessarily better or worse than the old administrative policy. Some donors may feel worse off because of the change, while others may prefer the results. Remember that the new approach was always achievable in the past by buying the annuity before giving the balance of the capital to the charity. With the new rules, the choice between donation methods has been removed.

I/R 1600.03

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