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COMMENT

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# GIFFORD V. CANADA

Whenever a tax case makes it to the Supreme Court of Canada, it warrants careful review to assess its impact on the current state of the law and whether it establishes any new precedents. One such recent decision is the case of *Gifford v. The Queen*.

Thomas Gifford, a commissioned financial advisor at Midland Walwyn, was considered an employee of the firm when he paid $100,000 to purchase a customer list and a non-compete agreement from another employee who was retiring. Gifford sought to deduct his $100,000 payment as well as the interest expense on a loan incurred to acquire funds for the payment.

The Tax Court had determined earlier that the $100,000 payment was not a capital outlay, concluding the clients on the list were those of Midland Walwyn and that no enduring value was created for Gifford. The $100,000 was characterized by the lower court as a current marketing expense and, therefore, tax deductible. The lower court also decided that since the borrowed funds related to a current expense, the interest was also a current expense and, therefore, deductible.

The case was appealed to the Federal Court of Appeal, which overturned the lower court's ruling. The Appeal Court decided that prior cases that dealt with the nature of client lists should apply despite Mr. Gifford's lack of proprietary interest in the clients. It also determined that the court could not treat the interest as a current expense since interest was always a capital expenditure.

The case was further appealed to the Supreme Court, which upheld the Appeal Court's decision, but clarified the reasoning for reaching the same conclusions. The Supreme Court determined that the $100,000 payment for accumulated goodwill created an enduring benefit for Mr. Gifford, and was therefore a capital outlay. The court also reiterated that, as an employee, Gifford could only deduct certain expenses as allowed by the Act and, since the payment was "on account of capital," the deduction of this amount was specifically disallowed.

The Supreme Court then considered Gifford's ability to deduct the interest expense incurred on the loan to fund the $100,000 payment. The court determined that the borrowing added to Gifford's financial capital and that, as a result, the interest was on capital account. As an employee, Gifford could only claim such interest if the loan related to the purchase of an automobile or aircraft. Since this was not the case, his interest expense was not deductible.

The Supreme Court's comments about the deductibility of interest were perhaps the most interesting aspect of the case. In arriving at its decision, the Court considered whether interest expense is always on account of capital (and therefore only deductible if it meets specific requirements

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set out in the Act), or whether it could sometimes be a current expense (in which case it could be deducted under the more general provisions of the Act).

The Court concluded that the tax treatment of interest depends on what the proceeds represent to the borrower when they are received, and not what they are spent on. Interest is usually paid on account of capital since it generally adds to financial capital. However, it is possible, though not usual, for interest to be a deductible current expense where it is part of the business that is being carried on (such as in the case of moneylenders, where it is a regular cost of doing business).

I/R 2121.00, 7401.01

# PRINCIPAL RESIDENCE EXEMPTION

One of Canada's last "tax shelters" is the principal residence. When certain conditions are met, a homeowner is entitled to a reduction or elimination of the capital gain realized upon the disposition of the family home.

The term principal residence is defined in the Income Tax Act (the "Act"). Generally, the definition includes a house, condominium, mobile home, trailer, houseboat, and cottage. In addition, the property must be "ordinarily inhabited in the year" by the individual, the individual's spouse, common-law partner or child, or a former spouse or common-law partner. While the term "ordinarily inhabited in the year" is not specifically defined in the Act, the words are interpreted to mean that the property need only be inhabited at some point in the year, not continuously throughout the year. As such, a cottage would generally qualify as a principal residence.

The gain realized on disposition of a principal residence is reduced by the principal residence exemption, which is calculated as follows:

**Principal Residence Exemption = (Capital Gain) x ((Designated years +1) ÷ (Years of ownership))**

A year can only be "designated" in the above formula if the individual was resident in Canada in that year and the year is after 1971 (the year capital gains became subject to income tax). The individual can own the property alone or jointly with another person or persons. Years of ownership are calculated as full or partial years of ownership after 1971. The "plus one" in the formula provides relief for situations where an individual owns more than one principal residence in a particular year. This happens anytime a taxpayer sells one home and replaces it with another in the same calendar year.

While an individual may have more than one residence in a year, only one principal residence may be designated per family in any taxation year after 1981. Prior to 1982, spouses could each claim a separate property as their principal residence, allowing a total of two per couple.

Where more than one residence is owned, therefore, it is necessary to decide which property should be designated as the principal residence. Without considering the time value of money, the optimum designation is achieved by determining the average annual capital gain for each property and designating (or reserving the designation for) the property with the highest such gain. Consider the example of a couple that sells their city home while retaining their cottage:

While the home has the larger capital

| | City Home | Cottage |
|---|---|---|
| Purchase date | 1965 | 1989 |
| Purchase price | $60,000 | $60,000 |
| V-day value | $110,000 | |
| Value today (sometime in 2004) | $440,000 | $260,000 |
| Post-1971 years of ownership | 33 | 16 |
| Capital gain | $330,000 | $200,000 |
| Average annual gain per year | $10,000 | $12,500 |

gain, it is more beneficial to designate the cottage as the family's principal residence beginning in 1990 (the cottage need not be designated for 1989 because of the "plus one" factor in the formula). The average annual gain per year on the cottage is $12,500, making it more beneficial to shelter that gain. The principal residence exemption could be claimed for the city home for the years 1972 to 1989.

| | | |
|---|---|---|
| Designated years | | |
| pre-1990 | 18 | none |
| post-1989 | none | 15 |
| Exemption (includes +1 factor) | $190,000 | $200,000 |
| Net capital gain | $140,000 | 0 |

To demonstrate why it is more beneficial to maximize the claim on the cottage before the claim on the home, consider the result of shifting one designated year from the cottage to the city home. In this case, the net gain on the cottage increases by $12,500, from zero to $12,500, while the net gain on the city home decreases by only $10,000, from $140,000 to $130,000. The net effect of this shift is a larger tax liability. However, that tax liability is deferred until the cottage is disposed of, without any interest charged on that tax deferral.

The tax deferral reflects the time value of money. Consider the situation where the above couple intends to retain the cottage for many years. While the optimum claim would involve sheltering the accrued gain on the cottage, there is a real tax cost in the current year from exposing some of the gain on the city home. Depending on when the couple intends to sell the cottage, it may make financial sense to shelter all of the gain on the city home, thereby paying no taxes currently.

I/R 7401.01

# WILL PLANNING

Many advisors work from the premise that a well-thought-out estate plan should use one or more trusts. Beyond the basic benefits of asset management and control, trusts can provide other significant advantages. For instance, the use of testamentary trusts provides the opportunity to reduce the tax burden to heirs by splitting income amongst the surviving spouse, children, and trusts. The actual savings will depend upon the total income, the number and type of taxpayers involved, and the amount of income each taxpayer has from other sources.

Many wills are drafted to utilize two trusts in the estate planning process. The first trust is structured as a qualified spousal trust, in order to allow the rollover of property with an accrued capital gain and/or accrued recapture of capital cost allowance, or other types of property whose disposition would trigger income. The second trust is established as a family trust. This trust provides the trustee with discretion as to the allocation (or "sprinkling") of income amongst the beneficiaries. The will should be drafted to allow the executor discretion about which assets, including the estate residue, will be distributed to each trust. This allows the executor to make the most tax-effective allocation of assets within the distribution proportions specified in the will. The trusts would also be drafted with appropriate capital encroachment powers in order to protect the spouse and children.

Using two trusts allows tax planning that can be customized based on the facts of the situation both at the time of death and over time as the survivors continue on with their lives. An income-splitting strategy typically involves the allocation of income amongst the trusts and the beneficiaries in order to take maximum advantage of their lower marginal tax rates. The remaining income

could be directed to the surviving spouse. The actual income allocation would be structured to make optimal use of the various marginal tax rates and tax credits. While the spousal trust can only allocate income to the surviving spouse, the family trust can allocate income to the surviving spouse and children.

In addition to the two trusts described above, additional testamentary trusts may enhance the tax-saving opportunities, depending on the individual's asset base and objectives. For instance, planning may dictate that a separate testamentary trust be settled for each child. Settling multiple trusts increases the number of taxpaying entities amongst which income can be split, multiplying the benefit of lower tax rates. Further planning can even involve splitting income between the child and his or her testamentary trust. Depending on the design of the trust, it could distribute its after-tax income to the beneficiary for his or her benefit.

An important issue to consider when establishing a separate testamentary trust for each child is an anti-avoidance provision under Canadian tax law that groups multiple trusts into a single taxable entity if substantially all of the property in the trusts is derived from one person and the beneficiaries are the same person or same class of persons. The Canada Revenue Agency (the "CRA") has stated that determining whether beneficiaries are the "same class of persons" is a question of fact. The CRA will consider a number of factors, including family links, whether the trusts have common beneficiaries, and the nature of each beneficiary's respective interests in the trusts. Generally, though, the CRA will not apply this provision where each beneficiary has his or her own trust and there are no overlapping interests.

Designing an estate structure that makes each of the testamentary trusts distinct from one another is an integral aspect of estate planning. The trusts may have separate and distinct distributions dates, levels of discretion, or even different trustees. The structure needs to reflect each child's ability to manage income and capital distributions as well as his or her specific needs. Separate record-keeping will be required for each trust. As a practical matter, the costs and complexity of administering a multi-trust structure can be prohibitive.

I/R 8500.00

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