Is there a hole in the bucket (…dear Liza… dear Liza)?

Shareholder Benefits under Subsections 15(1), 56(2) and 246(1)

2020 TSG Conference

January 20, 2020

Hilton Toronto

Manu Kakkar, CPA, CA, TEP, MTax, BSc(Hons)

Kenneth Keung CPA, CA, CPA(CO, USA), TEP, CFP, MTax, LLB

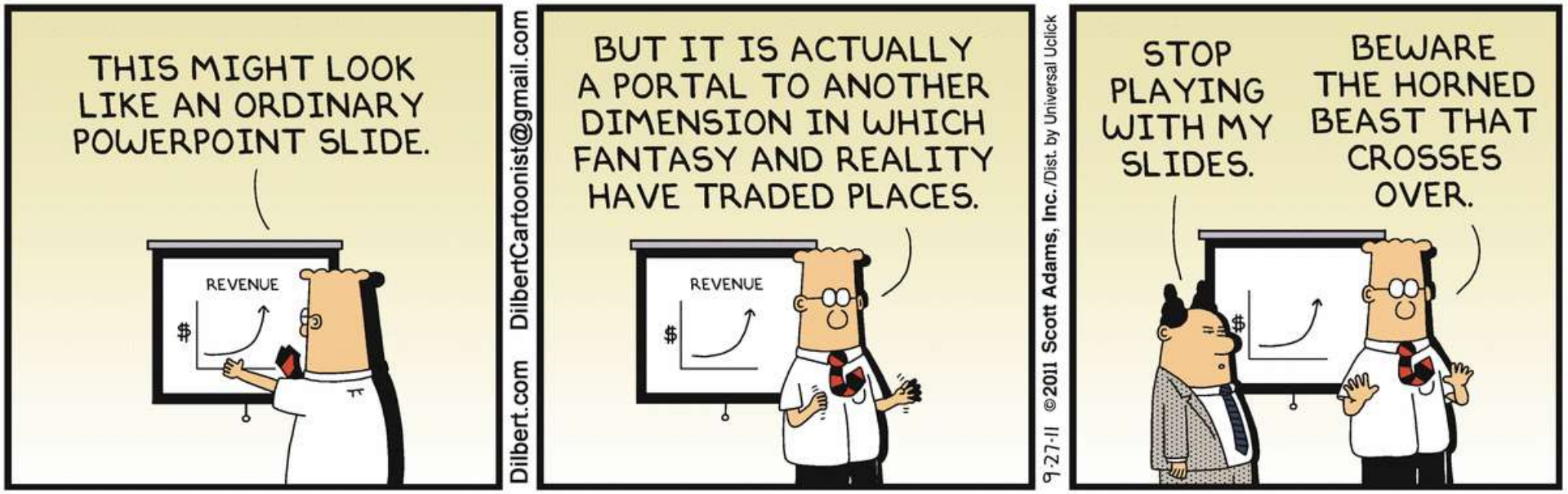
KAKKAR

Moodys™ TAX WELL SOLVED

Disclaimer

This material is for educational purposes only. As it deals with technical matters which have broad application, it is not practical to include all situations. As well, the course material and the references contained therein reflect laws and practices which are subject to change. For this reason a particular fact situation should be reviewed by a qualified professional.

Although the course material has been carefully prepared, none of the persons involved in the preparation of the material accepts any legal responsibility for its contents or for any consequences arising from its use.


THIS MIGHT LOOK LIKE AN ORDINARY POWERPOINT SLIDE.
REVENUE
$
Dilbert.com DilbertCartoonist@gmail.com
BUT IT IS ACTUALLY A PORTAL TO ANOTHER DIMENSION IN WHICH FANTASY AND REALITY HAVE TRADED PLACES.
REVENUE
$
9-27-11 ©2011 Scott Adams, Inc./Dist. by Universal Uclick
STOP PLAYING WITH MY SLIDES.
BEWARE THE HORNED BEAST THAT CROSSES OVER.
$

Agenda

Introduction to Shareholder Benefits

- Overall concept: taking wealth out of a corporation outside of accepted means is income to the shareholder.
- Subsection 15(1):
  - *"If, at any time, a benefit is conferred by a corporation on a shareholder of the corporation, a member of a partnership that is a shareholder or on a contemplated shareholder… then the amount or value of the benefit is to be included in computing the income of the shareholder, … or contemplated shareholder…"*

Exceptions to Subsection 15(1)

- Exceptions to subsection 15(1) include:
  - Dividends;
  - Stock dividends;
  - Deemed dividends under section 84;
  - PUC reductions; and
  - Share redemptions.
- i.e. actions the Act already has a scheme to deal with
- Ordinary income treatment

Interpretation Provision
Subsection 15(1.4)

- Relatively recent, introduced in 2012 and effective October 30, 2011.
- Paragraph 15(1.4)(c): if a benefit is conferred on an individual (other than an excluded trust) who is non-arm's length ("**NAL**") with or affiliated with a shareholder, member of a partnership that is a shareholder or a contemplated shareholder, then the subsection 15(1) benefit is conferred on the shareholder, member or contemplated shareholder, as the case may be.

Interpretation Provision
Subsection 15(1.4) – Cont'd

- Paragraph 15(1.4)(c) prevents double tax by only including a paragraph 15(1.4)(c) benefit to the extent that the benefit is not already included in computing the income of the individual or any other person.
- Joint Committee's 2011 report warned that wording of paragraph 15(1.4)(c) broad enough to apply even where the benefit is not conferred 'qua shareholder'.
- Applies even if shareholder played no role in the conferral of benefit.

Who is Assessed under Subsection 15(1)?

Who is the Taxpayer Assessed under Subsection 15(1)?

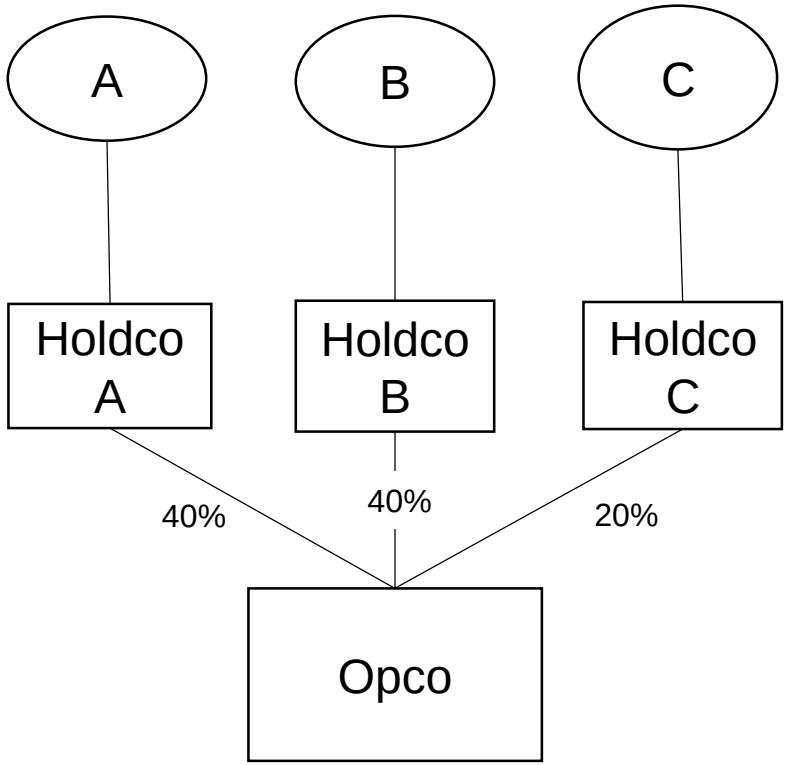
- Income is assessed in the hands of the shareholder (or member of partnership that is a shareholder, or contemplated shareholder) who received the benefit.
- Where a benefit is conferred to an individual who is NAL with the shareholder, the income inclusion goes to the shareholder.
- Wording of paragraph 15(1.4)(c) prevents double counting.
- In CRA #2015-0575911E5 – CRA assessed the most blameworthy shareholder in a situation where four siblings are shareholders and the corporation conferred a benefit on one of the spouses.
- In IT-335R2, regarding subsection 56(2), CRA says the shareholder who acquiesces the direction of the payment will be taxed on a pro-rata basis based on number of shares
- Paragraph 15(1.4)(c) could only apply if the conferee is not a shareholder, but technically a shareholder could be considered NAL to themselves.

(Non)-Application of Subsection 15(1) to Indirect Shareholder

- *Mullen v MNR* – 90 DRC 1151 (TCC)
  - Opco purchased a condo that was used by the shareholder of Holdco.
  - TCC: subsection 15(2) uses express wording to cover an indirect link between a shareholder and a corporation. If Parliament had intended for subsection 15(1) to apply to indirect shareholders, it would have used the same wording as subsection 15(2).
- In *Massicotte c. R.*, 2008 FCA 60, CRA originally assessed under 15(1) where an Opco conferred a benefit on the shareholder of Holdco. However, since 15(1) couldn't apply, CRA changed the basis of its reassessment to subsection 246(1).
- See CRA views #9335505 and subsequent views for assessing under multiple sections for indirect benefits to shareholders.
- Today, paragraph 15(1.4)(c) also provides ability to assess income on Holdco under subsection 15(1).

CRA #2016-0666841E5

- Opco disposed of a condominium unit in favor of B's child for $250,000, when the FMV was $500,000.
- Even though subsection 15(1) can't apply to B since Holdco B did not confer a benefit directly to B or B's child, Opco conferred benefit to B's child who is NAL with Holdco B, paragraph 15(1.4)(c) would allow CRA to assess income in Holdco B for the benefit.
- Subsections 56(2) and 246(1) also have application – to be discussed later.



Non-Residents and Subsection 15(1) Shareholder Benefits

Non-Residents and Subsection 15(1)

- Outbound situation:
  - Subsection 15(7) – section 15 applies whether the corporation was resident or carrying on business in Canada or not.
  - Subsection 15(1) applies to Canadian shareholders receiving benefits from foreign corporations.

Non-Residents and Subsection 15(1) – Cont'd

- Inbound situation:
  - Non-resident shareholder taking benefits from a Canco is not subject to Part I income tax.
  - Paragraph 214(3)(a) deems the amount to be a dividend paid to the taxpayer if section 15 or subsection 56(2) would have been applicable if Part I applied.
  - Withholding tax required on deemed dividend.
    - Dividend deemed paid at the time of the benefit conferral.
    - Generally, CRA allows Treaty rates as long as the benefit recipient meets the ownership requirements in Canco, and Treaty has deemed dividend provision (example – X(3) of US-Canada Treaty)
    - Note: unlike deemed dividend 15(2) benefits (via subsection 227(6.1) repayment refund), the Part XIII tax on 15(1) benefits cannot be recovered.

Non-Resident to Non-Resident Situations

- Combination of subsection 15(7) and paragraph 214(3)(a) technically means any foreign shareholders receiving a benefit from a foreign corporation is subject to Canadian withholding tax, which is absurd.
- CRA states it would apply Part XIII only where "there is sufficient nexus with Canada" or where "benefit consists in making available to the shareholder a property located in Canada".
  - CRA #9134125, #2006-0196241C6, #2012-0451241C6.
  - CRA states that it could alternatively apply section 247 (transfer pricing) to achieve the same result.
- CRA #2011-040930117:
  - Canco owned by U.S Parent. U.S Parent sold shares of Canco (not TCP) to EU Sub for proceeds > FMV. Per CRA, EU Sub conferred benefit to US Parent. However, because there is no appropriation of Canco funds and Canco not been impoverished, "it would be difficult to convince a court that paragraph 214(3)(a) should apply" in this case.

Subsection 6(1) – Benefit Received Qua Employee

Benefits Received Qua Employee

- Generally, CRA views benefits received qua employee if it is reasonable to conclude the benefit was provided as part of a reasonable remuneration package.
- Paragraph 6(1)(a) is preferred over a subsection 15(1) benefit since employee benefits are generally deductible by the corporation (but payroll withholding required on the value of the employee benefit)
- In case there is uncertainty, plan ahead to develop positive facts that support section 6.

Subsection 56(2) – Indirect Payments

Indirect Payments

- Overall concept: If you direct a payment to someone else, **you** are taxed.

- Subsection 56(2) – Indirect payments:
  - Income inclusion in the Taxpayer's hands to the extent there is:
    - A payment or transfer of property to someone other than the Taxpayer;
    - Made pursuant to the direction of, or with the concurrence of, the Taxpayer;
    - For the benefit of the Taxpayer or the other person the Taxpayer desires to have the benefit conferred upon; and,
    - Would be included in the Taxpayer's income if payment or transfer been made to the Taxpayer (instead of the other person).

Court Introduced 5th Condition to 56(2)

- *Winter v R* [1991] 1 C.T.C. 113:
  - Where the taxpayer had himself no entitlement to the payment, subsection 56(2) only applies if the transferee not subject to tax on the benefit he received.
- The actual existence of a fifth condition is not entirely clear.
  - The FCA in Neuman declined to find there was a fifth condition to subsection 56(2). SCC overturned FCA decision in Neuman but without commenting specifically on the fifth condition.

Subsection 56(2) Overlap with Subsection 15(1) due to Paragraph 15(1.4)(c)

- Introduction of paragraph 15(1.4)(c) effective Oct 30, 2011 potentially causes an overlap
  - Section 15: corporation confers benefit to someone NAL with shareholder, then income to shareholder.
  - Subsection 56(2): one person (the shareholder) wish to confer a benefit on someone else, then income to shareholder.
  - However, section 15 is subject to tax on split income ("**TOSI**"), whereas 56(2) is not.
- Threshold is low for paragraph 15(1.4)(c) to apply – no requirement for an intention to confer benefit.
- CRA audit manual – where it is not clear if the benefit was direct or indirect, the CRA may use both subsections in conjunction.
  - However, subsection 56(2) will not apply to use of property (e.g. cottage), because not a payment or transfer of property (CRA Audit Manual 24.11.3)

Degree of Participation Required to Invoke Subsection 56(2)

- *MNR v Bronfman*, 1965 C.T.C. 378 (Exch)
  - all shareholders subject to subsection 56(2), because of their failure to protest was tantamount to approval of the gift.
- *Smith v Queen* [1996] 1 C.T.C. 418 (FCTD)
  - taxpayer's concurrence in the conferring of indirect benefit may be passive.
- Will not apply to a bona-fide loan (IT-335R2)

Does Subsection 56(2) Replace Concept of Constructive Receipt?

- If a payment is payable to the Taxpayer (and the Taxpayer is entitled to it), and the Taxpayer merely instructs that it be paid to another person, the payment should still be taxable in the Taxpayer's hands under general concept of constructive receipt.
  - E.g. tax withheld and remitted to CRA by a payor is still income to the earner.
- It appears that subsection 56(2):
  - limits application of constructive receipt to only where all conditions of subsection 56(2) are met,
  - also covers situations outside of constructive receipt (unless it's a dividend – Neuman)

The Strange SCC Case of Neuman [1998] 1 S.C.R. 770

- Issue: if a corporation selectively pays dividend on one class of shares but not the other, should subsection 56(2) apply to the controlling shareholder(s)?
- Per the facts, dividends declared were at the discretion of the directors and could be made selectively on different classes of shares.

The Strange SCC Case of Neuman – Cont'd

- SCC found that subsection 56(2) cannot apply to dividend income, due to its nature:
  - Until a dividend is declared, profits belong to the corporation as RE.
  - Had dividend not been declared & paid to a third party, it would not otherwise have been received by the taxpayer.
  - The implicit interpretation of the fourth condition (i.e. payment would have been included in the taxpayer's income if it had been received by him/her) is that it includes an entitlement requirement.
  - Dividend cannot pass this fourth condition because the dividend, if not paid to a shareholder, remains with the corporation. Therefore, subsection 56(2) can never apply.
  - Contribution of a shareholder does not matter, since dividends are return on investment in a corporation and not determined by contribution.

The Strange SCC Case of Neuman – Cont'd

- However, this is an awkward interpretation of the fourth condition, the actual wording of which is "… shall be included in computing the taxpayer's income to the extent that it would be if the payment or transfer had been made to the taxpayer". The likely textual interpretation should be: if the same dividend had been made to the Taxpayer, would it have been taxable? No entitlement needed.
- *Winter v R* [1991] 1 C.T.C. 113, the Federal Court dealt with a situation where the majority shareholder caused the corporation to sell assets to his son-in-law (also a shareholder) for less than FMV. The Court reassessed the majority shareholder under subsection 56(2) for the benefit amount. In its reasoning, the Federal Court in Winter found that the fact that the taxpayer had no direct entitlement to the property did not preclude subsection 56(2), since nothing in subsection 56(2) confines its application that way.
- The SCC in Neuman acknowledged Winter; saying that the Winter case concerned conferral of a benefit that wasn't in the form of dividend, and application of subsection 56(2) to non-dividend income was not before the Court. Despite this unsatisfactory reasoning, this is now the law, and it led to introduction of Kiddie Tax in year 2000.

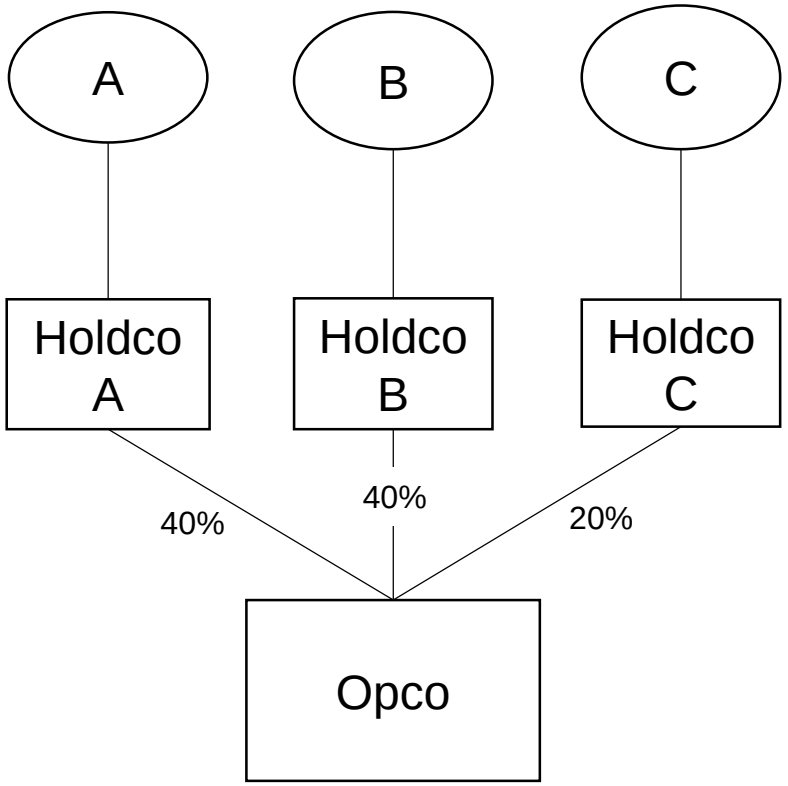
The Strange SCC Case of Neuman – Cont'd

- The state of the law appears to now be:
  - Dividend income: subsection 56(2) only applies if taxpayer already entitled to the dividend (e.g. waiver of dividend in a closely held corporation).
  - Non-dividend income: subsection 56(2) applies even if taxpayer not already entitled to the property.

Application of 56(2) to a Trustee

- In CRA #2012-0462891C6, CRA stated that subsection 56(2) may, based on facts, apply to an individual who is the sole trustee and one of the discretionary beneficiaries, where the trust makes distributions to other beneficiaries.
- However, this appears contrary to FCA decision in Ferrel, 99 DTC 5111.

CRA #2016-0666841E5



Opco sold condo with FMV of $500k to B's child for $250k.

- If Holdco B gave the instruction to cause the disposition of the condo, ss. 56(2) could apply to assess the benefit on Holdco B, because Holdco B would have had a ss. 15(1) income inclusion if it had received the condo directly.
- If benefit conferred under B's instruction or concurrence, then all facts need to be examined to determine whether B would have included an amount in his income if Opco made the transfer directly to B. If so, ss. 56(2) will apply to assess income to B.
  - This last part is confusing to us – is the only way B can have an income inclusion is if s. 246 applies because Opco transfer the condo directly to B under Holdco B's instructions?
- More on s. 246 – stay tuned.

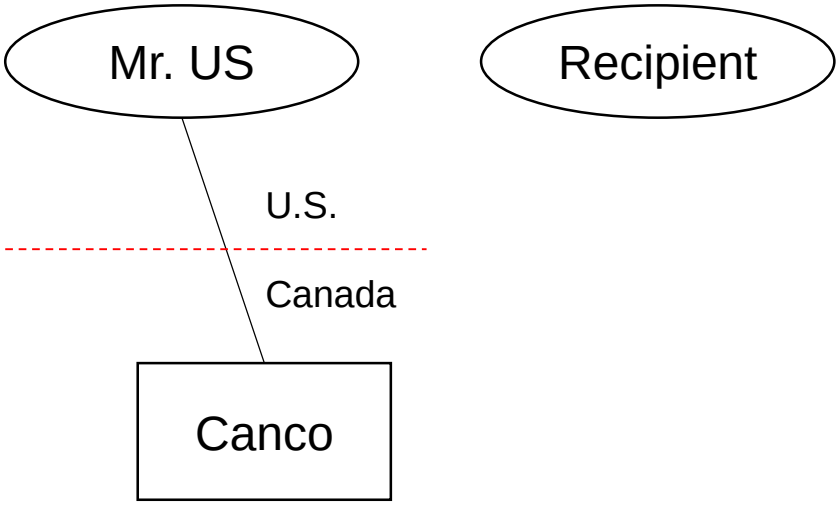
Non-Residents and subsection 56(2) Indirect Payments

Non-Residents and subsection 56(2) Indirect Payments

- Where subsection 56(2) would, if Part I were applicable, require an income inclusion to a non-resident, paragraph 214(3)(a) would deem that amount to be paid as a dividend from a Canco.

Example of 56(2) in a Cross-Border Context

- Where Mr. US is a shareholder of Canco, and Mr. US directed Canco to gift property to another person ("**Recipient**"), paragraph 214(3)(a) should result in a deemed dividend to Mr. US because:
  1. A payment or transfer of property to someone other than Mr. US
  2. made pursuant to the direction of, or with the concurrence of, Mr. US
  3. for the benefit of the other person Mr. US wishes to have the benefit conferred upon, and
  4. would be included in Mr. US's income if payment or transfer been made to Mr. US.
  5. (Assuming fifth condition exist) the amount is not taxable in hands of the recipient.



Example of 56(2) in a Cross-Border Context – Cont'd

- The fourth condition is met because had the payment been made by Canco to Mr. US, then ss. 15(1) would apply to cause an amount to be included in Mr. US's income.
  - Concept of "income" is governed by section 3, which applies to a "taxpayer", which is defined in 248(1) to be any person whether or not liable for tax.
  - In s.3, "income" of a taxpayer includes income from a source, including property.
  - Ss. 15(1) is not limited to Canadian resident taxpayer and is considered income from property of a taxpayer.
  - Nothing in s.4 takes this out of an income source of a non-resident taxpayer.
  - Section 250.1 confirms that a non-resident calculates "income" the same ways as a resident.
  - S.115 narrows down a non-resident income's into "taxable income earned in Canada". Not relevant to the question here.
  - Ss. 2(3) states when a non-resident needs to pay income tax on taxable income earned in Canada. Again not relevant.
  - Therefore, ss. 15(1) would indeed require Mr. US to include the benefit into his "income" if Canco gifted the property to him directly.

Example of 56(2) in a Cross-Border Context – Cont'd

- This should be the correct interpretation, otherwise, how else can paragraph 214(3)(a) works with ss. 56(2)?
- Note that paragraph 15(1.4)(c) could apply alternatively if Mr. US is found to be NAL with the benefit recipient (and the recipient is an individual).

Example – What if USco instead of Canco?

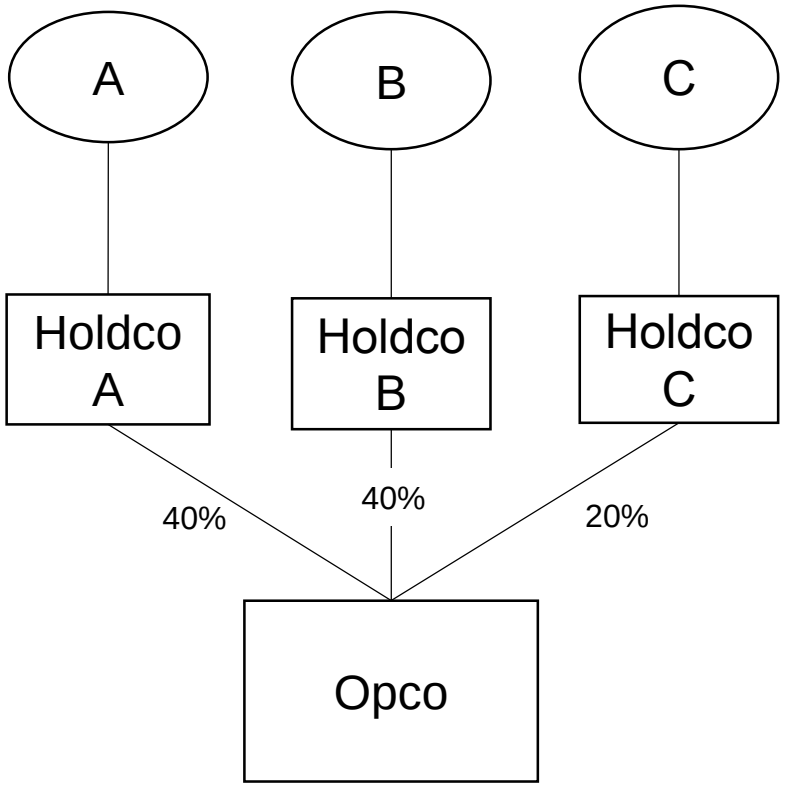
- Wording of subsection 56(2) board enough to apply.
- Likely Canadian nexus will be required for subsection 56(2) to apply, similar as discussed for subsection 15(1) particularly since there is no parallel of subsection 15(7) for subsection 56(2).

Subsection 246(1) – Benefit Conferred on a Person

Section 246 Benefits

- Overall Concept: If all else fails, tax the benefit recipient.
- Subsection 246(1) applies at any time the following conditions are met:
  - A person confers a benefit, directly or indirectly, by any means whatever, on Taxpayer,
  - The benefit amount is not otherwise included in the Taxpayer's income or taxable income earned in Canada under Part I,
  - The benefit amount would have been included in the Taxpayer's income if (i) the benefit amount were a payment made directly by the person to the Taxpayer and (ii) if the Taxpayer were resident in Canada.
- Consequence of subsection 246(1):
  - Benefit amount included in the Taxpayer's income or taxable income earned in Canada under Part I
  - If the Taxpayer is non-resident, benefit amount also deemed for Part XIII to be a payment made to the Taxpayer.
- Subsection 246(2) exception: subsection 246(1) doesn't apply to bona-fide transaction between arm's length persons (amongst other requirements).
- Unlike subsection 56(2), no requirement to have the desire to confer a benefit.

CRA #2016-0666841E5



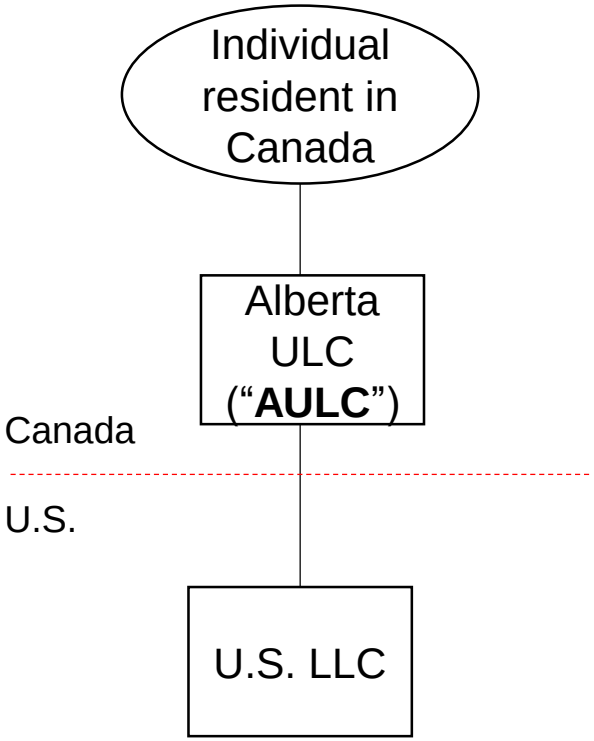
Opco sold condo with FMV of $500k to B's child for $250k.

- If factually, the benefit is indirectly conferred by Holdco B to B's child or B, ss. 246(1) applies to include the income in B's hands
- Although not mentioned by CRA, presumably indirect benefit to B exists only if this transaction between Opco and B's son indirectly, in any manner whatever, factually benefitted B.
- The application of ss. 246(1) to an indirect shareholder is supported by the decision of *Massicotte c. R.*, 2008 FCA 60.

Summary of CRA's Options in Assessing the Situation in #2016-088841E5

- Subsections 15(1) & 15(1.4) causes the income to be taxed in Holdco B's hands.
- Alternatively, subsection 56(2) can cause the income to be taxed in Holdco B's hands (and in B's hands?).
- In addition to the above, subsection 246(1) can cause the income to be taxed in B's hands.
- The only provision preventing double-tax is in paragraph 15(1.4)(c). Therefore, CRA has the option to rely on subsection 56(2) to assess Holdco B, then use subsection 246(1) to assess the same to B. subsection 248(28) will not prevent this.

CRA #2011-0411491E5



U.S. LLC pays tax on behalf of a Canadian resident individual who indirectly holds an interest in the U.S. LLC through an Alberta ULC

- The payment of tax by LLC on the Canadian individual's behalf is not a "dividend" to the Canadian individual.
- The U.S. tax paid could be a ss. 246(1) taxable benefit conferred by AULC on the individual. This is because if AULC had paid the U.S. tax rather than U.S. LLC, it would have been ss. 15(1) income to the individual.

CRA #2019-0798821C6 – IFA 2019 Q.7

- CRA was asked at IFA Round Table where a non-resident shareholder received a benefit indirectly conferred to it, whether paragraph 246(1)(a) would apply. The question did not provide any factual scenario, but an example of this scenario could be: NR shareholder – Holdco – Opco, and Opco conferred benefit to the NR shareholder.
- The CRA points out that all paragraph 246(1)(a) does is to include a subsection 246(1) benefit in the non-resident's "taxable income earned in Canada".
- Since subsection 15(1) is not "taxable income earned in Canada" under subsections 2(3) and 115(1), paragraph 246(1)(a) cannot apply to cause the non-resident to become subject to Part I income tax.
- The CRA then says that the subsection 246(1) benefit would still be "income" to the non-resident due to section 250.1.

246(1)(b) for Non-Resident Benefit Recipient

- The CRA question/response above is silent on paragraph 246(1)(b).
- There appears to be very little (no) guidance on how to apply paragraph 246(1)(b): "… deemed for the purposes of Part XIII to be a payment made at that time to the taxpayer in respect of property, services or otherwise, depending on the nature of the benefit"
- Assume a non-resident shareholder of CanHoldco appropriated cash from CanOpco, and all requirements of subsection 246(1) are met, and CRA confirmed paragraph 246(1)(a) can't apply.
- Paragraph 246(1)(b) would deem CanHoldco to have made a payment in respect of property to NR shareholder, for Part XIII purpose. The benefit is still not a dividend or a heading that Part XIII can attach to.
- Paragraph 246(1)(b) is badly drafted and it is not clear which Part XIII provision or treaty provisions apply. The scheme and context clearly suggest Part XIII should apply to 246(1)(b) and probably need to determine in each case what the closest Part XIII item it resembles for each fact pattern.

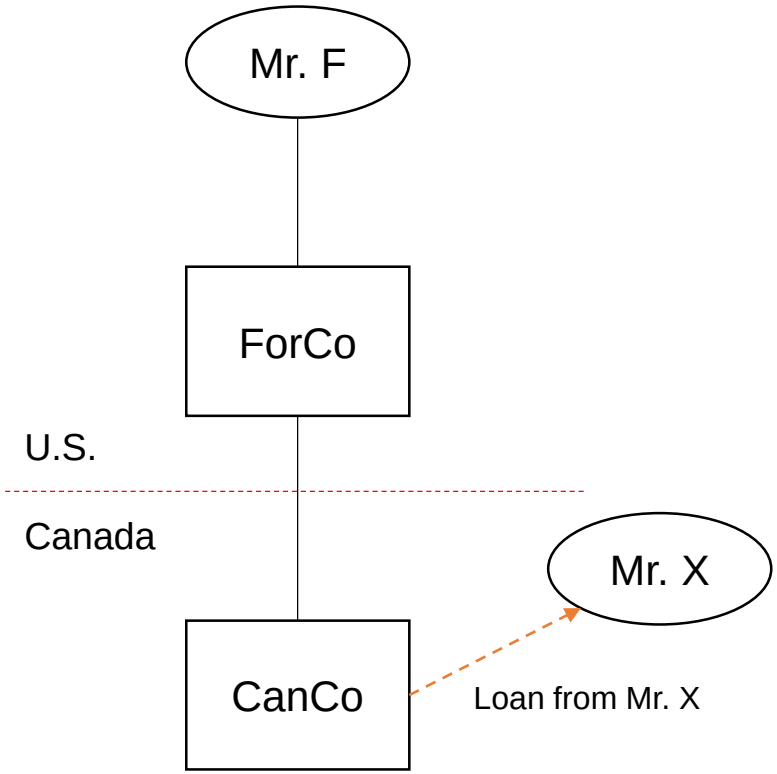
Planning Example

Planning Example #1:
100% Non-Resident Shareholder for Canadian Business

- Mr. X is a Canadian resident.
- Mr. X wants to start a new Canadian incorporated business.
- Mr. X wants to avoid the dividend tax regime.
- Mr. X's father, Mr. F, resides in a Treaty country that permits 5% withholding on dividend to holdcos.

Plan

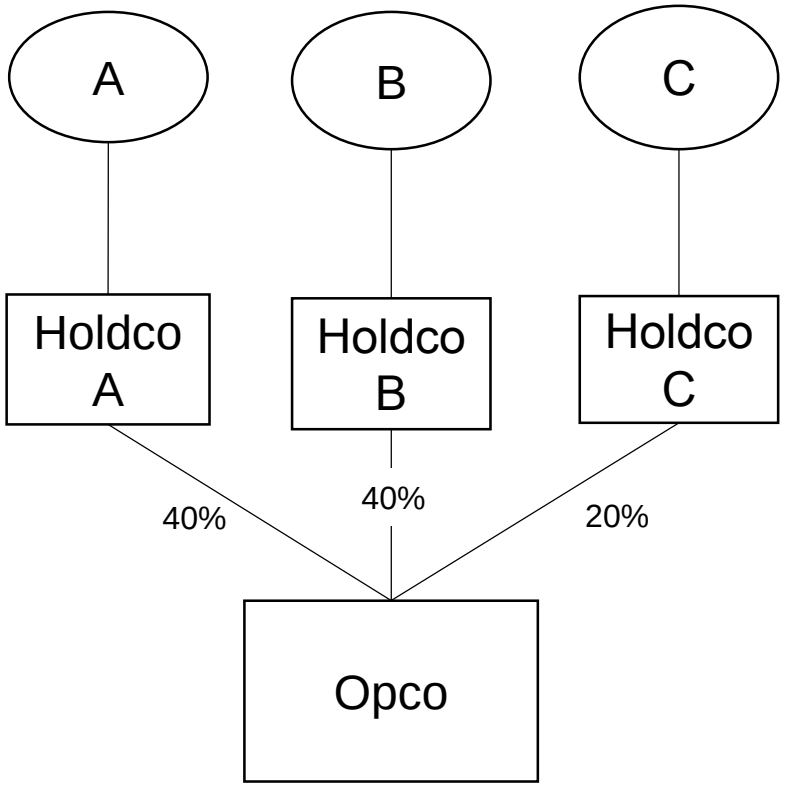
- Mr. F creates a holding corporation in the foreign country (ForCo)
- From the beginning, ForCo becomes sole shareholder of a Canadian corp (Canco).
- Mr. X funds the Canco with loans, and carry on business as an employee of Canco.
- Mr. X earns salary equal to an arm's length manager. Canco pays Cdn corporate tax.
- Each year, ForCo permits Mr. X to appropriate cash of Canco equal to profits.



Tax implication

- Subsection 15(1) doesn't apply to Mr. X because Mr. X not shareholder or contemplated shareholder.
- Subsections 56(2) & 214(3)(a) applies to ForCo, so Part XIII withholding of 5% applies to the appropriation.
- Subsection 246(1) doesn't apply to Mr. X because if the appropriation were a payment directly between ForCo (or Mr. F) and Mr. X, it still wouldn't be income to Mr. X.
- Result: converted dividend income into 5% withholding tax, which the ForCo may potentially claim FTC against other Cdn source income on its own foreign tax return. GAAR risk, and commercial risk.

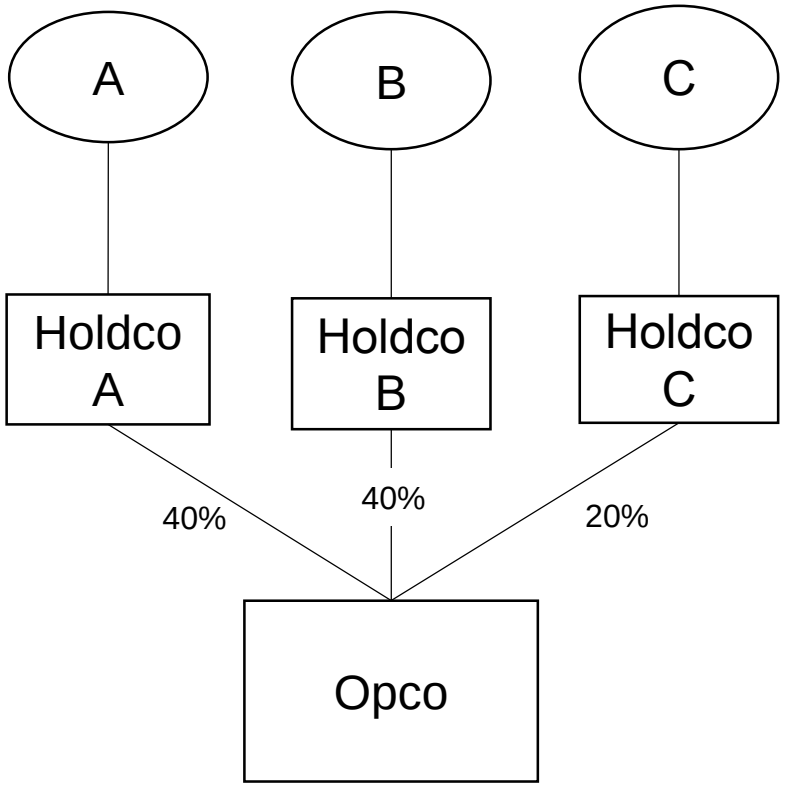
Planning example #2A



Opco sold condo with FMV of $500k to B's child for $250k.

- What if Holdco B's sole director is not related to B or Opco and does not know about the benefit conferral on B's child?
- Do any of subsections 15(1), 56(2) or 246(1) apply?

Planning Example #2B



Opco sold condo with FMV of $500k to B's child for $250k.

- What if, factually, Mr. B received no benefit from his son receiving the condo for less than FMV?
- Do any of subsections 15(1), 56(2) or 246(1) apply?

Conclusion

Conclusion

- On one hand, subsections 15(1), 56(2), 246(1) have too much overlap, and too much latitude granted to CRA to choose which provisions to apply and who to assess. On the other hand, because of poor drafting, there appear to be narrow circumstances where none of these provisions apply.
- Non-residents are caught under Part XIII, due to 214(3)(a) (i.e. 56(2) and 15(1)) and 246(1)(b).
- Paragraph 246(1)(b) is badly drafted, so manner of application can be uncertain.
- Section 250.1 provides CRA ammunition to tax non-residents under 56(2) and 246(1) even though those provisions do not fall under section 115 by defining that a person whose income for a taxation year is determined includes a non-resident.
- Subsections 56(2) and 246(1) can apply in non shareholder appropriation scenarios.
- Perhaps planning opportunity to convert Part I tax into Part XIII using these provisions.


WHERE ARE YOU TAKING ALL OF THAT OFFICE EQUIPMENT?
I'M HAVING A GARAGE SALE.
S. Adams
E-mail: SCOTTADAMS@AOL.COM
OUR NEW COMPANY SLOGAN IS "ACT LIKE YOU OWN THE COMPANY." SO I'VE BEEN SELLING THE STUFF THAT I DON'T USE AND KEEPING THE MONEY.
9/18 © 1995 United Feature Syndicate, Inc.(NYC)
IS THAT MY NEW COLOR MONITOR?
YEAH, I NEVER USED THAT THING.

Questions ?

Manu Kakkar

CPA, CA, BSc.(Hons), TEP, MTax

Kakkar CPA Professional Corporation

Tel: 1-877-988-4600

Email: info@kakkar.com

www.Kakkar.com

Kenneth Keung

CPA, CA, CPA (CO, USA), TEP, CFP, MTax, LLB

Moodys Gartner Tax Law LLP

Tel: 1-403-693-5106

Email: kkeung@moodystax.com

www.moodystax.com