

# TAX FLASH

Collins Barrow periodically publishes a Tax Flash for its clients and associates. It is designed to highlight and summarize the continually changing tax and business scene across Canada. While Tax Flash suggests general planning ideas, we recommend professional advice always be sought before taking specific planning steps.

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## Proposed Income Tax Legislation

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On Wednesday, March 16, 2011 the Department of Finance released proposed income tax legislation designed to address three decisions of the Federal Court of Appeal.

### Contingent Amounts and Limits on Expenses

In *Collins v. The Queen, 2010, FCA 12*, the issue was deductibility of interest. In brief, the taxpayers deducted accrued but unpaid interest at the full amount even though they had an existing right to discharge their obligations by electing to pay a significantly lower amount of interest. The Federal Court of Appeal ("FCA") ruled that it was not the original obligation to pay the interest that was contingent, but that it was each taxpayer's subsequent decision to exercise the option to pay the lower amount which was contingent. As such, the decision allowed interest payable under the original obligation to be deducted in computing income even though both taxpayers had a right to elect to pay a lower amount.

The draft legislation provides that where a taxpayer has a right to reduce an amount of an expenditure, the deductible amount is that reduced amount. The right may even be contingent upon an event happening but where it is reasonable to conclude having regard to all of the circumstances that the right will be exercisable, then the lower amount applies. In applying this to the *Collins* case, this would have meant that the amount of the interest in excess of the lower amount the taxpayers could ultimately have chosen to pay, would not have been deductible on an accrual basis and would only have been deductible if and when actually paid. The proposals apply to taxation years ending after March 15, 2011.

### Withholding Tax on Interest

In *Lehigh Cement Limited v. The Queen, 2010 FCA 124*, the taxpayer was a Canadian corporation which had a debt owing to a related foreign party and as such, Part XIII withholding tax was due on the interest on the loan. The creditor sold the right to receive interest on the loan to an arm's length third party but retained the principal portion of the debt. The FCA ruled that withholding taxes did not apply on the interest payments once the third party acquired the right to receive the interest, notwithstanding that the principal remained with a non-arm's length non-resident.

The draft legislation provides that subject to any applicable Treaty, Part XIII withholding tax on interest paid or credited to a non-resident (whether or not they are at arm's length) will apply where the debt is held by a non arm's length non-resident. The proposals apply to arrangements put in place after March 15, 2011.

### Insurance Policy Reserves

In *The Queen v. National Life Assurance Company of Canada, 2008 FCA 14*, the taxpayer concluded that certain policy reserves may be computed without reference to any liabilities of an insurer in respect of a segregated fund (other than liabilities in respect of an obligation on the part of a life insurer to make a guarantee payment).

The draft legislation proposes to amend the Income Tax Regulations to ensure that policy reserves are computed excluding only the reserves of the insurer in respect of a benefit that is payable to a policyholder from a segregated fund. The proposals apply to the 2012 and subsequent taxation years. §