of the corporation's activities are attributable to M & P (based on M & P assets and labour). If this percentage is under 50% and more than 25%, the M & P rate increases proportionately (straight line) from 4% to 8% for 2016.

[h] For Yukon, the figures assume that the individual is taxed at Yukon's personal income tax rate on income over $500,000. For income over $200,000 and up to and including $500,000, the figures are as follows: Eligible for SBD: no M & P—deferral 3,230, cost (23); M & P—deferral 3,380, saving 71. No SBD: general—deferral 1,580, saving 56; M & P—deferral 2,830, saving 1,033. The figures assume that the combined federal/Yukon eligible dividend tax rate is 21.777% (federal of 24.813% plus Yukon of –3.036%), and that the taxpayer has other income that can be sheltered by Yukon's negative eligible dividend tax rate. If the taxpayer has no other income, the combined federal/Yukon eligible dividend tax rate is 24.813% (federal of 24.813% plus nil for Yukon).

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CRA: Accrued Simple Interest Not Debt for Thin Cap

A TI (2016-0626841E5, March 4, 2016) says that a corporation's accrued simple interest is not included in "outstanding debts to specified non-residents" for the purposes of the thin capitalization rules because the compound interest on the accrued simple interest was not deductible. The compound interest had not been paid and therefore was not deductible under paragraph 20(1)(d).

The thin capitalization rules in subsections 18(4) to (8) generally limit a corporation's deduction for interest paid or payable on outstanding debts to specified non-residents. The deduction for that interest is generally limited if the outstanding debts to specified non-residents exceed a 1.5:1 debt-to-equity ratio. If this ratio is exceeded, some (or all) of the interest paid on the loan is denied as a deduction and is treated instead as a dividend paid to the non-resident. This dividend is subject to Canadian withholding tax.

A corporation's "outstanding debts to specified non-residents" in a taxation year are generally defined to include a debt payable to a specified non-resident shareholder (or to a non-resident person not at arm's length with a specified shareholder) on which interest paid or payable by the corporation is—absent the thin capitalization rules—deductible in the computing of the corporation's income for the year.

A "specified non-resident shareholder" is generally defined as a non-resident that, either alone or with non-arm's-length persons, owns shares of the corporation that have at least 25 percent of the voting rights in the corporation or that have an FMV of at least 25 percent of the FMV of all of the corporation's issued and outstanding shares.

A taxpayer may deduct compound interest in computing its income for a taxation year only if the taxpayer has paid the compound interest in the year (see paragraph 20(1)(d)). This deduction differs from the interest deduction under subparagraph 20(1)(c)(i) that is available for interest paid or payable on borrowed money used for the purpose of earning income from a business or property.

The CRA was presented with a situation in which a Canadian corporation (Canco) has an outstanding interest-bearing loan owing to a specified non-resident shareholder. Simple interest has accrued on the loan, and compound interest has accrued on the balance of the unpaid simple interest. The simple and compound interest balances were unpaid at the end of the taxation year in question.

In the TI, the CRA considers whether Canco's outstanding debts to specified non-residents for the particular taxation year include Canco's liability for the accrued simple interest on the loan. The CRA concludes that, in computing its income for that taxation year, Canco cannot deduct the compound interest on the accrued simple interest because the compound interest remains unpaid at the end of the taxation year. As a result, the accrued simple interest does not meet subsection 18(5)'s definition of "outstanding debts to specified non-residents," and Canco's liability for the accrued simple interest is not an outstanding debt to a non-resident for the particular taxation year.

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Tax Under Appeal Not Debt in Bankruptcy

Under section 69(1) of the Bankruptcy and Insolvency Act (BIA), all creditors (including the CRA) must stay all recovery activities. Under the BIA, personal tax debts may be released on a bankruptcy discharge. (In contrast, section 523 of the American Bankruptcy Code excepts a tax debt from discharge.) In *Schnier* (2016 ONCA 5), only $71,179.04 of over $4 million assessed was a personal tax debt for bankruptcy discharge purposes. (See "Appeal by an Undischarged Bankrupt," *Canadian Tax Highlights*, September 2015: the TCC dismissed the minister's motion to quash the appeal of the undischarged bankrupt, Schnier [2015 TCC 160].)

Under the BIA, a tax debt may be discharged on a bankruptcy proceeding, but restrictions on discharge apply to a tax-motivated bankruptcy. Section 172.1 governs the discharge proceedings of a bankrupt who has $200,000 or more of personal income tax debt that represents 75 percent or more of the bankrupt's total unsecured proven claims. In a number of respects, a bankruptcy discharge is more difficult to obtain under section 172.1 than it is in a standard bankruptcy:

- In a standard personal bankruptcy, the passage of time may result in automatic discharge, but under section 172.1, a court application must be made.

- In a standard personal bankruptcy, the court may grant an absolute order of discharge, but that order is not available if section 172.1 applies.
- If a court suspends the discharge in a section 172.1 bankruptcy, the bankrupt must monthly file income and expense statements with the trustee.
- A court on a section 172.1 discharge application must take into account (1) the circumstances of the bankrupt at the time the personal income tax debt was incurred; (2) the efforts, if any, made by the bankrupt to pay the personal income tax debt; (3) whether the bankrupt made payments in respect of other debts while failing to make reasonable efforts to pay the personal income tax debt; and (4) the bankrupt's financial prospects.

The restrictive regime in section 172.1 recognizes the important social impact of tax debts. In *Koch* (2012 QCCA 2207), the Quebec Court of Appeal confirmed that section 172.1 was implemented to ensure that personal income tax debtors were discouraged from paying non-government creditors first and thus from treating income tax debt as lower in priority than other debt. Industry Canada set out the rationale for the provision:

> [The new provision] specifies the types of orders that the court may make on the hearing of a bankrupt's application for discharge. The options available to the court include: refusing the discharge; suspending the discharge; requiring the bankrupt to perform any acts, pay any moneys, consent to any judgements or comply with any other terms that the court may direct [subsection 172.1(3)].
>
> Subsection (4) sets out the factors the court shall take into account when making a decision with respect to the bankrupt's discharge. The onus is on the bankrupt to justify the relief requested of the court. . . .
>
> Subsection (8) defines "personal income tax" in the context of the *Income Tax Act* [and] includes [similar tax] under any provincial legislation . . . [and] interest, penalties or fines.

In *Koch*, the QCCA noted that high-tax debtors are ineligible for automatic discharge or for an absolute order of discharge upon application (section 108.1 and subsections 172.1(1) and (4)).

The bankrupt taxpayer in *Schnier* sought exclusion from section 172.1. Mr. Schnier, a tax lawyer, invested in two yacht shelters between 1985 and 1991 and, later, in four computer software shelters; he claimed related interest expense or business losses. Mr. Schnier received opinions from independent lawyers and accountants confirming that the tax shelter deductions were permissible.

Beginning in 1989, Mr. Schnier received reassessments, and he immediately filed objections: they were not dealt with by the CRA for over 20 years although Mr. Schnier repeatedly asked the CRA to do so. In October 2011, the minister confirmed the reassessments for the yacht shelters, assessing $1,278,519.62 in income tax plus penalties and interest, for a total of $4,478,703.19. Appeals were filed forthwith; ultimately, a proposal to Mr. Schnier's creditors under the BIA was rejected by the CRA, his largest creditor, and Mr. Schnier became bankrupt in January 2012.

At issue before the ONCA was whether appealed-from personal income tax was a claim in bankruptcy, making the taxpayer subject to section 172.1. In 2014, the trustee noted in his report that only $71,170.04 of the CRA's claim was included: the remaining $4,424,558.19 was a contingent claim. The trustee's approach would allow Mr. Schnier to seek a bankruptcy discharge under the regular BIA provisions. The court said that

> a creditor's inability to enforce a claim bears directly on the creditor's ability to prove its claim under the *BIA*. In order to be a provable claim within the meaning of *BIA* s. 121, a claim must be one recoverable by legal process . . . . The restraints placed by *ITA* s. 225.1 on the enforceability of an assessed amount of tax that is under appeal are strong indicators that a claim based on those amounts would not be provable in a bankruptcy.

The trustee must consider whether the debt claimed by a creditor is liquidated, future, or contingent. A contingent claim must be determined to be provable, and, if it is found to be so, it is valued under subsection 135(1.1). The SCC in *Newfoundland and Labrador v. AbitibiBowater* (2012 SCC 67) said that a contingent claim can be asserted if it is not "too remote or speculative."

Section 172.1(8) defines a personal income tax debt to mean "the amount payable" under subsection 223(1) of the Income Tax Act. The ONCA concluded that an income tax assessment is deemed to be valid and binding unless it is found otherwise on an appeal. Relying on ITA subsections 152(8) and 248(2), the court said that the minister can compel payment only when the appeal is concluded.

The ONCA contrasted Mr. Schnier's case with that in *Re Norris* (1989 CanLII 4079 (ONCA)), in which no objection was filed; although the trustee did not disagree with the amount proposed by the minister, no final determination was made, and the CRA's claim could not be valued. The court in *Schnier* warned against the potential abuse of the bankruptcy process by the CRA if the minister's argument was accepted: the minister could have sought an adjournment to allow for a decision in the appeal, which would have resolved the contingency and made the claim provable or not. Although the minister is concerned that the government might not be able to go after the bankrupt's funds, the court wanted to prevent the CRA from obtaining "an unjustified advantage over other creditors in the bankruptcy proceeding" if the government was allowed to fully claim amounts that had not been proven in the courts.

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