Character Rolls: Property Transfers and Characterization Issues

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PRÉCIS

Les récents cas de *Mara Properties* et de *Hickman Motors* portent sur la nature d'un bien reçu par une société mère à la liquidation de sa filiale en propriété exclusive. Des roulements sont prévus dans la Loi, incluant ceux visant la restructuration des sociétés aux termes de l'article 87 et du paragraphe 88(1), les transferts à une société ou à une société en nom collectif en vertu des paragraphes 85(1) et 97(2) et les transferts entre les conjoint aux termes des paragraphes 73(1) et 70(6). Il serait présumé, selon ces dispositions de roulements, que la nature du bien entre les mains de l'auteur du transfert demeurera la même entre les mains du cessionnaire.

Cependant, il survient des résultats irréguliers lorsque le but pour lequel le cessionnaire a acquis le bien, donc la nature, diffère de celle existant avant le roulement. Plus particulièrement, les dispositions de roulement pourraient avoir comme effet de changer la nature du traitement fiscal de tout gain ou perte qui serait survenu s'il y avait existé une cession imposable ou une cession réputée à la juste valeur marchande plutôt qu'un roulement. Étant donné que le but d'un roulement est de reporter l'incidence fiscale, l'auteur allègue qu'un bien transféré en vertu d'un roulement devrait conserver la nature qui lui était rattachée avant le roulement. Toutefois, si le bien est acquis par le cessionnaire dans un but lui conférant une nature différente, les incidences fiscales devraient être déterminées en fonction du fait que le bien a été converti après le roulement.

Le traitement de la conversion d'un bien, soit d'un bien produisant un revenu à un bien autre est un problème réel. Aucune législation ne s'applique dans ce domaine, bien que Revenu Canada ait publié sa pratique administrative. L'auteur suggère que cette pratique administrative contient des failles fondamentales et il décrit ses suggestions du traitement approprié de ces conversions. Il suggère plus particulièrement que la conversion d'un bien devrait se traduire par une cession théorique à la juste valeur marchande et un report de la dette fiscale tant que le bien n'a pas été finalement cédé.

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À vrai dire, s'il était possible de réclamer une perte finale relative à un bien qui ne nous a jamais appartenu, il serait difficile de concevoir que nous ayons à payer des impôts à quelque moment que ce soit.

ABSTRACT

The recent cases of *Mara Properties* and *Hickman Motors* concern the characterization of property received by a parent company on the winding up of its wholly owned subsidiary. There are a number of rollovers provided in the Act, including those for corporate reorganizations under section 87 and subsection 88(1), transfers to a corporation or partnership under subsections 85(1) and 97(2), and interspousal transfers under subsections 73(1) and 70(6). The provisions governing these rollovers appear to presume that property characterized in one manner in the hands of the transferor will retain that character in the hands of the transferee.

Anomalous results, however, arise where the purpose for which the transferee acquired the property, and hence its character, differs from its pre-rollover character. In particular, the rollover provisions may have the effect of recharacterizing the tax treatment of any gain or loss that would have arisen had there been a taxable disposition or deemed disposition at fair market value rather than a rollover. Given that the purpose of a rollover is to defer the incidence of tax, the author argues that property transferred on a rollover should retain its pre-rollover character. However, if the property is acquired by the transferee for a purpose that indicates a different character, the tax consequences should be determined on the basis that there has been a conversion of property following the rollover.

The treatment of a conversion of property from one income-earning use to another is an existing problem; there is no legislation applicable in this area, although Revenue Canada has published its administrative practice. The author suggests that there are fundamental flaws with this administrative practice and outlines his proposals for the appropriate treatment of such conversions. In particular, he suggests that the conversion of property should result in a notional disposition of the property at its fair market value with a deferral of the resulting tax liability until the property is ultimately disposed of.

> Indeed, if it were possible to claim a terminal loss in respect of property which one never owned it is difficult to see why anyone should ever have to pay any taxes at all.[1]

INTRODUCTION

It is trite to say that a property is characterized in the hands of its owner. What may be inventory to one taxpayer may be non-depreciable capital

[1] Hugessen JA, in *Hickman Motors Limited v. The Queen*, 95 DTC 5575, at 5580 (FCA).

property to another and depreciable capital property to a third.[2] The characterization of property is primarily a question of fact and is generally dependent on the purpose for which the property is acquired.[3] The recent cases of *Mara Properties Limited v. The Queen*[4] and *Hickman Motors Limited v. The Queen*[5] concerned the characterization of property received by a parent company on the winding up of its wholly owned subsidiary. One would have thought that 25 years after tax reform in 1971, the characterization of property transferred in the context of a tax-free corporate reorganization would not be an issue.

This article focuses on the character of property in the hands of a person following a transfer of the property in certain specific circumstances. In particular, there are a number of provisions of the Income Tax Act[6] that either presume or deem property that is characterized in one manner in the hands of a person (the transferor) to retain that character or certain attributes when transferred to another person (the transferee), even if the transferee does not acquire the property for the same purpose or a similar purpose to that of the transferor.[7] It is beyond the scope of this article to discuss the treatment of the consideration, if any, received by the transferor on the transfer.[8]

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[2] Take as an example a residential building. In the hands of a real estate developer, a home completed for sale is inventory; to a taxpayer purchasing the property to live in, it is non-depreciable capital property; a taxpayer who rented out the property would characterize it as depreciable capital property.

[3] The characterization of profits on the sale of property as a capital gain or as ordinary income—which is arguably equivalent to determining whether the property sold is capital property or inventory—depends on the taxpayer's *intention* at the time the property is acquired, a subjective test. However, the courts generally determine the taxpayer's intention by inference from objective criteria. Thus, the distinction, if any, between the terms "purpose" and "intention" in the context of characterizing property is largely immaterial. For a general discussion of these terms in the context of income tax legislation, see J.F. Avery Jones, "Nothing Either Good or Bad, but Thinking Makes It So—The Mental Element in Anti-Avoidance Legislation—I" [1983], no. 1 *British Tax Review* 9-43; and Walter J. Blum, "Motive, Intent, and Purpose in Federal Income Taxation" (Winter 1967), 34 *The University of Chicago Law Review* 485-544. See also Brian J. Arnold and James R. Wilson, "The General Anti-Avoidance Rule—Part 2" (1988), vol. 36, no. 5 *Canadian Tax Journal* 1123-85, at 1156-59.

[4] 96 DTC 6309 (SCC), rev'g. 95 DTC 5168 (FCA).

[5] Supra footnote 1.

[6] RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act"). Unless otherwise stated, statutory references in this article are to the Act.

[7] The terms "transfer," "transferor," and "transferee" are used in a generic sense. In this context, a transfer refers to any manner by which property originally owned by one taxpayer (the transferor) becomes the property of another taxpayer (the transferee). It is not limited to a "disposition" of property, as that term is defined in the Act.

[8] Briefly, there are important differences in the treatment of the transferors in the various transactions described in this article. For example, subsection 87(4) provides rollover treatment for shareholders of corporations involved in an amalgamation who hold the shares as capital property and who receive as consideration only shares of the new corporation. Since

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Questions about the characterization of property arise primarily with respect to property whose cost may be deducted in some manner by its owner in computing the owner's income for tax purposes (otherwise than simply in determining the gain subject to tax when the property is sold). Examples of this type of property include depreciable property, eligible capital property, various resource properties, and inventory.[9] This article

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[8] Continued . . .
the shares of the predecessor corporation must be capital property in order to obtain rollover treatment, the shares received in the new corporation also will be treated as capital property.

Under paragraph 88(1)(b), the parent corporation involved in a winding up is deemed to have disposed of its shares for an amount that normally avoids the recognition of a gain or loss. The character of the shares is not relevant in this context. The character of the property received by the parent corporation, namely, the assets of the subsidiary, is considered in detail later in this article.

The rollovers under subsections 85(1) and 97(2) pose greater difficulties. Under the former, the transferor must receive shares as part of the consideration for the assets transferred to the corporation. Under the latter, the transferor must be a partner of the partnership. Since 1974, neither provision requires that the transferor have a significant interest in the transferee following the transfer.

Where a person has transferred all or substantially all of the assets of an active business to a corporation for consideration that includes shares of that corporation, section 54.2 deems the shares to be capital property of the transferor. Accordingly, the transferor can effectively convert what would otherwise have been ordinary income from a sale of the underlying business assets (for example, recaptured depreciation or the increase in value of inventory) into a capital gain from the sale of shares, although if the corporation to which the property is transferred is also the purchaser of the transferor's shares, subsection 84(3) will deem the transferor to have received a dividend of the amount by which the proceeds of sale for the shares exceed the paid-up capital of the shares. Section 54.2 was added as part of the 1987 tax reform. The purpose of the rule, according to the Department of Finance's technical notes, "is to ensure that the sale of a business through a sale of shares of a corporation to which the business was recently transferred is not treated as a sale on income account": Canada, Department of Finance, *Explanatory Notes to Legislation Relating to Income Tax* (Ottawa: the department, June 1988), clause 33. The provision was intended to preclude the application of the new general anti-avoidance rule in these circumstances on the basis that the sale of the shares was in effect a sale of the underlying assets of the business. There is no corresponding provision applicable to subsection 97(2) rollovers, nor does section 54.2 apply to transfers to a corporation of property that is not all or substantially all of the property of an active business. If section 54.2 is not applicable, it is arguable that the sale of the shares or partnership interest, as the case may be, following a rollover should be treated in the same manner as a direct sale of the underlying assets transferred to the corporation or partnership: *Fraser v. MNR*, 63 DTC 1083 (Ex. Ct.), aff'd. 64 DTC 5224 (SCC). Revenue Canada has adopted this view in the context of the sale of real property: see *Interpretation Bulletin* IT-218R, September 16, 1986, paragraph 9. In the recent decision of *The Queen v. Continental Bank Leasing Corporation et al.*, 96 DTC 6355 (FCA), the court held that the sale of a partnership interest was on capital account where the sale of the interest was part of a series of transactions that involved the creation of the partnership and the transfer to the partnership of virtually all of the assets of a business. The only assets involved in the business were leases having cost amounts significantly below their fair market value. A direct sale of the leases would have given rise to significant recapture. (The court allowed the Crown's appeal on other grounds.)

[9] The cost of depreciable property is deductible to the extent permitted by the regulations under paragraph 20(1)(a). The cost of eligible capital property is deductible to the

(The footnote is continued on the next page.)

considers the treatment of depreciable property and inventory, the two most common types of property mentioned. However, the considerations arising in respect of these types of property may be applicable to the other types of property mentioned above.

The transfers of property discussed in this article may be divided into two broad categories: rollovers and certain other, predominantly non-arm's-length, transfers of property for which the Act contains specific rules affecting the character of the transferred property in the hands of the transferee. The rollovers include

- a winding up to which subsection 88(1) is applicable;
- a transfer of property to a corporation or partnership governed by subsection 85(1) or 97(2), respectively;
- an amalgamation to which section 87 is applicable; and
- a transfer of property to a spouse or spouse trust either inter vivos (governed by subsection 73(1)) or on death (governed by subsection 70(6) or paragraphs 70(5.2)(c) and (d), depending on the nature of the property).[10]

The remaining transactions that are considered are

- a non-arm's-length transfer of property governed by paragraph 13(7)(e); and
- a transfer of property on death other than to a spouse or spouse trust, governed by subsection 70(5).

The article first outlines the characteristics of depreciable property and inventory for tax purposes; it then considers the effect of the transfers noted above on these characteristics. Proposals for reform are outlined in detail at the end of the discussion of the winding-up provisions.

In brief, it is submitted that where the Act provides rollover treatment, the rollover should not have the effect of recharacterizing the tax treatment of gains or losses that would have arisen had there been a taxable disposition or deemed disposition at fair market value rather than a rollover. In effect, the character of the property involved in the rollover should not change as a consequence of the rollover. If the transferee uses the property for an income-earning purpose different from that of the transferor, the property should be treated as if its use had changed immediately after the rollover and this change in use should give rise to a notional disposition of

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[9] Continued . . .
extent permitted under paragraph 20(1)(b). The cost of various resource properties may be deductible as permitted in sections 66 to 66.7 (for example, as a Canadian exploration expense or Canadian development expense). The cost of inventory is used to determine the cost of goods sold, which is deducted from gross sales to determine sales profits.

[10] Characterization issues also may arise with respect to the rollovers in paragraph 107(2)(d), applicable where a capital distribution by a personal trust includes depreciable property, and paragraph 98(3)(e), applicable where a Canadian partnership ceases to exist and the partners elect for rollover treatment of property distributed from the partnership.

the property. The recognition of the income or loss from this notional disposition should be deferred until the property is ultimately disposed of.

DEFINITIONS

Depreciable Property

Depreciable property is defined in subsection 13(21) as "property acquired by the taxpayer in respect of which the taxpayer has been allowed, or would, if the taxpayer owned the property at the end of the [taxation] year . . . , be entitled to, a deduction under paragraph 20(1)(a) in computing income for that year or a preceding taxation year." Under paragraph 20(1)(a), in computing a taxpayer's income for a taxation year from a business or property, the taxpayer is allowed a deduction on account of capital cost allowance as permitted under the Income Tax Regulations.[11] Paragraph 20(1)(a) is one of the exceptions to the limitations in computing income from a business or property in paragraphs 18(1)(a), (b), and (h). The capital cost allowance system also contains provisions that require a taxpayer to include an amount in income as "recaptured depreciation"[12] or allow a deduction as a "terminal loss"[13] when the taxpayer disposes of depreciable property. The terminal loss deduction is a further exception to the limitations in paragraphs 18(1)(a), (b), and (h).

Paragraph 20(1)(a) does not provide any further guidance as to what property constitutes depreciable property; it simply refers to "property" having a "capital cost." The definition of "property" in subsection 248(1) encompasses more than depreciable property, and "capital cost" is not defined in the Act. By inference, "capital cost" simply refers to the original cost of depreciable property, whereas "cost," which also is not defined in the Act, is generally used in reference to other types of property, including non-depreciable capital property (the definition of "adjusted cost base" in section 54) and inventory (section 10).

Regulation 1100(1) allows a taxpayer to claim a deduction in respect of property in the various classes in schedule II of the Regulations at prescribed rates based on the "undepreciated capital cost . . . of property of the class." The definition of "undepreciated capital cost" in subsection 13(21) is the amount determined by an algebraic formula; it provides no further elaboration of the meaning of depreciable property. Simply put, any property included in one of the classes in schedule II of the Regulations may be depreciable property, and there is a general "catchall" in paragraph (i) of class 8 of schedule II: all tangible property that is not included in another class in the schedule is included in class 8 except property specifically excluded in paragraph (i). The excluded property is the only tangible property that cannot be depreciable property. All other tangible property may be (but is not necessarily) depreciable property. In

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[11] CRC 1978, c. 945, as amended (herein referred to as "the Regulations").

[12] Subsection 13(1).

[13] Subsection 20(16).

summary, any tangible property (and certain intangible property) owned by a taxpayer is depreciable property of the taxpayer where, in respect of the property, the taxpayer has been allowed or, if the taxpayer owned the property at the end of the taxation year, would be entitled to, a deduction under paragraph 20(1)(a).

The only real assistance in determining whether a particular property is depreciable property of a taxpayer is found in regulation 1102. Regulation 1102(1) excludes certain property from "[the classes of property] described in [part XI] and in Schedule II" of the Regulations.[14] Specifically excluded are property

(a) the cost of which is deductible in computing the taxpayer's income;

(b) that is described in the taxpayer's inventory;

(c) that was not acquired by the taxpayer for the purpose of gaining or producing income.[15]

Paragraph (a) excludes property whose cost is immediately deductible to the taxpayer. For example, where the cost of a property is deductible as a repair or is treated as a Canadian exploration expense, the property is not depreciable property of a prescribed class. Paragraph (b) excludes inventory since its cost is specifically accounted for in accordance with the rules of inventory accounting. Paragraph (c) is probably the most significant limitation. If the taxpayer did not acquire the property for the purpose of gaining or producing income, the property is not depreciable property of a prescribed class. Land, as well as certain other property, also is specifically excluded.

An important issue, which will be considered below, is whether there is a distinction between depreciable property, on the one hand, and depreciable property of a prescribed class, on the other. The distinction is important because subsections 13(1) and 20(16) are applicable to depreciable property of a particular prescribed class or of a particular class and not simply to depreciable property.

Inventory

"Inventory" is defined in subsection 248(1) (in part) as "a description of property the cost or value of which is relevant in computing a taxpayer's income from a business for a taxation year or would have been so relevant if the income from the business had not been computed in accordance with the cash method."

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[14] The Act is not consistent in its terminology when referring to depreciable property included in part XI and schedule II of the Regulations. Subsection 13(1) refers to "depreciable property of a particular prescribed class" while subsection 20(16) refers to "depreciable property of a particular class." This article will use the term "depreciable property of a prescribed class" when referring to depreciable property included in part XI and schedule II of the Regulations.

[15] There are a number of other more specific exclusions in regulation 1102(1), which are not relevant in the context of this article.

The definition is not particularly useful. It is excessively broad, in that it arguably includes a number of types of property that are clearly not inventory. For example, depreciable property may be included, since the deduction under paragraph 20(1)(a) is based on the cost of depreciable property. Similarly, the definition is broad enough to include eligible capital property, resource properties the acquisition of which gives rise to a deduction under sections 66 to 66.7, and other property for which a taxpayer is entitled to a deduction based on its cost[16] otherwise than when calculating a capital gain or loss under subsection 39(1).

In the absence of a useful statutory definition, the meaning of inventory is left to administrative practice and ultimately to the courts. The term is generally considered to have a "technical" as opposed a common meaning and accordingly derives its meaning from commercial or accounting principles.[17] The accounting definition of inventory includes three elements:[18]

1) tangible property held for sale in the ordinary course of business, including goods purchased for resale (stock-in-trade) and goods manufactured for sale (finished products);

2) tangible property that is in the process of production for sale (work-in-progress); and

3) property that is to be currently consumed in the production of goods or services to be available for sale (for example, parts, raw materials, and so on).

Although the accounting definition is more specific than that in the Act, it is not generally sufficient to resolve particular cases. There are two areas of uncertainty that are germane to this article. The first is the distinction between inventory and capital property; that is, whether the profit or loss on the sale of the property is treated as business income or loss or as a capital gain or capital loss. This issue probably accounts for the largest number of cases in Canada's tax jurisprudence.[19] In the context of this article, the issue concerns the treatment of property held as an adventure or concern in the nature of trade. Although the definition of "business" in subsection 248(1) specifically includes an adventure or concern in the nature of trade, there is some dispute as to whether property held as an adventure constitutes inventory in the taxation years preceding its sale.

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[16] For example, property included in regulation 1102(1)(a) or (d) (property whose cost is deductible under section 37 as an expense relating to scientific research or experimental development).

[17] See, generally, B.J. Arnold, *Timing and Income Taxation: The Principles of Income Measurement for Tax Purposes*, Canadian Tax Paper no. 71 (Toronto: Canadian Tax Foundation, 1983), 301-22.

[18] Canadian Institute of Chartered Accountants, *Terminology for Accountants*, 3d ed. (Toronto: CICA, 1983), 81.

[19] The jurisprudence in this area is generally well known.

The second area concerns avoidance transactions and, in particular, whether property acquired by the taxpayer, even with the intention of resale, does not constitute inventory to the taxpayer where the property was acquired primarily or exclusively to obtain a tax advantage. This issue is considered in more detail in connection with the discussion of the *Mara Properties* decision.

Assuming that a particular property is part of the taxpayer's inventory, the rules of inventory accounting will generally apply in determining the taxpayer's income from a business for the year. A taxpayer's income from a business, being the profit therefrom, includes the amount by which sales revenue exceeds the cost of goods sold. The basic purpose of inventory accounting, then, is to determine the cost of inventory that can be properly deducted in determining the profits of a particular period. "Cost of goods sold" is determined by taking the opening inventory of the taxpayer for the period, adding the cost of inventory acquired during the period, and subtracting the closing inventory. The determination of closing inventory is the most important element in this formula, and tax principles do not necessarily follow accounting practice. The importance of the value placed on closing inventory is obvious: a higher value for closing inventory reduces the cost of goods sold and hence increases profits; a lower value for closing inventory increases the cost of goods sold and hence reduces profits.

For accounting purposes, there is significant flexibility in the treatment of inventory, both in tracing the flow of inventory and in valuing inventory, which are necessary elements in determining closing inventory. For tax purposes, some of these accounting practices are prohibited by statute, by jurisprudence, or by administrative practice.[20] With respect to the value of closing inventory, subsection 10(1) provides that "inventory shall be valued at its cost to the taxpayer or its fair market value, whichever is lower, or in such other manner as may be permitted by regulation."[21] Regulation 1801 states that "all the property described in all the inventories of the business may be valued at its fair market value."[22] It appears that the taxpayer may freely choose between the two valuation methods, so long as the method chosen is consistently applied.

In *Friesen v. The Queen*,[23] the Supreme Court of Canada considered whether inventory accounting, and particularly the valuation method in

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[20] For example, the "last in, first out" (LIFO) method for valuing closing inventory is prohibited for tax purposes: *MNR v. Anaconda American Brass Ltd.*, 55 DTC 1220 (PC); and *Interpretation Bulletin* IT-473, March 17, 1981, paragraph 11.

[21] Amendments to subsection 10(1) were released on June 20, 1996 and are discussed in greater detail below.

[22] Before January 15, 1987, regulation 1801 provided two alternatives: a taxpayer coud value all inventory at either cost or fair market value. The cost option was eliminated in 1987 as part of the government's efforts to eliminate the abuse of loss transfers between corporations. The *Mara Properties* case, supra footnote 4, illustrates one example of such abuse.

[23] 95 DTC 5551 (SCC).

subsection 10(1), applied to property held for resale in the course of an adventure or concern in the nature of trade. The court, in a 3-2 decision, held that it did. The facts of the case are simple. The taxpayer, with others, purchased a parcel of vacant land in 1982 for the purpose of reselling it at a profit. In the following years, the property declined significantly in value, and in 1986 the mortgagee foreclosed on the property. There was no dispute that the taxpayer held the property as an adventure or concern in the nature of trade. The taxpayer claimed deductions in 1983 and 1984 based on the decline in fair market value of the property in those years.[24]

The reasoning of the majority is relatively straightforward. "Business," by definition in subsection 248(1), includes an adventure or concern in the nature of trade. "Inventory," by definition, means any property the cost or value of which is relevant in computing a taxpayer's income from a business for a taxation year. The majority held that the plain meaning of the definition of "inventory" is that an item of property

> need only be relevant to business income in a single year to qualify as inventory. . . . [I]nventory is property which a business holds for sale and this term applies to that property both in the year of sale and in years where the property remains as yet unsold by a business.[25]

Given that the taxpayer was involved in a business and the property in question was inventory of that business, the application of subsection 10(1) was mandatory. The change in value of unsold inventory must be recognized in determining a business's profit or loss under section 9. Inventory accounting does not require there to have been any sales of inventory in a particular year.[26] Finally, the common law limitation of inventory accounting to stock-in-trade was displaced by the plain meaning of subsection 10(1) and the definitions of business and inventory in subsection 248(1). Accordingly, where a single property held as an adventure or concern in the nature of trade declines in value over the course of a year, a loss may be recognized for tax purposes.

The most controversial element of the court's decision is not the conclusion that property held as an adventure or concern in the nature of trade is characterized as inventory from the time it is acquired until the time it is disposed of. The controversy centres around the consequences of that conclusion—whether subsection 10(1), which forms an exception to the general rule that income is not taken into account until it is realized (that is, by a disposition of inventory), applies to property held, but not as yet disposed of, as an adventure in the nature of trade.

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[24] In each year, the cost of goods sold yielded a positive figure since the value of opening inventory exceeded the value of closing inventory. The loss arose because the cost of goods sold exceeded gross sales proceeds (nil).

[25] Supra footnote 23, at 5555.

[26] Ibid., at 5563-64.

There is fundamental disagreement between the majority and the dissenting judges regarding the character of the property in the period during which it was held by the taxpayer. In characterizing the property, the majority focused on the scheme of the Act and its basic division between business income and capital gain. The characterization of a particular property as inventory (the disposition of which gives rise to business income or loss) or capital property (the disposition of which gives rise to a capital gain or capital loss), according to the majority, is determined "*from the time of the original purchase*";[27] it is not an annual determination. The majority acknowledged that the character of a property may change at a later point in time. Unfortunately, the majority suggested that subsections 13(7) and 45(1) specifically apply to conversions of real estate from capital property to inventory and vice versa in particular circumstances. These provisions do nothing of the sort; they apply only to changes of use between income-earning and non-income-earning capital property. They have no relevance at all to the conversion of property from one income-earning use to another. While Revenue Canada has published administrative guidelines concerning conversions between capital property and inventory of a business,[28] there are no statutory provisions governing these situations.

The dissent focused on the purpose of subsection 10(1) and concluded that the provision was applicable only to ordinary trading businesses, and not to an adventure or concern in the nature of trade. Accordingly, the decline in value of the property was not relevant in calculating the taxpayer's income until the year of disposition. While this conclusion disposed of the case, the dissent went on to consider the more basic question whether the land in issue was inventory and concluded that, at least in 1982 and 1983, it was not. The dissent considered that the definition of inventory in subsection 248(1), by referring to the relevance of its cost or value "for a taxation year," required a consideration of the particular taxation year in question.[29] The difficulty with the dissent's view is that the question whether a property is inventory or not becomes an annual determination. If the property was not inventory until the year in which it was disposed of, one is left with the nagging question of what exactly the property was in years before its disposition.

Three months following the decision, on December 20, 1995, the Department of Finance issued a press release announcing amendments to the Act to reverse the *Friesen* decision:

> The proposed amendments will clarify that the rules which apply to the valuation of business inventory on an annual basis do not apply to property held as an adventure in the nature of trade. Consistent with Revenue

[27] Ibid., at 5556 (emphasis in original).

[28] *Interpretation Bulletin* IT-102R2, July 22, 1985; and IT-218R, supra footnote 8, at paragraphs 10 to 24.

[29] Supra footnote 23, at 5573.

> Canada's historical practice, any income or loss experienced in respect of property held as an adventure in the nature of trade is to be recognized for tax purposes only on disposition of the property.[30]

These proposals were carried forward to draft legislation released on June 20, 1996. The proposed amendments confine subsection 10(1) to the computation of income from a business that is not an adventure or concern in the nature of trade.[31] However, the amendments clarify that property held as an adventure or concern in the nature of trade is otherwise characterized as inventory.[32]

The discussion that follows examines the effects of certain statutory provisions on the character of property transferred from one taxpayer to another. The various provisions are considered in the context of the transactions or events to which they apply.

There are few specific statutory provisions governing the treatment of inventory of the transferor in the various transactions. Since dispositions of inventory are treated as being on income account, there is little need for specific rules. However, problems arise where property involved in a rollover is inventory to the transferor but is characterized as capital property to the transferee.

A disposition of depreciable property can give rise to both an income inclusion (reflecting recaptured depreciation) and a capital gain (if the proceeds of disposition exceed the capital cost of the property). Special rules are therefore required to preserve the income inclusion where, under the rollover provision, the depreciable property is considered to be transferred at its cost amount (essentially, its undepreciated capital cost). A

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[30] Canada, Department of Finance, *Release*, no. 95-111, December 20, 1995. The included background material stated in part: "Property held as an adventure or concern in the nature of trade is treated in part like business income, in that profits or losses on the property are recognized on income account and, until the *Friesen* decision, in part like capital property, in that the profits or losses are recognized only on disposition." This statement supports the minority's view in *Friesen* that property held as an adventure or concern in the nature of trade is characterized as inventory only in the year of sale; in preceding years (to answer the question postulated above), it is capital property (presumably, non-depreciable) of the taxpayer.

[31] Canada, Department of Finance, Notice of Ways and Means Motion To Amend the Income Tax Act, the Income Tax Application Rules, the Bankruptcy and Insolvency Act, the Canada Pension Plan, the Children's Special Allowances Act, the Cultural Property Export and Import Act, the Customs Act, the Excise Tax Act, the Old Age Security Act, the Tax Court of Canada Act, the Tax Rebate Discounting Act, the Unemployment Insurance Act, the Western Grain Transition Payments Act and Certain Acts Related to the Income Tax Act, June 20, 1996, subclause 4(1).

[32] The amendments further provide, in proposed subsection 10(1.01) that "[f]or the purpose of computing a taxpayer's income from a business that is an adventure or concern in the nature of trade, property described in an inventory shall be valued at the cost at which the taxpayer acquired the property." Because property held as an adventure or concern in the nature of trade must now be valued at its original cost, the proposals also add a stop-loss rule in new subsection 10(10) applicable on the acquisition of control of a corporation. Additional amendments are discussed below, infra footnote 130.

recurrent theme found in all of the rollover provisions is that the capital cost of depreciable property to the transferee is deemed to be its capital cost to the transferor and the transferee is deemed to have claimed capital cost allowance in previous years equal to the difference between the property's capital cost and its cost amount. This treatment is extended to non-arm's-length dispositions of depreciable property where the fair market value of the property at the time of the transfer is less than its capital cost to the transferor. As a result of these provisions, the property is, by definition, depreciable property to the transferee, at least for the purposes of the capital cost allowance provisions in the Act, even if the property would otherwise be characterized as inventory or personal-use property to the transferee.

The interaction of the rollover provisions in general as they apply to inventory of the transferor and the provisions designed to preserve recaptured depreciation claimed by the transferor can lead to anomalous tax consequences where the character of the property involved in the rollover differs as between the transferor and transferee. Five fact situations, set out below, are used to illustrate the problems with subsections 88(1), 85(1), and 97(2), and section 87. Further examples, used to illustrate the problems with the spousal rollover provisions and the other provisions that affect the character of property, are set out in the later sections of the article that deal with those particular provisions.

Example 1: Inventory of the transferor with fair market value greater than historic cost; depreciable property of the transferee

The principal business of Aco is developing and selling rental apartment buildings. Its inventory on hand consists of five completed buildings. Each building (ignoring the land component) has an original cost of $1 million and a current fair market value of $2 million. The principal business of Bco is residential leasing.

a) Aco is a wholly owned subsidiary of Bco and is wound up into Bco under subsection 88(1). Bco's sole business following the winding up is residential leasing.

b) Aco and Bco form a partnership whose sole business is residential leasing. Aco transfers its properties to the partnership and receives no consideration other than its partnership interest. An election is filed pursuant to subsection 97(2) so that no gain is recognized on the transfer. The transfer is not part of a series of transactions by which the property is ultimately transferred to a corporation.

c) Aco amalgamates with Bco under the name Cco. Cco's sole business following the amalgamation is residential leasing.

Example 2: Inventory of the transferor with fair market value less than historic cost; depreciable property of the transferee

The principal business of Dco is developing and selling rental apartment buildings. Its inventory consists of four completed buildings. Each building (ignoring the land component) has an original cost of $2 million and a current fair market value of $1,250,000. The principal business of Eco is residential leasing.

a) Dco is a wholly owned subsidiary of Eco and is wound up into Eco under subsection 88(1). Eco's sole business following the winding up is residential leasing.

b) Dco and Eco form a partnership whose sole business is residential leasing. Dco transfers the properties to the partnership and receives no consideration other than its partnership interest.

c) Dco amalgamates with Eco under the name Fco. Fco's sole business following the amalgamation is residential leasing.

Example 3: Depreciable property of the transferor with fair market value greater than historic cost; inventory of the transferee

The principal business of Xco is residential leasing. Each property owned by Xco is a separate class 3 property, as prescribed under regulation 1101(1ac). Taking one of these properties as an example (and ignoring the land component of the property), it has a capital cost of $3 million, an undepreciated capital cost of $1 million, and a fair market value of $4 million. The principal business of Yco is developing and selling rental apartment buildings.

a) Xco is a wholly owned subsidiary of Yco and is wound up into Yco under subsection 88(1). Yco's sole business following the winding up is the development and sale of real estate.

b) Xco transfers the buildings to Yco in exchange for shares of Yco. Xco and Yco file a joint election under subsection 85(1) so that no gain is recognized on the transfer. Yco's sole business following the winding up is the development and sale of real estate.

c) Xco amalgamates with Yco under the name Zco. Zco's sole business following the amalgamation is the development and sale of real estate.

Example 4: Depreciable property of the transferor with fair market value less than cost amount; inventory of the transferee

The principal business of Rco is residential leasing. Each property owned by Rco is a separate class 3 property, as prescribed under regulation 1101(1ac). Taking one of these properties as an example (and ignoring the land component of the property), it has a capital cost of $3 million, an undepreciated capital cost of $2 million, and a fair market value of $1,500,000. The principal business of Sco is developing and selling rental apartment buildings.

a) Rco is a wholly owned subsidiary of Sco and is wound up into Sco under subsection 88(1). Sco's sole business following the winding up is residential leasing.

b) Rco transfers the building to Sco in exchange for shares of Sco. Sco's sole business following the transfer is the development and sale of real estate.

c) Rco amalgamates with Sco under the name Tco. Tco's sole business following the amalgamation is the development and sale of real estate.

Example 5: Capital property of the transferor; transferee intends to sell the property following the transfer

The principal business of Lco is residential leasing. Each property owned by Lco is a separate class 3 property, as prescribed under regulation

1101(1ac). Taking one of these properties as an example (and ignoring the land component of the property), it has a capital cost of $3 million, an undepreciated capital cost of $1 million, and a fair market value of $4 million. The principal business of Mco also is residential leasing.

a) Lco is a wholly owned subsidiary of Mco and is wound up into Mco under subsection 88(1). Mco intends to sell certain of Lco's properties following the winding up.

b) Lco transfers the properties to Mco in exchange for shares of Mco. Lco and Mco file a joint election under subsection 85(1) so that no gain is recognized on the transfer. Mco intends to sell certain of Lco's properties following the transfer.

c) Lco amalgamates with Mco under the name Nco. Nco's sole business following the amalgamation is residential leasing, although it intends to sell certain of Lco's properties following the amalgamation.

WINDING UP

Application of Subsection 88(1)

Subsection 88(1) sets out the tax consequences of a winding up of a 90 percent owned subsidiary into a parent. Under paragraph 88(1)(a), subject to certain limited exceptions, each property of the subsidiary distributed to the parent on the winding up is "deemed to have been disposed of by the subsidiary" for proceeds (except in the case of a Canadian resource property) equal to the cost amount to the subsidiary of the property immediately before the winding up. The cost to the parent of such property is generally determined under paragraph 88(1)(c) to be equal to the proceeds of disposition to the subsidiary plus, where the property is not ineligible property, an amount determined under paragraph 88(1)(d) (often referred to as a "bump").

There are certain rules governing the treatment of depreciable property on a winding up, which are considered below. However, there are no specific rules in subsection 88(1) regarding the treatment of inventory. A winding up under subsection 88(1) necessarily involves a disposition of property by the subsidiary corporation and an acquisition of such property by the parent.[33] It is therefore questionable whether the character of property acquired by the parent will necessarily be the same as its character in the hands of the subsidiary. Where the parent continues to carry on the same business as the subsidiary, it follows that the character of the property in the hands of the subsidiary should flow through to the parent. However, the character of the property in the hands of the subsidiary should not necessarily be determinative. It is possible that property characterized in one manner in the hands of the subsidiary may be characterized in another manner in the hands of the parent as part (a) of examples 1 through 5 illustrates.

[33] In the absence of the rollover provisions in subsection 88(1), the disposition and acquisition of the subsidiary's assets would be deemed to occur at fair market value under subsection 69(1).

Both *Mara Properties* and *Hickman Motors* concerned the character of property of a subsidiary in the hands of the parent corporation following a winding up. It seems apparent from both cases that the taxpayers assumed that under subsection 88(1), property of the subsidiary retained its character for tax purposes in the hands of the parent. When Revenue Canada disagreed with this presumption, the taxpayers were left to test the argument in court. *Mara Properties* concerned inventory of the subsidiary, and *Hickman Motors* concerned depreciable property. The cases are considered separately below.

Depreciable Property of the Parent

Paragraph 88(1)(f) provides that where the subsidiary's capital cost of depreciable property exceeds its deemed proceeds of disposition under paragraph 88(1)(a), then for the purposes of the capital cost allowance provisions in the Act, the capital cost to the parent of the property is deemed to be the subsidiary's capital cost, and the parent is deemed to have deducted the excess as capital cost allowance in previous years. This provision is intended to preserve the potential recapture in the event that the property is ultimately sold for an amount in excess of its undepreciated capital cost. Paragraph 88(1)(f) appears to presume that depreciable property of the subsidiary will become depreciable property of the parent on a winding up, although this is not necessarily the case. Technically, paragraph 88(1)(f) applies any time depreciable property of a subsidiary is distributed to the parent on a winding up. The provision does not explicitly state that the property must also be characterized as depreciable property to the parent.

Two difficulties arise from this provision. The first, which is considered in *Hickman Motors*, is whether the parent can claim a deduction for capital cost allowance in respect of depreciable property acquired from a subsidiary on a winding up. The second, which is considered below in the context of examples 1(a) and 2(a), is how, if at all, the provision applies where depreciable property of a subsidiary would not otherwise be treated as depreciable property in the hands of the parent.

In *Hickman Motors*, the taxpayer, a car distributor, was a profitable corporation with a calendar year-end. Hickman Equipment Limited ("Equipment"), a wholly owned subsidiary of the taxpayer, was in the business of leasing heavy equipment and was generating substantial losses. Shortly before the end of its 1984 taxation year, as part of a corporate restructuring involving the taxpayer and a number of associated companies, Equipment was wound up into the taxpayer. The taxpayer claimed over $2 million capital cost allowance in its 1984 taxation year based on the undepreciated capital cost of the property received from Equipment. On January 2, 1985 (five days after receiving the property), the taxpayer transferred all of the assets received from Equipment, net of liabilities, to a newly incorporated subsidiary. As a result of the capital cost allowance deduction (and the application of certain non-capital loss carryovers of Equipment, which was not contested by Revenue Canada), the taxpayer reported a loss in excess of $1 million in its 1984 taxation year, which it carried forward to reduce its taxable income in its 1985 and 1986 taxation years. Revenue Canada denied the taxpayer's capital cost allowance deduction in 1984 and consequently redetermined its income for its 1984, 1985, and 1986 taxation years. The taxpayer's appeal to the Federal Court—Trial Division[34] and further appeal to the Federal Court of Appeal[35] were both dismissed.

The entire premise of the taxpayer's argument was that the purpose and intent of subsection 88(1) was

> to permit a parent company to retain and continue the tax character, attributes and history of its wholly owned subsidiary on the winding up of the latter so as to allow the parent to step into the "tax shoes" of the subsidiary.[36]

While the Federal Court of Appeal was prepared to accept this view of the purpose and intent of subsection 88(1),[37] it rejected the taxpayer's arguments regarding the consequences of this view. The court noted that subsection 88(1) does not, in and of itself, create rights to any deductions. The ability of the parent to claim capital cost allowance would depend entirely on the statutory principles applicable to its deduction, namely, subsection 9(1), paragraphs 18(1)(b) and 20(1)(a), and the regulations under paragraph 20(1)(a). In order for the parent to claim capital cost allowance, according to regulation 1102(1)(c), it must have acquired the property for the purpose of gaining or producing income. This determination is a question of fact, which the trial judge determined adversely to the taxpayer. The taxpayer held the property for only five days, over a holiday long weekend, before transferring it to another wholly owned subsidiary. The assets acquired from Equipment and the liabilities assumed were not reflected on the taxpayer's audited financial statements for the 1984 year (apart from a reference in a note to the financial statements), and no income or loss in respect of the leasing business of Equipment was reported on the statements.[38] The Federal Court of Appeal concluded that the trial judge's finding was in accordance with applicable principles of law and was supported by the evidence.[39]

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[34] 93 DTC 5040 (FCTD). No analysis of the trial judge's decision is made here. For a criticism of that decision, see Judith M. Woods, "Recent Jurisprudence," in *Report of Proceedings of the Forty-Fifth Tax Conference*, 1993 Conference Report (Toronto: Canadian Tax Foundation, 1994), 48:1-22, at 48:8-13.

[35] Supra footnote 1.

[36] Ibid., at 5577.

[37] Ibid.

[38] In the evidence at trial, an officer of the appellant indicated that the decision was taken not to include this information because its determination did not justify the additional costs arising from the time that would have been spent on it by the taxpayer's staff and its external auditors.

[39] To a large degree, the taxpayer was the author of its own misfortune. Particularly in aggressive tax-planning transactions, it is important that the taxpayer properly document the transactions, including their proper reflection in audited financial statements.

The taxpayer further argued that regulation 1102(14) provided an exception to the normal rules regarding the preconditions for the availability of capital cost allowance. Regulation 1102(14) deems depreciable property of a prescribed class of the subsidiary to be depreciable property of the same prescribed class of the parent where it has been acquired as a result of a winding up under subsection 88(1).[40] The court rejected the argument:

> Subsection 1102(14) does not have the reach contended for it. It does not say that it operates notwithstanding the general rule set out in subsection 1102(1) or the underlying principle enshrined in paragraph 18(1)(a). The purpose of subsection 1102(14) is manifestly to prevent the acquirer of depreciable property, in the circumstances described in the various paragraphs thereof, from switching such property from one class to another. This is all that it does. One has only to look at the provisions of paragraph 1102(14)(d) (which, incidently [sic], also applies to the acquisition by the appellant of the assets of "Equipment") to see that this provision cannot possibly have the effect of automatically allowing a non-arm's length acquirer to claim capital cost allowance simply because the person from whom the property was acquired had the right to do so.[41]

The final argument put forward by the taxpayer was that, if the property was not depreciable property of a prescribed class on December 31, 1984, the taxpayer was entitled to claim a terminal loss under subsection 20(16). This argument was not raised before the trial judge, nor did it appear in the pleadings before the Federal Court of Appeal. The court properly rejected this argument on its merits. In order for subsection 20(16) to apply, the taxpayer must have had at some time depreciable property of the particular prescribed class which it no longer owns, and the court concluded that the equipment acquired by the taxpayer from its subsidiary was never depreciable property of a prescribed class of the taxpayer.[42]

Of course, the question then left is, if it was not depreciable property of a prescribed class to the transferee, what was it? Essentially, the court concluded that the equipment was depreciable property to the taxpayer, but not depreciable property of a prescribed class because the taxpayer did not acquire it for the purpose of gaining or producing income.[43] This

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[40] Regulation 1100(14) has since been amended to remove the specific reference to a winding up. However, it still applies to a subsection 88(1) winding up by virtue of regulation 1100(14)(d) since the parent acquires property from a non-arm's-length person.

[41] Supra footnote 1, at 5578.

[42] Thus generating the quote at the beginning of this article.

[43] Hugessen JA stated, supra footnote 1, at 5577-78:

> It nothing serves the appellant to show that it is deemed to have the same undepreciable capital cost for the property which it acquired from "Equipment" as "Equipment" itself had immediately prior to the winding-up; nor that the depreciable property of "Equipment" has become depreciable property in the appellant's hands. . . .
>
> Depreciable property which was not acquired for [the purpose of gaining or producing income] is deemed not to be included in any of the classes of property in respect of which capital cost allowance may be claimed.

determination is ultimately a question of fact. While there is a presumption that all corporations carry on business[44] and accordingly use their assets for the purpose of earning income from business, the presumption is rebuttable. There is no doubt that had the taxpayer continued to hold the equipment of the subsidiary and carry on the leasing business itself for a reasonable period of time, it would have been entitled to claim a capital cost allowance deduction in 1984. The taxpayer wanted the benefit of the capital cost allowance deduction without essentially taking on the business of the subsidiary with its associated risks and liabilities.[45] Given the short period of time that the taxpayer held the property, the fact that the time period spanned a holiday weekend, and the fact that the taxpayer itself did not record any rental income from the property in its financial statements for this period, it is difficult to fault the court's decision.

Following the decision of the Federal Court—Trial Division in *Hickman Motors*, Michael Hiltz, director of the Reorganizations and Non-Resident Division in Revenue Canada's Rulings Directorate, provided comments on loss utilization within a corporate group at the 1994 annual tax conference. His comments were not confined to loss utilization in a winding up but rather applied to all domestic in-house loss-consolidation schemes. He confirmed that section 245 will not generally be applied by Revenue Canada to such schemes; however, they may fail for other reasons. In one example, he considered a scheme involving

> the transfer of a depreciable asset of one corporation to another corporation in the group, followed by a transfer of the asset back to the transferor or yet another corporation in the group. Such schemes will not usually achieve the desired result unless the asset is depreciable property to the transferee. . . .
>
> In order for the asset to represent depreciable property to the transferee, paragraph 1102(1)(c) of the Regulations requires that the transferee acquire the asset for the purposes of gaining or producing income. . . . Whether the reasoning in *Hickman Motors* applies to a particular loss-consolidation scheme will depend on all of the relevant circumstances, including the length of time over which the asset is held by the transferee, the use to which the asset is put by the transferee and the income earned by the transferee with the asset.[46]

Hiltz's remarks suggest that the "purpose" requirement in regulation 1102(1)(c) is based on objective criteria, such as the length of time the

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[44] *Canadian Marconi v. The Queen*, 86 DTC 6526 (SCC).

[45] Even if it were permitted, the capital cost allowance deduction for 1984 would presumably have been limited by regulation 1100(15) to the taxpayer's income from the leasing business for that year. It is apparent from the facts of the case that the taxpayer's principal business was not leasing property, and the taxpayer therefore would not benefit from the principal business corporation exemption in regulation 1100(16). Regulation 1100(15) was argued by the Crown before the Federal Court—Trial Division, but neither that court nor the Federal Court of Appeal considered the application of the provision.

[46] Michael A. Hiltz, "Revenue Canada Forum," in *Report of Proceedings of the Forty-Sixth Tax Conference*, 1994 Conference Report (Toronto: Canadian Tax Foundation, 1995), 47:1-20, at 47:2-3.

asset is held, the use to which it is put, and the income earned with the asset. If the objective indicia do not support an income-earning purpose, the property will not constitute depreciable property to the transferee. The fact that the property was depreciable property to the transferor in the same corporate group is irrelevant.

In normal commercial transactions, there are circumstances where property characterized as depreciable property to the parent was not necessarily depreciable property to the subsidiary. Consider examples 1(a) and 2(a).

In example 1(a), subparagraph 88(1)(a)(iii) deems Aco to have disposed of each building for $1 million and, under paragraph 88(1)(c), the cost of each building to Bco is deemed to be $1 million. On the basis that the property's character to Bco depends on the purpose for which the property was acquired, the property should constitute depreciable property to Bco regardless of the fact that it was inventory to Aco. Accordingly, each building would be treated as a separate class 1 property with an initial capital cost of $1 million. However, because the property was not depreciable property to Aco, Bco would be subject to the half-year rule regardless of the length of time that Aco owned it.[47] Assuming that the property is subsequently sold for $2 million, Bco would realize a capital gain of $1 million in addition to any recaptured depreciation. In effect, the increase in value of the inventory in Aco's hands is taxed preferentially as a capital gain in the hands of Bco.

In example 2(a), Dco is deemed to have disposed of its inventory for its cost amount immediately before the winding up pursuant to subparagraph 88(1)(a)(iii). If Dco had already written down the cost of the building under subsection 10(1), the cost amount of the building to Dco would be $1,250,000. Eco's cost of the building is deemed to be the same amount. As in example 1(a), each building constitutes a separate class 1 property, and Eco will be entitled to claim capital cost allowance based on a capital cost of $1,250,000, subject to the half-year rule in the first year. If Eco subsequently disposed of the building for an amount in excess of $1,250,000, the excess would be considered a capital gain to Eco notwithstanding that Dco's profits in a taxation year before the winding up would have been reduced by the full $750,000 writedown.

On the other hand, if Dco had not yet written down the cost of the building (that is, its decline in value occurred in the course of the year immediately preceding the winding up), it appears that Dco would be deemed to have disposed of the building and Eco would be deemed to have acquired it for $2 million,[48] since there is no deemed year-end

[47] The exception to the half-year rule in regulation 1100(2.2) requires in paragraph (f) that the property be depreciable property of the transferor.

[48] This figure assumes that Eco did not acquire control of Dco immediately before the winding up. Had Eco done so, Dco would have had a deemed year-end as a result of subsection 249(4) and would have had to write down the cost of the inventory as a consequence.

immediately before the winding up of Dco.[49] Eco would be entitled to claim capital cost allowance based on the full $2 million, subject to the half-year rule in the first year. If Eco disposed of the property for $1,250,000, it would be entitled to claim a terminal loss under subsection 20(16). If Eco continued to hold the property and the building subsequently increased in value to $2 million, any further increase in value would be treated as a capital gain at the time of disposition.

Inventory of the Parent

Mara Properties concerned an avoidance transaction designed to transfer the accrued but unrealized losses of one corporation to an arm's-length corporation. The decision pertained to the taxpayer's 1982 taxation year, before the amendments to the stop-loss rules in 1987.[50]

In *Mara Properties*, the taxpayer, a property development company, acquired all the shares of another company ("Fraserview") involved in a similar business and subsequently wound up that company. At the time of the winding up, Fraserview had a single remaining asset, land inventory, which had a cost of approximately $7.6 million and a fair market value of $3 million.[51] Fraserview's inventory property was "pregnant" with this loss since it had been valued for tax purposes at its historic cost, as was then allowed. Following the winding up of Fraserview under subsection 88(1) of the Act, the taxpayer sold the land to an arm's-length purchaser for its fair market value. The sale had been pre-arranged by the taxpayer before the winding up. The taxpayer claimed approximately $4.6 million as a business loss, which it applied to reduce its income for that year to nil, carrying over the excess to subsequent taxation years. The total tax recovery claimed was approximately $2.3 million. Revenue Canada disallowed the loss and the taxpayer appealed. The taxpayer's counsel stated explicitly before the court that the sole motivation for the transactions

[49] *Interpretation Bulletin* IT-488R2, June 24, 1994, paragraph 15.

[50] The 1987 amendments were first announced in a press release on January 15, 1987: Canada, Department of Finance, *Release*, no. 87-09. Draft legislation attached to the release included new subsection 249(4), which deems a year-end to occur immediately before an acquisition of control, as well as the repeal of regulation 1801, removing a taxpayer's option to value inventory at anything other than the lower of cost and fair market value. Regulation 1801 was amended to its current wording by Canada, Department of Finance, Notice of Ways and Means Motion To Amend the Income Tax Act, a Related Act, the Canada Pension Plan and the Unemployment Insurance Act, 1971, June 5, 1987.

[51] The cost of the land and related development expenses were financed by two mortgages and various shareholder loans. A first mortgage of approximately $3 million was in favour of a bank. A second mortgage of approximately $4 million was a vendor takeback mortgage and the balance of approximately $600,000 represented the shareholder loans. Given the property's fair market value, the second mortgage and shareholder loans were essentially worthless. The debts were purchased by a party related to the taxpayer for approximately $200,000. On the winding up, these debts became enforceable against all of the taxpayer's assets, although it is unlikely that the "friendly" creditor would have unilaterally demanded payment. These debts were eventually repaid by the taxpayer.

was reducing tax. The crux of the taxpayer's argument was that property that was inventory of a subsidiary retained its character on a winding up.

The minister's main argument before all three courts that heard the case was that the cost of the land was not an expense incurred by the taxpayer for the purpose of gaining or producing income since it was not possible to derive a profit from a sale of the land, and therefore it did not become part of the taxpayer's inventory.[52] The minister suggested that the decision in *Hickman Motors*[53] supported this conclusion. The minister also alleged that the anti-avoidance provision in former section 245 denied the loss.

The Tax Court of Canada allowed the taxpayer's appeal. Kempo TCCJ distinguished the case from *Hickman Motors*. She concluded that the result in *Hickman Motors* was predicated on the specific statutory restrictions governing capital cost allowance. There are no similar statutory provisions regarding the treatment of inventory. With regard to paragraph 18(1)(a) and section 245, the judge followed established authority[54] to the effect that the cost of inventory was not an "outlay" or "expense," or a "deduction" or "disbursement made or incurred," and thus neither of these provisions applied.

The judge distinguished the authorities cited by the minister to the effect that the land did not constitute inventory to the taxpayer. Unfortunately, the judge did not adequately deal with the issue of the character of the property in the parent's hands. The judge seemed to accept the notion that the property retained its character as inventory through the winding up. To her, the sole issue appears to have been the availability to the taxpayer of the deemed cost of the property under subsection 88(1), and she agreed with the taxpayer's counsel that subsection 88(1) "drives the results."[55] The judge indicated that Parliament must have been aware that a parent's deemed cost of property under subsection 88(1) could greatly exceed its fair market value.[56] There is some merit to this allegation. There is a long history of provisions in the Act preventing the transfer of

[52] The argument was derived from the well-known doctrine in *Moldowan v. The Queen*, 77 DTC 5213 (SCC).

[53] At the time the Tax Court heard *Mara Properties*, the Federal Court—Trial Division had rendered its decision in *Hickman Motors*, supra footnote 34.

[54] *Oryx Realty Corporation v. MNR*, 74 DTC 6352 (FCA); and *MNR v. Shofar Investment Corporation*, 79 DTC 5347 (SCC).

[55] 93 DTC 1449, at 1458 (TCC). Kempo TCCJ previously stated, ibid., at 1456: "[I]t is important to recognize that what this case is really about is the Appellant's purported inability to utilize the deemed cost amount against its actual proceeds of disposition. . . . No question or issue concerning the nature or characterization of the Appellant's proceeds of disposition arises here." With respect, Kempo TCCJ appears to have confused the minister's argument. The crux of that argument was that the property that was inventory of the subsidiary was not necessarily inventory of the parent. The availability of the loss was dependent on the property's retaining its character as inventory on the winding up, and this character in turn depended on the purpose for which the taxpayer (that is, the parent company) acquired the property.

[56] Ibid., at 1455.

losses between corporations. Rules preventing the transfer of property pregnant with losses were first introduced with effect from November 12, 1981, but were limited to depreciable property and eligible capital property. No rules were introduced at that time concerning the transfer of non-depreciable capital property or inventory. The taxpayer submitted that, by denying the taxpayer's loss, the minister was attempting to give retrospective effect to the 1987 amendments. The judge concluded that the 1987 amendments were substantive and went beyond mere clarification of existing law; the new rules "were publicly touted to preclude the results of the very situation at hand."[57]

The majority of the Federal Court of Appeal allowed the minister's appeal. The majority concluded that property that was inventory of a subsidiary did not necessarily become inventory of the parent on the winding up of the subsidiary as a result of the application of subsection 88(1); in order to constitute inventory of the parent, it must have been acquired by the parent in the course of, within the ambit of, or for the purposes of its business. If the transaction is devoid of any ordinary characteristics of trade, "especially if devoid of any possibility of yielding some direct or indirect, immediate or eventual profit, [it] is not a trading transaction and any property so acquired cannot be regarded as stock-in-trade."[58] Since the taxpayer's counsel admitted that the transactions were solely motivated by tax avoidance, the majority concluded that the property did not become part of the inventory of the parent. What, indeed, it did become in the hands of the parent, was left unanswered. Presumably, in these circumstances, the land would be characterized as capital property.

The majority cited two decisions of the House of Lords[59] and one decision of the Supreme Court of Canada[60] supporting its conclusion. The facts in these cases are easily distinguished from *Mara Properties*. More important, a close examination of these cases suggests that they are not authority for the proposition put forward by the majority. The House of Lords decisions both concerned dividend-stripping transactions involving dealers in securities.[61] The decision in *Finsbury Securities* turned on the

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[57] Ibid. Finance's press release of January 15, 1987, supra footnote 50, announcing the changes to the stop-loss rules supports this conclusion. Nevertheless, it is unlikely that Parliament actually had a "policy objective obviously unrelated to the raising of revenue in maintaining a parent's ability to utilize its subsidiary's unrealized non-capital losses following its wind-up into the parent," as Kempo TCCJ suggested, supra footnote 55, at 1460.

[58] Supra footnote 4, at 5170 (FCA).

[59] *Bishop v. Finsbury Securities, Ltd.*, [1966] 3 All ER 105 (HL); and *FA & AB Ltd. v. Lupton*, [1971] 3 All ER 948 (HL).

[60] *Deputy Minister of Revenue (Que.) v. Lipson*, [1979] 1 SCR 833.

[61] The cases arose out of certain anomalies in the UK tax legislation. A dealer in securities was not required to include in income dividends paid out of taxed profits of a corporation. A dividend strip involved transactions whereby shares were sold to a dealer in securities at a price reflecting the amount of dividends that could be paid out of either existing retained earnings (a backward strip) or anticipated earnings (a forward strip). The

(The footnote is continued on the next page.)

proper characterization of the property in the hands of the taxpayer, rather than tax avoidance.[62] In *FA & AB Ltd.*,[63] although all five Law Lords referred in their judgments to the tax-avoidance aspects of the scheme, that alone was not determinative. The Inland Revenue argued that if the main purpose of a scheme was to secure a tax advantage, the share acquisition could not be regarded as having been made in the course of a trade. The majority of the Law Lords expressly declined to uphold this contention; rather, they said, it was necessary to consider the transactions in their entirety and to determine whether, on that basis, they were trading transactions. The majority held that the terms of the agreement tainted it as something other than a trading transaction.[64]

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[61] Continued . . .
vendors would claim that the profit on the sale was a capital gain, which at that time was not subject to tax. The dividends paid would be used to pay the purchase price. The purchaser, as a dealer in securities, would consider the shares to be stock-in-trade and would reflect the decline in value or the loss on a subsequent sale as a trading loss, either paying less tax or claiming a tax refund on the basis of the loss. The vendor thus avoided paying surtax on a direct distribution of profits, and the purchaser reduced its tax liability or obtained a tax refund. The only loser was the public purse.

[62] *Finsbury Securities*, supra footnote 59, concerned a forward strip. The price paid by the taxpayer for the shares was equal to the dividends to be paid over the following five years (to a maximum of £60,000) plus one-half of the tax savings that the purchaser would realize as a result of the writedown in value of the shares over the term of the agreement. Lord Morris of Borth-y-Gest, who wrote the only judgment, held that the shares did not constitute inventory to the taxpayer because the taxpayer did not purchase them for the purpose of dealing with them, a hallmark of inventory; rather, the taxpayer could not sell the shares during the currency of the agreement with the vendors without violating the agreement.

[63] Here, the vendors of the shares warranted in the sale agreement that the purchaser would be entitled to a tax refund and that the vendors would pay an amount as liquidated damages in the event that the purchaser failed to recover the tax.

[64] The predominant discord in the judgments concerned the potential inconsistency between *Finsbury Securities* and the earlier House of Lords decision in *Griffiths v. J.P. Harrison, Ltd.*, [1962] 1 All ER 909. *J.P. Harrison, Ltd.* also concerned a dividend strip. The taxpayer, a dealer in securities, purchased shares on which a dividend was about to be declared; following the payment of the dividend, the taxpayer sold the shares. The majority of the House of Lords held that the transaction constituted a trading transaction and that the taxpayer was entitled to deduct the loss on the sale of the shares. Although the purchase price paid for the shares exceeded the amount of the dividend received, there was nothing in the agreement that in any way tied the price to the success of the taxpayer's claim for tax relief. Lord Morris and Lord Guest, both of whom wrote judgments in *J.P. Harrison, Ltd.*, held in *FA & AB Ltd.*, supra footnote 59, that the two cases were distinguishable. Viscount Dilhorne and Lord Donovan considered there to be no distinction between the two cases, and preferred *Finsbury Securities*. They concluded that the transactions, viewed as a whole, were carried out in order to establish a claim against the Inland Revenue and accordingly did not constitute trading activities. Lord Simon of Glaisdale attempted to reconcile the two cases. Dividend-stripping activities were not, in themselves, part of a trade. However, share dealing that is a trade will not cease to be so merely because there is inherent in it an intention to obtain a fiscal advantage. He agreed with Lord Morris and Lord Guest that the warranty in the agreement tainted the transaction as something other than a trading transaction. *Mara Properties* is similar to *J.P. Harrison, Ltd.*, in that the transactions involved did not have any anomalous characteristics differing from normal business transactions.

The Supreme Court of Canada decision in *Lipson* did not concern the acquisition of property at all. It concerned a scheme undertaken by the shareholders of a corporation in financial difficulty to claim the business losses of the corporation personally. The case centred on the deductibility of a shareholder's expenses under the equivalents of section 9 and paragraph 18(1)(a) in Quebec's income tax legislation. The Supreme Court of Canada denied the deduction on the basis that the taxpayer had no reasonable expectation of profit in the scheme.[65]

The difficulty with the Crown's argument in *Mara Properties* and with the conclusion of the majority in the Court of Appeal, as indicated by McDonald JA in dissent, was that "[a]lthough counsel for the appellant urged this Court not to deem the rolled over property as inventory, he could not assist the Court in determining how this land should be defined for income tax purposes."[66] The majority was not concerned with the property's ultimate character; whatever it was, it was not inventory.[67]

McDonald JA concluded that the loss on the sale of the land was a business loss because the land was inventory of the taxpayer. He appears to have attached importance to the fact that the taxpayer's acquisition of Fraserview's shares was an arm's-length transaction and was carried out in a manner characteristic of an ordinary share acquisition. McDonald JA said that, upon winding up, the assets of the subsidiary

> should be grouped with assets of the parent of the same character. Here, both companies are in the same business and consider land as an item of inventory. Consequently, on the winding up of a [sic] Fraserview, its inventory should have merged with Mara's inventory for income tax purposes.[68]

McDonald JA agreed with the trial judge that the 1987 amendments to the stop-loss rules constituted a material change in the pre-existing law.

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[65] The taxpayer's appeal of his federal income tax liability was rejected by the Tax Review Board on the basis that the scheme was artificial and a sham: 72 DTC 1222.

[66] Supra footnote 4, at 5174 (FCA).

[67] Compare *Nova Corporation of Alberta v. The Queen*, 95 DTC 599 (TCC); and *The Queen v. Husky Oil Limited*, 95 DTC 5244 (FCA). Both of these cases concerned tax-avoidance transactions very similar to the scheme in *Mara Properties*, except that the property involved was capital property with significant accrued but unrealized losses. In *Nova Corporation*, the minister argued that the resulting capital loss was denied under subsection 55(1) on the basis that the taxpayer had artificially or unduly created a loss from a disposition. The court rejected the argument on the basis that the taxpayer had not created the loss; rather, the loss resulted from the pre-existing high adjusted cost base of the property, which was mechanically carried over to the taxpayer under paragraph 88(1)(c). In *Husky Oil*, the minister invoked former subsection 245(2), arguing that the vendors of the subsidiary's shares conferred a benefit on the taxpayer by effectively making available to the taxpayer the loss on the sale of the subsidiary's property. The court rejected the argument; the taxpayer and the vendor were dealing at arm's length, the price paid for the subsidiary's shares was negotiated openly, and therefore the price paid represented their fair market value.

[68] Supra footnote 4, at 5174 (FCA).

The Supreme Court of Canada heard the taxpayer's appeal on May 21, 1996. La Forest J delivered the oral judgment of the court allowing the taxpayer's appeal. He stated simply:

> We agree with the conclusion reached by the Tax Court and Mr. Justice MacDonald [sic], the dissenting judge in the Court of Appeal. In our view, in the circumstances of this case, the property retained its character as inventory in the hands of the appellant.[69]

The issue faced by the Supreme Court had much broader significance than tax-avoidance transactions of a similar ilk.[70] The court should have taken the opportunity to provide guidance on the character of property received in the course of a winding up. Although the Supreme Court justices agreed with the conclusion reached by Kempo TCCJ in the Tax Court and McDonald JA in the Federal Court of Appeal, they did not discuss the rationale of either judge's decision, and these decisions are not wholly congruent. Kempo TCCJ appeared to assume that property that was inventory to the subsidiary necessarily became inventory of the parent. It is difficult to discern from McDonald JA's decision whether inventory of a subsidiary automatically becomes inventory of its parent as a consequence of the winding up, or whether its character in the hands of the parent is an independent determination based on other factors, such as the similarity of the businesses conducted by the two corporations.

It is submitted that the reasoning of the majority of the Federal Court of Appeal was wrong. If Fraserview had sold the land inventory, there is no question that the loss generated would have been a business loss, which would have given rise to a non-capital loss if Fraserview did not have sufficient income in the year. If the taxpayer had then acquired the shares of Fraserview and commenced winding-up proceedings, paragraph 88(1.1)(e) would have denied the availability to the taxpayer of the non-capital loss since the taxpayer had acquired control of Fraserview and Fraserview's business had effectively ceased with the sale of the land.[71] However, what would the outcome have been if Fraserview had sold the land *after* the taxpayer had acquired all of its shares but *before* the winding up? It would be difficult to argue that the land ceased to be inventory to Fraserview simply as a result of the acquisition of its shares.[72] The loss

69 Supra footnote 4, at 6310 (SCC).

70 The caveat "in the circumstances of this case" in the quoted extract above suggests that the reasoning may not even extend to other anti-avoidance cases such as *Sabo Bros. Construction*, infra footnote 79.

71 Accordingly, the taxpayer could not have met the precondition in subparagraph 88(1.1)(e)(i) that the business of the subsidiary must continue to be carried on for profit or with a reasonable expectation of profit.

72 To do so, the minister would have to allege that the change in control of Fraserview resulted in a conversion of its inventory into some other type of property or that Fraserview's operations ceased to be a business after the acquisition of control. Since a corporation is a separate entity from its shareholders, a mere change in shareholders, without some fundamental change in the business carried on by the corporation, should not result in a conversion of property from inventory to something else or a termination of the corporation's operations as a business.

generated on the land sale would have created a non-capital loss to Fraserview, and this loss would have been deemed to be the taxpayer's non-capital loss on the winding up of Fraserview under subsection 88(1.1). The acquisition-of-control rules in paragraph 88(1.1)(e) would not have denied the non-capital loss to the parent since the loss did not arise until after the acquisition of control. Of course, it is not the court's task to consider alternative methods by which a transaction might have been structured.[73]

If the land remained inventory of Fraserview until the subsidiary was wound up, its character should not have been affected where the parent corporation carried on the same business and acquired the land on the winding up in order to sell it, as it would any other piece of land inventory (and, indeed, as the subsidiary could otherwise have done). The taxpayer's loss arose because of the mechanical application of statutory provisions that dictated that the cost of the land remained $7.6 million on the winding up. The loss was real; the transactions did not artificially create a loss that did not already exist. The loss arose while the property was owned by Fraserview, but it was not realized until the property was sold by the taxpayer. To suggest that the property acquired by the taxpayer on the winding up in these circumstances was not inventory is disingenuous. Even though the taxpayer's only purpose in undertaking the transactions was to obtain a tax benefit, that alone should not have had the effect of recharacterizing the land as something other than inventory. The taxpayer and the owners of Fraserview were dealing at arm's length, and the price paid for the shares was in no way dependent on the taxpayer's successful claim of a loss on the sale of the land.[74] Further, the Department of Finance should have been aware of schemes by which inventory and capital property with pregnant losses could be transferred between taxpayers. The 1981 amendments to the stop-loss rules reflect an awareness of schemes utilizing depreciable property and eligible capital property. *Mara Properties* illustrates the tax-avoidance problems associated with inventory pregnant with losses.

There is little doubt that the transactions undertaken by the taxpayer produced consequences that were unintended by Parliament. The earliest anti-avoidance provisions designed to prevent the transfer of losses predate 1952 and were aimed at preventing the carryover of a corporation's

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[73] *The Queen v. Bronfman Trust*, 87 DTC 5059 (SCC). It is submitted that the taxpayer would have had better success had the transaction been structured in this manner. In all likelihood, this structure was not used because of timing considerations. The taxpayer's year-end was November 30, and all of the transactions occurred on November 30, 1982 because the taxpayer wanted the benefit of the loss in its 1982 taxation year. If Fraserview's year-end was after November 30, the non-capital loss would not have arisen until that year-end and therefore would not have been available to the taxpayer until its 1983 taxation year.

[74] These factors alone distinguish the case from the House of Lords decisions in *Finsbury Securities* and *FA & AB Ltd.*, supra footnote 59. Granted, the price paid was based exclusively on the value of the anticipated tax benefit, but the vendor did not guarantee the tax claim, nor did the price depend on the claim's success.

business losses following an acquisition of control. The 1981, 1983, and 1987 amendments to the stop-loss rules are all confined to circumstances where control of a corporation is acquired. Although the minister did not argue that the transactions were contrary to the "object and spirit" of the winding-up provisions, it is doubtful that such an argument would have been successful.[75]

While the judiciary's sympathy for transactions undertaken solely for tax-avoidance purposes has waned, any rejection of such transactions must be based on established principles. A general business purpose test was rejected in *Stubart*;[76] arguably, the majority of the Federal Court of Appeal sought to apply a business purpose test, although it specifically denied that it was doing so. It was arguably open to that court and the Supreme Court of Canada to find in favour of the Crown on the basis that the transactions in issue did not form part of the taxpayer's business since there was no reasonable expectation of profit; that is, there was no source of income, and therefore there was no loss for tax purposes. A basic premise of the Act is that income is calculated on a source-by-source basis. Not only is each business considered a separate source of income, but each business carried on in a particular place is considered a separate source of income.[77] The taxpayer's principal place of business was in Vancouver. The Fraserview land constituted 92 acres overlooking the Fraser River near Maple Ridge, a distinct location. If the ultimate sale of the land was negotiated as part of the acquisition of the Fraserview shares, the taxpayer could not possibly show a profit on its sale. The taxpayer paid only for the tax savings it anticipated through the application of the technical provisions of the Act, and the pursuit of tax savings does not constitute a business.[78] The taxpayer otherwise bore no risk in the acquisition of the shares.

The decisions in *Mara Properties* and *Friesen* make it difficult to articulate any general guidelines for characterizing property as inventory. The difficulties with *Mara Properties* are demonstrated in *Sabo Bros. Construction Ltd. v. The Queen*,[79] which predates the Supreme Court's decision in *Mara Properties*. The facts of the two cases are very similar. *Sabo Bros. Construction* concerned a real estate development company

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[75] The "object and spirit" approach to statutory interpretation was endorsed by the Supreme Court of Canada in *Stubart Investments Limited v. The Queen*, 84 DTC 6305. The Supreme Court's more recent decisions in *Friesen*, supra footnote 23, and *Antosko et al. v. The Queen*, 94 DTC 6314, suggest that this approach has limited scope in the interpretation of legislation as detailed and precise as the Act. The provisions in subsection 88(1) that determine the cost of property to the parent corporation are clear and admit no ambiguity or doubt.

[76] Supra footnote 75.

[77] Section 4.

[78] See, for example, *Moloney v. The Queen*, 92 DTC 6570 (FCA), application for leave to appeal to the Supreme Court of Canada denied May 6, 1993.

[79] 96 DTC 1188 (TCC).

that acquired shares of two corporations ("Snowcap" and "Symac"). The sole assets of each of these corporations were land inventory with accrued but unrealized losses ("the Snowcap lands" and "the Symac lands"). Both corporations were wound up into the taxpayer. The taxpayer sold the Snowcap lands shortly after the winding up to the shareholders of Snowcap pursuant to an option in the original share purchase agreement. The taxpayer claimed that the loss on the sale was a business loss. The taxpayer retained the Symac lands for five years following their acquisition before transferring the property to a related company. The taxpayer wrote down the cost of the land under subsection 10(1) at the end of the taxation year in which the land was acquired and claimed the resulting loss as a business loss. Revenue Canada disallowed the loss on the sale of the Snowcap lands and denied the inventory writedown in respect of the Symac lands. The taxpayer appealed to the Tax Court of Canada.

The Tax Court of Canada concluded that the Snowcap lands were not inventory:

> The speed with which the Appellant sold the lands at a loss, viewed in the context of the other facts of this transaction, indicates that this was not a business transaction. It did not have the possibility of yielding a direct or indirect, immediate or eventual profit.[80]

Beaubier TCCJ held that the resulting loss on the sale therefore constituted a capital loss. He further concluded that the "deduction was claimed as a result of an action by the Appellant that has no business purpose" and therefore former subsection 55(1) denied the capital loss.[81]

The taxpayer's appeal regarding the writedown of the Symac lands was allowed. The taxpayer had attempted, unsuccessfully, to find a buyer or a tenant for these lands following their acquisition. The property was eventually developed and leased by a related company seven years after its acquisition. The trial judge considered that the taxpayer had a reasonable expectation of profit from the Symac lands, applying the criteria set out in *Moldowan v. The Queen*.[82] The court concluded:

> [T]he Appellant had a profitable experience in its past years, it had the training, it had an intended course of action of sale or development based upon proven experience in the immediate area, and it had a capability as capitalized to show a profit after charging capital cost allowance. In 1986 the Appellant had a reasonable expectation that it would profit from the acquisition of the Symac lands.[83]

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[80] Ibid., at 1195.

[81] Ibid., at 1196. As noted above, the application of a business purpose test was specifically rejected by the Supreme Court of Canada in *Stubart*, supra footnote 75. In addition, the judgment in *Sabo Bros. Construction* did not refer to either *Nova Corporation* or *Husky Oil*, supra footnote 67.

[82] Supra footnote 52.

[83] Supra footnote 79, at 1196.

With respect, if the court applies a reasonable expectation of profit test in these circumstances, surely it ought to do so without the benefit of hindsight. The agreed statement of facts stated that the reason the taxpayer entered into the Symac transactions was

> so that the Appellant would acquire on the winding up of Symac, the Symac lands for sale, or development and sale, and thereby obtain the benefit it considered would flow from the application of the provisions of the Act. That benefit obtained was the reduction in tax that would otherwise have been payable by the Appellant.[84]

Moreover, if the court is going to apply the reasoning of the Federal Court of Appeal in *Mara Properties*, it must do so consistently. If the taxpayer's purpose in acquiring the shares of both corporations was to obtain the perceived benefit of the provisions in subsections 88(1) and 10(1), then according to the Federal Court of Appeal in *Mara Properties*, that should end the matter. The fact that the taxpayer could not find a buyer for the lands shortly after their acquisition does not change the taxpayer's purpose in acquiring the property. These problems have not necessarily been obviated by the Supreme Court's decision in *Mara Properties* because of the paucity of reasons given by the court.

Of course, not all windups are arranged solely or primarily for tax purposes. Regardless of the purpose underlying the winding up, the character of property in the hands of the subsidiary may not necessarily be determinative of its character to the parent.

In example 3(a), Xco has disposed of the buildings on the winding up and Yco has acquired them. Under the rules in subsection 88(1), Xco is deemed to have disposed of each of its class 3 properties for its cost amount ($1 million for the particular building used in the example). Yco's cost of such property is deemed to be the same $1 million. Even though the buildings are treated by Yco as part of its inventory, paragraph 88(1)(f) applies. For the purposes of the capital cost allowance provisions, the capital cost of the particular building to Yco is deemed to be $3 million, and Yco is deemed to have deducted $2 million as capital cost allowance in previous years. The property is therefore deemed to be depreciable property of Yco,[85] although for the purpose of the capital cost allowance provisions only. Since, in the absence of paragraph 88(1)(f), the property would be characterized as inventory of Yco, it should retain the same character for the purposes of the remaining provisions of the Act. This dual characterization could lead to some anomalous results. It is submitted that while the property may be deemed to be depreciable property of Yco, it is not therefore deemed to be depreciable property of a prescribed class of Yco.[86] Regulation 1102(1)(b) excludes inventory of a taxpayer

[84] Ibid., at 1191. Virtually identical wording was contained in the agreed statement of facts regarding the Snowcap lands. The trial judge, however, considered it significant that the Snowcap lands were bought "for sale" and not "for sale, or development and sale."

[85] See the definition of "depreciable property" in subsection 13(21).

[86] The decision in *Hickman Motors* supports this conclusion.

from depreciable property of a prescribed class. Accordingly, Yco could not claim capital cost allowance in respect of this property, and neither subsection 13(1) nor 20(16) would apply on the ultimate disposition of the property. If Yco subsequently disposed of the property for $4 million, it would include $3 million in income. The preservation of recapture under paragraph 88(1)(f) is unnecessary. However, the increase in value while the property was capital property to Xco would be fully taxed as business income in the hands of Yco.

Alternatively, it may be argued that, as a consequence of the rollover in subsection 88(1) and the special rules accorded depreciable property in paragraph 88(1)(f), the depreciable property of Xco remains depreciable property of Yco when Yco acquires it; however, it is then immediately converted from depreciable property to inventory. The consequences of the conversion of property are discussed below, under the heading "Analysis and Proposals for Reform."

Similar reasoning may be applied to the situation described in example 4(a). Paragraph 88(1)(f) applies for the purposes of the capital cost allowance provisions of the Act, although its application is of no consequence in the example. The property is deemed to be depreciable property of Sco for the purpose of the capital cost allowance provisions, but it would not be depreciable property of a prescribed class. In addition, its character as inventory would still apply for the purposes of the remaining provisions of the Act.

Applying this analysis, the tax consequences to Sco on the ultimate sale of the property depend in part on whether Sco acquired control of Rco before the winding up. Assuming that it did not, the pregnant loss would not be triggered and paragraph 88(1.1)(e) would not apply on the winding up.[87] The cost of the property to Sco would be deemed to be $2 million, being its cost amount to Rco. If Sco subsequently sold the property for $1,500,000 or held the property at the end of its first taxation year following the winding up, it could claim a business loss of $500,000, the same consequence as if Rco had sold the property before the winding up. The winding-up provisions thus permit transactions that have the effect of consolidating profits and losses within a corporate group. Subsection 85(5.1), or its proposed replacement, subsection 13(21.2), is not applicable in a winding up.[88]

[87] If Sco acquired control of Rco at a time when the property was pregnant with a loss, Rco would have a deemed year-end as a consequence of the acquisition of control (subsection 249(4)) and the pregnant loss would be triggered under subsection 111(5.1). Rco would be deemed to have been allowed a further $500,000 as capital cost allowance in the year ending immediately before the change of control. If Rco realized a non-capital loss in that year, paragraph 88(1.1)(e) would prevent Sco from utilizing that loss following the winding up since Sco does not carry on Rco's business following the winding up.

[88] Paragraph 88(1)(d.1). Subsections 85(5.1) and 13(21.2) are considered in more detail below: see infra footnotes 115 to 118 and the accompanying text.

Alternatively, it may be argued that as a consequence of paragraph 88(1)(f), the depreciable property of Rco is also depreciable property of Sco upon its acquisition. However, the property is then immediately converted from depreciable property to inventory. The consequences of the conversion are considered further below.

Capital Property of the Subsidiary That the Parent Intends To Sell Following the Winding Up

Example 5(a) tests the limits of the decisions in *Hickman Motors* and *Mara Properties*. These two cases arguably hold that it is the purpose for which the parent acquired a particular property from its subsidiary, and not the character of the property to the subsidiary, that determines its character for tax purposes.[89] As indicated in the discussion of examples 3(a) and 4(a), paragraph 88(1)(f) applies on the winding up of Lco and therefore the property is deemed to be depreciable property of Mco. However, Mco cannot claim capital cost allowance, and subsections 13(1) and 20(16) will not apply on the property's ultimate disposition unless the property is also considered to be depreciable property of a prescribed class. If the parent intends to sell certain of the subsidiary's property immediately following the winding up, that property is arguably inventory to the parent since the parent acquires it for the purpose of resale at a profit.

It was previously suggested that if, in a winding up, the parent continues to carry on the business of the subsidiary, the character of the property in the hands of the subsidiary should flow through to the parent. Indeed, it is suggested below that the character of property should flow through in any winding up, at least for the moment in time immediately following that event. In example 5(a), if Lco sold the particular properties before the winding up, there is no question that the transaction would be treated as a disposition of depreciable property. Since Mco intends to carry on the same business as Lco following the winding up, the disposition of the property by Mco should be treated in the same manner. If the only concern of the taxpayers is to preserve capital gains treatment, the winding up should be deferred until Lco has disposed of the property. However, the taxpayers may want the sale to occur after the winding up if, for example, Mco has unused non-capital or net capital losses. These losses could then be used to shelter the gain on the sale of the buildings.

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[89] The *Mara Properties* decision is not as clear on this point. McDonald JA, with whom the Supreme Court of Canada agreed, emphasized the fact that the parent and subsidiary corporations were both involved in the same business when he concluded that inventory of the subsidiary became inventory of the parent. On this basis, it may be argued that it is the similarity of the businesses of the two corporations that is relevant in characterizing each property after the rollover, rather than the parent's intentions regarding the use of the property.

Both the Department of Finance[90] and Revenue Canada[91] have indicated that the consolidation of profits and losses within a corporate group is permitted under the Act. According to the Department of Finance's technical notes dealing with section 245,

> the scheme of the Act as a whole, and the expressed object and spirit of the corporate loss limitation rules, clearly permit [loss utilization] transactions between related corporations where these transactions are otherwise legally effective and comply with the letter and spirit of [the stop-loss rules].[92]

Assuming that Mco did not acquire the shares of Lco before the winding up as part of a scheme to utilize its own losses in order to reduce the tax payable on the sale of Lco's property, the transaction appears to comply with the letter and spirit of the stop-loss rules.[93] *Information Circular* 88-2 contains the following example:

> 9. *Facts*
>
> A person has property with an unrealized capital gain that it wishes to sell to a third party. A related corporation has a net capital loss. Instead of selling the property directly to the third party and realizing a capital gain, the person transfers the property to the related corporation and elects under subsection 85(1) to defer the recognition of the gain. The related corporation sells the property to the third party and reduces the resulting taxable capital gain by the amount of its net capital losses.
>
> *Interpretation*
>
> Subsection 69(11) does not permit a person to transfer property to an *unrelated* corporation on a tax-deferred basis where it is intended that the unrelated corporation will sell the property and reduce the amount of the gain by amounts of losses or similar deductions which it may claim. By implication, the subsection does permit a transfer to a related corporation on a tax-deferred basis. In these circumstances such a transfer would be acceptable as it is within the object and spirit of the Act.

Revenue Canada's example assumes that the property will be considered capital property to the transferee following the subsection 85(1) rollover, notwithstanding the fact that the transferee's sole purpose in acquiring the property is to resell it immediately to a third party. The same results

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[90] See *Explanatory Notes to Legislation Relating to Income Tax*, supra footnote 8, at clause 186.

[91] *Information Circular* 88-2, "General Anti-Avoidance Rule: Section 245 of the Income Tax Act," October 21, 1988, paragraphs 8 and 9; and *Information Circular* 88-2, Supplement 1, July 13, 1990, paragraph 5.

[92] *Explanatory Notes to Legislation Relating to Income Tax*, supra footnote 8, at clause 186.

[93] Subsection 69(11), the only stop-loss rule potentially applicable here, would not generally apply to a winding up since the parent and subsidiary are affiliated. Where, however, the parent acquired control of the subsidiary before the winding up, subsection 69(11) could apply on the basis that the series of transactions commenced with the acquisition of the shares, before which the two corporations were not affiliated, rather than with the winding up.

should follow if, instead of a subsection 85(1) rollover, the sale is preceded by a winding up under subsection 88(1). Accordingly, in example 5(a), each property should remain a separate class 3[94] depreciable property of Mco; and if the property remains unsold at Mco's year-end following the winding up, Mco should be entitled to claim capital cost allowance in respect of the property.

Summary

A number of difficulties arise regarding the characterization of property acquired by a parent corporation on a winding up governed by subsection 88(1). In particular:

- It is unclear what effect, if any, paragraph 88(1)(f) has where property that was depreciable property of the subsidiary is, in the absence of the specific deeming rules in that provision, considered to be inventory of the parent.
- An accrued but unrealized gain or loss in the value of the subsidiary's property may be converted from ordinary income or loss into a capital gain or capital loss or vice versa as a consequence of the rollover.

Related to these problems is the more fundamental underlying policy question whether property distributed by a subsidiary to its parent on a winding up should necessarily retain its character. This issue is addressed in more detail below.

Analysis and Proposals for Reform

Following the Federal Court of Appeal decision in *Mara Properties*, Robert Couzin commented:

> There is no reason why a change of use cannot coincide with a change in ownership, on a rollover or otherwise. An independent examination is always required to determine whether the assets received on contribution, liquidation, or even amalgamation are depreciable or trading property to the new owner.[95]

In an arm's-length transfer of property to which no rollover applies, it is appropriate that the tax consequences to the transferee arising from its subsequent dealings with the property should depend on the purpose for which the property was acquired. The character of the property before the transfer is irrelevant. However, a rollover provides an exception to the realization principle. A disposition of property occurs on a winding up. In the absence of the rollover provisions in subsection 88(1), the subsidiary would be deemed to have disposed of its property at its fair market value,[96] and the tax consequences to the subsidiary would depend on the character of the property at the time of the disposition. A rollover is intended to

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[94] Since Lco and Mco are related, regulation 1102(14)(d) deems the property acquired by Mco to be property of the same prescribed class as that of Lco.

[95] Robert Couzin, "More on Mara" (October 17, 1995), 3 *Canadian Tax Highlights* 76.

[96] Paragraph 69(1)(b).

defer the incidence of tax as a consequence of this disposition; it should not recharacterize the tax treatment of gains or losses that would have arisen had there been a taxable disposition or deemed disposition at fair market value, rather than a rollover, at the time of the transfer.

It is therefore submitted that, where a winding up takes place pursuant to subsection 88(1), there should be no change, as a consequence of the rollover, in the character of property transferred by a subsidiary to its parent. However, if the parent's purpose in acquiring the property indicates that its character is different from that previously ascribed, the property should be treated as if its use changed immediately following the winding up.

This treatment is appropriate for all of the rollover provisions in the Act involving the disposition of property by one person and its acquisition by another, including those for windups under subsection 88(1); transfers to a corporation or partnership under subsections 85(1) and 97(2), respectively; and interspousal transfers under subsections 73(1) and 70(6) and paragraph 70(5.2)(d). Amalgamations governed by section 87 are not included in this list since an amalgamation does not involve a rollover of the property of the predecessor corporations.[97]

There are no statutory provisions governing the conversion of property from inventory to depreciable property or vice versa. For guidance, one must turn to Revenue Canada's administrative practice and any applicable jurisprudence.[98] The first issue that must be resolved is whether there is a disposition of property at the time of a conversion of property between inventory and depreciable property. There is no judicial or statutory authority for the proposition that a disposition at fair market value occurs as a consequence of this conversion.[99] In the absence of such authority, it is

[97] The treatment of amalgamations is considered in more detail in a later section of this article. Rollover treatment is provided to the shareholders of amalgamating companies since they are considered to dispose of their shares of the predecessor corporations as a consequence of the amalgamation and to acquire shares of the new corporation. However, as explained later, an amalgamation does not involve a disposition and acquisition of the property of the predecessor corporations.

[98] See, generally, Arnold, supra footnote 17, at 312-22; and Brian Arnold, "Conversions of Property to and from Inventory: Tax Consequences" (1976), vol. 24, no. 3 *Canadian Tax Journal* 231-40. While the jurisprudence in this area has determined that property can be converted between capital property and inventory, it does not provide clear guidance on the manner in which the tax consequences of the ultimate sale of the property are determined: see, for example, *Canadian Kodak Sales Limited v. MNR*, 54 DTC 1194 (Ex. Ct.); *Moluch v. MNR*, 66 DTC 5463 (Ex. Ct.); and *Anthes Equipment Limited v. MNR*, 87 DTC 59 (TCC). In *Hughes v. The Queen*, 84 DTC 6110 (FCTD), the court ordered an apportionment of the gain on the sale of an apartment building between capital and income. The court found that the taxpayer did not have a primary or secondary intention to sell the property at the time it was first acquired; however, the court found that her intention changed when she applied to the municipality to have the apartment converted to strata title.

[99] Contrast the deemed dispositions in subsections 13(7) and 45(1) where property is converted from an income-producing to a non-income-producing use or vice versa. The treatment accorded in these provisions is consistent with the well-known decision of the House of Lords in *Sharkey (HM Inspector of Taxes) v. Wernher* (1955), 36 TC 275.

clear that such a conversion would not constitute a disposition within the ordinary meaning of that term. Revenue Canada does not consider a disposition to take place when capital property used to earn income is converted to inventory or vice versa. Assuming that no disposition occurs at that time, there are no immediate tax consequences of a conversion.

Revenue Canada's administrative practice regarding the conversion of inventory to capital property and vice versa is set out below. It is my view that this practice contains serious flaws that lead to anomalous results. Accordingly, I will present a number of recommendations for more appropriate treatment where property used for an income-earning purpose is converted from capital property to inventory or vice versa.

Conversion of Inventory to Capital Property

In the case of inventory that is converted to depreciable property, it is necessary to determine what basis is used for the purpose of the capital cost allowance provisions and what the consequences are when the property is ultimately disposed of.

Revenue Canada's administrative practice, applicable to property other than real property, is that if "at any time a taxpayer finds it necessary to convert a particular property from inventory to capital property, its capital cost for all purposes of the Act will be its inventory value at that time."[100] The inventory value will be deducted from the cost of goods sold in computing the taxpayer's business profits for the year, so that the property is removed from inventory with no resulting profit or loss. The same value will be added to the undepreciated capital cost of the appropriate class of property for the purposes of determining capital cost allowance in the future.[101] Revenue Canada acknowledges that there are circumstances where real property may be converted from inventory to capital property; unfortunately, it does not indicate the consequences of such a conversion.[102] Presumably, the same consequences as those applicable to property other than real property should apply.

Revenue Canada's administrative practice regarding the conversion of property from inventory to capital property essentially permits the conversion of what would otherwise be ordinary income into a capital gain.[103]

Examples 1(a) and 2(a) can now be reconsidered on the assumption that the character of a subsidiary's inventory does not change as a consequence

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[100] IT-102R2, supra footnote 28, at paragraph 9. The inventory value will be the lower of the property's cost and its fair market value at the end of the previous taxation year.

[101] IT-102R2, ibid., further provides, at paragraph 10: "The conversion of a unit of merchandise from inventory to capital property, as envisaged by 9 above, is not considered to be either a disposition or an acquisition. Therefore, on such a conversion, the application of the half-rate capital cost allowance rules in the first year of ownership will be based on the actual date of acquisition rather than the date of conversion."

[102] IT-218R, supra footnote 8, at paragraph 21. By contrast, IT-218R does specifically set out the consequences of a conversion of capital property to inventory.

[103] Arnold, supra footnote 17, at 320.

of a winding up under subsection 88(1), but that the inventory is converted to capital property immediately following the winding up. In example 1(a), each building received from Aco would be considered inventory of Bco having a cost of $1 million as a consequence of the winding up. These buildings would then be immediately converted from inventory to capital property. On the basis of Revenue Canada's administrative practice, Bco could claim capital cost allowance based on an original capital cost of $1 million. The half-year rule would still apply since Bco acquired the property as a consequence of the winding up.[104] When Bco ultimately sold the property, its increase in value while inventory to Aco would be preferentially taxed as a capital gain.

In example 2(a), Dco's inventory would remain characterized as inventory of Eco as a consequence of the winding up. The tax consequences of the conversion from inventory to capital property immediately following the winding up would depend on whether or not Dco had written down the value of its inventory before the winding up. In either case, the tax consequences would be the same as those discussed above when example 2(a) was first considered. The capital cost of the property to Eco immediately following the conversion would be the inventory value of the property immediately before the conversion, either $1,250,000 or $2 million, as the case may be. Eco could claim capital cost allowance based on this amount, subject to the half-year rule in the first year following the winding up. In the former case, if the property was sold for an amount in excess of $1,250,000, the gain would be treated as a capital gain. In the latter case, Eco could claim a terminal loss if the property was sold for an amount less than its cost amount. The property would have to appreciate to a value in excess of $2 million before the gain would be treated as a capital gain (although until it was sold, Eco's capital cost allowance deduction would be based on an amount in excess of the property's fair market value).

Arnold[105] concludes that the conversion of income to a capital gain is difficult to justify and suggests that a conversion from inventory to capital property should be treated similarly to a conversions of capital property to inventory (discussed below). Ultimately, he suggests that the treatment of conversions of capital property to inventory and vice versa is a matter requiring specific rules, which should be contained in the Act.

Conversion of Capital Property to Inventory

Revenue Canada's administrative practice regarding the conversion of capital property (other than real property) to inventory is summarized in IT-102R2 as follows:

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[104] Thus, Bco could not take advantage of Revenue Canada's administrative practice as set out in paragraph 10 of IT-102R2, supra footnote 101.

[105] Arnold, "Conversions of Property to and from Inventory," supra footnote 98, at 238 and 240.

> 8. Where capital property is converted to inventory, the action of conversion does not constitute a disposition within the meaning of [that term in subsection 13(21) and section 54]. It is, however, recognized that the ultimate disposition of a property that was so converted may give rise to a gain or loss on capital account, a gain or loss on income account or a gain or loss that is partly capital and partly income. Accordingly, with respect to capital property that has been converted to inventory, taxpayers may calculate capital gains or losses, if any, on the basis that a notional disposition of such property occurred on the date of conversion. The amount of such a notionally determined capital gain or loss in respect of a property will be the difference between its adjusted cost base, as defined in [section 54], (subject to the ITAR rules for property held on December 31, 1971) and its fair market value on the date of conversion. These notionally determined capital gains or losses will be considered to give rise to taxable capital gains or allowable capital losses for the taxation year during which the actual disposition of the relevant property occurs and will be required to be so reported in that same year. The amount of any income gain or loss arising on actual disposition of the converted property will be determined in accordance with generally accepted accounting principles on the basis that its initial inventory value is its fair market value on the date of conversion.[106]

IT-102R2 does not explicitly deal with the conversion of depreciable property to inventory, although IT-218R does consider the consequences in the case of the conversion of depreciable property that is real property.[107] IT-218R provides in part:

> 18. The Act provides rules governing the treatment of proceeds arising on the disposition of depreciable capital property but it does not envisage the possibility that such property may be converted to inventory before its disposition. Accordingly, where . . . depreciable real estate is converted to inventory, it is the Department's position that
>
> (a) the initial cost of the real estate for inventory valuation purposes will be its fair market value as at the time of conversion, and
>
> (b) the ultimate sale of the real estate may give rise to results similar to those described in 15 above [similar to IT-102R2, paragraph 8, quoted above].
>
> The classes of property described in Part XI and Schedule II of the Income Tax Regulations are, by virtue of paragraph 1102(1)(b) thereof, deemed not to include property that is described in a taxpayer's inventory. Accordingly, where depreciable property (e.g., an apartment building) is converted to inventory it ceases to qualify for capital cost allowance for the taxation year during which the conversion occurs and subsequent years, but continues to have an undepreciated capital cost balance in the class of Schedule II of the Regulations to which it was assigned until its ultimate disposition, at which time the class will be credited with the lesser of the cost of the asset and its fair market value at the time of conversion to inventory.

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[106] Real property is treated by Revenue Canada in a similar manner: see IT-218R, supra footnote 8, at paragraph 15.

[107] Presumably, the same results apply to a conversion of depreciable property other than real property.

Examples 3(a) and 4(a) can now be reconsidered on the assumption that the character of a subsidiary's depreciable property does not change as a consequence of a winding up under subsection 88(1), but that the depreciable property is converted to inventory immediately following the winding up.

In example 3(a), Yco would be considered to have acquired a number of class 3 properties as a consequence of the winding up. One of these properties has a capital cost of $3 million and an undepreciated capital cost of $1 million. This property is immediately converted to inventory. On the basis of Revenue Canada's administrative practice, Yco would notionally dispose of this building for $4 million; however, there would be no immediate tax consequences arising from this notional disposition. Each of Yco's separate class 3 properties would continue to have an undepreciated capital cost balance of $1 million, although Yco could not claim any further deductions in respect of capital cost allowance. If, for example, Yco subsequently disposed of the building for $4,500,000, it would have recapture of $2 million (the lesser of its fair market value and capital cost at the time of conversion minus its undepreciated capital cost at that time) and a capital gain of $1 million (its fair market value at the time of conversion less its capital cost), both reflecting the notional disposition at the time of the conversion to inventory. Yco would also include $500,000 in income as profit from the sale (the difference between the sale proceeds and the notional cost of the property for inventory purposes). If Yco sold the building for $3,600,000, the consequences reflecting the notional disposition would be the same, and instead of including $500,000 in income, Yco would have a $400,000 loss in computing its income from business.

Revenue Canada's administrative practice, taken to its logical conclusion, would allow a writedown of the notional cost of the inventory in the event that the property declined in value before its actual disposition. This result is tantamount to allowing a deduction based on a notional expense before that expense is recognized for tax purposes. It is likely an unintended result, and certainly not warranted.

Reforming the Treatment of Property Rollovers

Unfortunately, there is no simple solution to the problem posed by the changing character of property on a winding up or other rollover. Short of eliminating rollovers completely, any solution may give rise to as many difficulties as it eliminates. I do not propose to consider whether the existing rollover treatment is justified.[108] Any solutions offered here are based on the assumption that the existing rollover provisions will remain. As noted above, the most obvious solution begins with the premise that where rollover treatment is accorded under the Act, the property involved

[108] The rollover treatment under the Act is generous by comparison with that provided in a number of other countries.

in the rollover necessarily retains its pre-rollover character immediately following the rollover. That is the underlying assumption in most of the rollover provisions in any event. That assumption should be made explicit.

It must, however, be recognized that the character of property held by the transferee may not necessarily be the same as it was when the property was held by the transferor. In these circumstances, it is submitted, the property should be treated as if its use changed immediately following the rollover. This solution effectively limits the necessary amendments to those dealing with the change in use of property from one income-earning use to another. This is a problem that currently exists and ought to be addressed through statutory provisions. Revenue Canada's existing administrative practice, outlined above, is used as a starting point for discussion. It may be summarized as follows:

- Where property is converted from capital property to inventory, a notional (as opposed to an actual or deemed) disposition occurs at fair market value, but there are no immediate tax consequences. The recognition of the income or loss (including a capital gain or capital loss) is deferred until the property is ultimately disposed of. The cost of the property for inventory purposes is considered to be its fair market value at the time of the conversion.

- Where property is converted from inventory to capital property, no taxable disposition of the property is considered to occur at that time. Following the conversion, the cost or capital cost of the property is considered to be its inventory value at the time of conversion, and that value will also be deducted in determining the value of the closing inventory in the year in which the conversion occurs.

Revenue Canada's administrative practice gives rise to a number of anomalous results, as noted in the context of part (a) of examples 1 through 4.[109] In my view, the treatment of a conversion from capital property to inventory is the more appropriate of the two, although subject to a number of important amendments.

It is proposed that the conversion of property from one income-earning use to another should result in a notional disposition[110] of the property at the time of conversion, but that the tax resulting from the notional disposition should be deferred until the property is ultimately disposed of.

Where the property has increased in value, the notional disposition ought to occur at fair market value. It is in these circumstances that the notional disposition is essential in order to prevent the abuse of the rollover provisions, as well as perceived anomalies with the existing legislation. The fair market value of the property at the time of the rollover will be

[109] Similarly anomalous results would arise in the context of parts (b) and (c) of these examples.

[110] Or, as discussed below, a deemed disposition where the fair market value of the property at the time of the conversion is less than its cost amount at that time.

used for determining the tax consequences of the notional disposition, although the liability will be deferred until the ultimate disposition of the property. However, the fair market value cannot be used for inventory valuation purposes or as a basis for claiming capital cost allowance following the conversion. If the fair market value were used for these purposes, it would permit the taxpayer to write down the notional cost of inventory, assuming that it subsequently declined in value, or to claim capital cost allowance on an increased capital cost, without actually paying the higher cost of the property or having recognized the inherent gain at the time of the conversion. Since there are no immediate tax consequences resulting from the change in use, the cost amount[111] of capital property or inventory, as the case may be, immediately before the conversion ought to be used for the purpose of applying subsection 10(1) or for the purpose of determining the deduction permitted under paragraph 20(1)(a), respectively, following the conversion.

Where the property has declined in value before the change in use and the decline in value has already been recognized for tax purposes, it would be reflected in the cost amount of the particular property; therefore, a notional disposition at the property's fair market value should not give rise to any notional tax consequences. Where this decline has not been recognized before the change in use (that is, the property is pregnant with a loss),[112] a notional disposition at fair market value would give rise to a loss, in the case of depreciable property and inventory, or a capital loss, in the case of non-depreciable capital property. However, it may not be considered appropriate that this lower value be used following the change in use for inventory valuation or capital cost allowance purposes, since the taxpayer would be denied the benefit of future deductions (either a writedown in inventory or an enhanced claim for capital cost allowance) without actually having recognized the loss at the time of the change in use.

Two possible solutions may be considered for property with an unrecognized decline in value. The first, which is simpler to draft and administratively easier to apply, is a deemed disposition and reacquisition at fair market value at the time of the change in use, rather than a notional disposition. On this basis, the taxpayer could recognize the loss or capital loss, and the lower fair market value would then be used as the cost of the property following the change in use. This solution may be considered inappropriate because the recognition of the loss is accelerated before its actual realization. However, this criticism is largely fatuous. If capital property becomes inventory as a consequence of its change in

[111] As defined in subsection 248(1).

[112] A decline in value of the property of a subsidiary will not have been recognized before the winding up if the property is inventory of the subsidiary that has declined in value since the last year-end of the subsidiary before the winding up or, in the case of depreciable property, if the parent did not acquire control of the subsidiary before the winding up at a time when the property was pregnant with a loss.

use, the taxpayer will be able to recognize the decline in value when the property is sold or at its first year-end following the conversion as a consequence of the operation of subsection 10(1); accordingly, the recognition of the decline in value will, at most, be deferred until the end of the taxation year in which the change in use occurs. If the property that is converted is inventory, the decline in value will generally already have been recognized as a consequence of the application of subsection 10(1) in a taxation year preceding the change in use, and could be recognized if the change in use (or rollover) is deferred until after the upcoming year-end of the taxpayer. It is therefore only in limited circumstances that a deemed disposition at fair market value of property that has declined in value would accelerate the recognition of a loss for any substantial period of time.

The alternative would be similar to that proposed for property that has increased in value; that is, there would be a notional disposition at fair market value with a deferral of the recognition of the tax consequences, but the cost amount of the property would continue to be used for inventory valuation or capital cost allowance purposes, as the case may be, following the change in use. The only benefit of this solution is that all property that is converted from one income-earning use to another is treated identically. However, this solution will complicate the drafting of the legislative amendments necessary and the determination of the tax consequences at the time the property is ultimately disposed of.

If the second solution were adopted for property whose decline in value has not been recognized, the legislation would provide that all property that is converted from one income-earning use to another is notionally disposed of at that time for an amount equal to its fair market value. However, for the purposes of subsection 10(1) and the capital cost allowance provisions, the property would be considered to have been reacquired for its cost amount.

The tax consequences of the notional disposition would be recorded in special accounts to be carried forward and recognized when the property is ultimately disposed of by the taxpayer. Any double inclusion or deduction as a consequence of the continued use of the property's cost amount following the rollover would be avoided under subsection 248(28).

With these proposals in mind, the remaining rollover provisions may be considered.

TRANSFER TO A CORPORATION OR PARTNERSHIP

Application of Subsections 85(1) and 97(2)

Subsection 85(1) allows a taxpayer to transfer eligible property to a taxable Canadian corporation on a tax-deferred basis where the consideration received by the taxpayer includes shares of the corporation. Subsection 97(2) provides a similar rollover by a partner to a Canadian partnership, although it is not as restrictive concerning the types of properties that may be transferred. Subsection 97(2) generally adopts the rules in subsection 85(1) for the purposes of determining the transferor's proceeds of disposition of the property transferred and the transferee's cost of such property.

The difficulties associated with the changing character of property involved in a subsection 85(1) or 97(2) rollover are similar to those involved in a winding up. There are no specific provisions dealing with the cost of inventory in the context of a rollover under either subsection 85(1) or 97(2). Subsection 85(5) is similar in scope and effect to paragraph 88(1)(f). Subsection 85(5) applies to both rollovers where the capital cost of depreciable property to the transferor exceeds the property's proceeds of disposition as determined under subsection 85(1). In these circumstances, for the purposes of the capital cost allowance provisions, the capital cost of the property to the transferee (corporation or partnership) is deemed to be the capital cost to the transferor and any excess is deemed to have been allowed to the transferee as capital cost allowance in previous years. The provision is designed to preserve recaptured depreciation in the event that the property is subsequently sold by the transferee for an amount in excess of its undepreciated capital cost. The provision presumes that depreciable property of the transferor will be depreciable property to the transferee, though this is not necessarily the case. Subsection 85(5) does not apply to property that is depreciable property to the transferee but was not depreciable property to the transferor.

The key distinction between a rollover applicable on a winding up under subsection 88(1) and a rollover under subsection 85(1) or 97(2) is that a winding up necessarily involves non-arm's-length corporations. The parent corporation must own at least 90 percent of the issued shares of each class of the subsidiary. Under subsection 85(1), the transferor must receive shares of the transferee corporation, but there are no minimum ownership requirements.[113] This distinction will likely result in different treatment in example 5(b) from that in example 5(a) where the transferor and transferee corporations are not part of the same corporate group.

A second distinction between the two rollovers is that under a winding up, the transferor disappears at the end of the transaction. This distinction gives rise to two consequences. First, inventory pregnant with a loss, as in example 2, cannot be transferred under either subsection 85(1) or 97(2)

[113] Before May 6, 1974, a subsection 85(1) rollover was available only if, immediately after the transfer, the transferor owned not less than 80 percent of the issued shares of each class of the corporation. No similar threshold was included in subsection 97(2). The threshold requirement in subsection 85(1) was deleted by SC 1974-75-76, c. 26, section 48(1), which included a number of measures that expanded the ambit of subsection 85(1). In the 1981 budget, the minister of finance proposed to restrict subsection 85(1) rollovers to circumstances where the transferor controlled the transferee corporation. This proposal, along with a number of other proposals that would have restricted the availability of rollover treatment in a number of corporate reorganizations, was never enacted. For a history of these proposals and discussion of their potential impact, see Elinore J. Richardson and Robert Langlois, "A Discussion Paper on the 1981 Budget Proposals Affecting Corporate Reorganizations: 'Round and Round the Mulberry Bush' " (1982), vol. 30, no. 2 *Canadian Tax Journal* 179-213.

without triggering the loss in the hands of the transferor.[114] Second, depreciable property pregnant with a loss, as in example 4, is handled differently under the two rollovers.

Examples 1(b) and 3(b) would be treated in a manner similar to examples 1(a) and 3(a). Example 2(b) would be treated in a manner similar to example 2(a), except that Dco would have to recognize the loss in value of the inventory as a consequence of the transfer to the partnership if the loss had not previously been recognized.

Example 4(b) illustrates the potential application of subsection 85(5.1) and its proposed replacement, subsection 13(21.2). Since the fair market value of the transferred property is less than its undepreciated capital cost, no election under subsection 85(1) is necessary. If immediately after the transfer Rco is affiliated with Sco, no election is permitted.[115] Under proposed subsection 13(21.2), Rco will be deemed to have disposed of the property for $2 million, giving rise to no immediate tax consequences. Rco is deemed to continue to own a property of the same prescribed class as the transferred property having a cost equal to $500,000, the amount by which the deemed proceeds of disposition exceed the property's fair market value.[116] Essentially, subsection 13(21.2) prevents a taxpayer from triggering a terminal loss on an interaffiliate transfer. For the purpose of the capital cost allowance provisions, Sco is deemed to have acquired the property at a capital cost of $3 million and is deemed to have taken $1,500,000 as capital cost allowance in preceding years.[117] If the property is characterized as depreciable property to Sco, Sco's basis for subsequent capital cost allowance purposes is the fair market value of the property at the time of the transfer. The amount by which Rco's undepreciated capital cost exceeds this fair market value is retained in Rco's hands as a notional depreciable property of a separate prescribed class that is the same class as the property transferred, and can be amortized until the earliest of four events:

1) the subsequent disposition of the property by Sco to someone other than Rco or a person affiliated with Rco;

2) a change in use of the property from an income-earning to a non-income-earning purpose;

3) a deemed disposition of the property as a result of Sco's becoming non-resident or non-taxable; and

4) an acquisition of control of Rco.

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[114] Paragraph 85(1)(c), which is also incorporated by reference to subsection 97(2) under paragraph 97(2)(a).

[115] Subsection 85(5.1). The June 20, 1996 amendments, supra footnote 31, propose to repeal this provision and replace it with subsection 13(21.2). Paragraph 13(21.2)(d) likewise prevents an election under either subsection 85(1) or 97(2) in these circumstances.

[116] Subparagraph 13(21.2)(e)(iii).

[117] Paragraph 13(21.2)(f).

Subsection 13(21.2) applies where the property is characterized as depreciable property to the transferor. Its character in the hands of the transferee is irrelevant. If the property is characterized as inventory to Sco, the deeming provisions in paragraph 13(21.2)(f) continue to apply to Sco, but only for the purposes of the capital cost allowance provisions. The property is deemed to have a capital cost to Sco of $3 million, and Sco is deemed to have deducted $1,500,000 as capital cost allowance in previous years. Accordingly, the property is deemed to be depreciable property of Sco for the purposes of the capital cost allowance provisions. Two alternative approaches follow, although both give rise to the same tax consequences. First, the property may be considered inventory of Sco from the moment it is acquired. Sco will be prevented from claiming capital cost allowance under regulation 1102(1)(b). Paragraph 13(21.2)(f) does not apply for the purpose of determining the cost of inventory to Sco or the subsequent application of section 10. The cost to Sco of the property will be determined under general principles, as the amount that Sco paid for the property—that is, the value of the shares it issued to Rco as consideration for the property. Assuming that the shares have a value equal to the value of the property received, the cost to Sco of the property will be $1,500,000.[118]

Alternatively, the property may be considered depreciable property of Sco at the time it is acquired from Rco, but it is then immediately converted to inventory. The property will initially be considered to have a capital cost of $3 million and an undepreciated capital cost of $1,500,000. Sco will then notionally dispose of it for its fair market value of $1,500,000, giving rise to no tax consequences (notional or otherwise). The cost of the property to Sco for the purpose of the application of subsection 10(1) and for determining the tax consequences of any subsequent sale will be $1,500,000.

If Rco is not affiliated with Sco—that is, the sale is at arm's length—subsection 13(21.2) does not apply. Rco's proceeds of disposition for the property are its sale price, $1,500,000, giving rise to a $500,000 terminal loss. Since there is no rollover involved, the character of the property to Sco depends solely on the purpose for which it acquired the property. Its cost or capital cost, as the case may be, is $1,500,000.

Example 5(b) poses greater difficulties. If Mco is a wholly owned subsidiary of Lco, on the basis of Revenue Canada's administrative practice, each building should remain class 3 depreciable property to Mco,[119] and its disposition by Mco should be taxed on the basis that the property

[118] If the shares had a value in excess of $1,500,000 (for example, if they were preferred shares with a higher retraction value), the cost to Sco would still be $1,500,000 as a consequence of paragraph 69(1)(a). If the shares had a value less than $1,500,000, the cost of the land would be that lower value. In these circumstances, the excess would probably be considered a "contribution of capital": *Interpretation Bulletin* IT-456R, July 9, 1990, paragraph 6.

[119] Regulation 1102(14)(d).

is depreciable property and not inventory to Mco. If the property remains unsold at Mco's year-end following the transfer, Mco should be entitled to claim capital cost allowance in respect of the property.

Would the results be different if Lco and Mco were not related corporations? As previously noted, subsection 85(1) is not limited to transfers between related corporations. However, it is doubtful that Revenue Canada would accord the same treatment in an arm's-length application of subsection 85(1). Where the transferor and transferee are dealing at arm's length, it is arguably more appropriate to determine the character of the property to the transferee using general principles; its character to the transferor is irrelevant in these circumstances. This argument is considered further below, under the heading "Analysis."

Summary

The problems arising under subsections 85(1) and 97(2) with property characterized differently by the transferor and transferee are similar to the problems associated with a winding up. Namely:

- It is unclear what effect, if any, subsection 85(5) has where property that was depreciable property of the transferor is, in the absence of the specific deeming rules in that provision, considered to be inventory of the transferee.

- Accrued gains or losses in the value of property may be converted from ordinary income or loss to a capital gain or capital loss or vice versa.

Analysis

If a rollover under either subsection 85(1) or 97(2) were treated in a manner similar to a winding up under subsection 88(1)—that is, the character of property did not change as a consequence of the transfer but could be converted immediately after the transfer—the difficulties in interpreting and applying the various provisions would largely disappear.

The key distinction between subsections 85(1) and 88(1), with respect to characterizing the transferred property, is that under the former, the transferor and transferee need not be related in order to obtain rollover treatment. The one circumstance in which this distinction could lead to a difference is the situation outlined in example 5.

Couzin suggests that Revenue Canada's administrative practice regarding the use of subsection 85(1) in order to consolidate profits within a corporate group follows the basic structure of the Act distinguishing between capital gains and business income. He suggests that the administrative practice is "premised on a conclusion that the sub [to which capital property with an accrued gain is transferred] is not engaged in an activity that gives rise to business income or loss when it resells the property."[120] However, the character of property to a taxpayer is a question of fact,

[120] Supra footnote 95.

depending on all the circumstances. If a taxpayer acquires property (from an arm's-length person) with the specific intent of reselling it at a profit, the property is generally considered to be held either in the course of a business (if the taxpayer carries on a business involving the sale of such property) or as an adventure or concern in the nature of trade (if the taxpayer is not otherwise carrying on a business). Revenue Canada's administrative practice is intended to permit taxpayers in a corporate group to consolidate profits and losses without adverse tax consequences (such as converting a capital gain into a gain on income account). This administrative practice can be justified on the basis that the character of the property to the transferor is an important factor in determining its character to the transferee where the parties involved in the transfer are closely related.

It is not necessary to debate whether the rollover provided under subsection 85(1) is too generous. It is submitted that once the decision has been made to grant rollover treatment for a disposition of property, the same rules should apply regardless of the relationship between the transferor and transferee. Accordingly, in example 5(b), the character of the property transferred should not change as a consequence of the rollover, regardless of the relationship between Lco and Mco. However, if Mco is not related to Lco and Mco acquires the property for a purpose different from that for which it was used by Lco, the property should be treated as if it were converted immediately following the rollover. This conversion would not generally affect the tax consequences of the property's sale by Mco; the accrued gain at the time of the rollover would be treated as a capital gain to Mco when the property is sold. However, if Lco and Mco are at arm's length following the rollover, Mco could not claim capital cost allowance in respect of the property (assuming that it held the property at its year-end following the rollover) as a consequence of regulation 1102(1)(b). In addition, the difference between the sale proceeds received by Mco and the property's fair market value at the time of the rollover would be treated on income account rather than capital account.

AMALGAMATION

Application of Section 87

Section 87 of the Act contains detailed rules concerning the amalgamation of two or more taxable Canadian corporations.[121] Subsection 87(1) refers to the merger or amalgamation of these corporations to "form" one corporation. Paragraph 87(2)(a) provides that "the corporate entity formed as a result of the amalgamation shall be deemed to be a new corporation," although the exact scope of the deeming provision is somewhat unclear.

When the amalgamation provisions were first introduced in 1958, provincial legislation varied as to the effect of an amalgamation; some

[121] Section 87 refers to each amalgamating corporation as a predecessor corporation and the corporation formed by the amalgamation as the new corporation. This terminology will be used throughout the discussion that follows.

provincial statutes provided that a new corporation was created as a result of the amalgamation, while others provided that the new corporation was a continuation of the predecessor corporations.[122] The manner by which property of the predecessor corporations becomes property of the new corporation, for corporate law purposes, corresponds to this treatment: under Ontario law, the new corporation simply "possesses" all of the property, rights, and so on of the predecessor corporations;[123] under the relevant federal legislation, "the property of each [predecessor corporation] continues to be the property of the [new corporation]."[124] For corporate law purposes, it is generally understood that an amalgamation does not result in a disposition of property by each predecessor corporation and an acquisition of property by the new corporation.[125]

The Act distinguishes between a number of different types of property, and there are rules in subsection 87(2) governing the treatment of some of these types of property on an amalgamation. Under paragraph 87(1)(a), all of the property of the predecessor corporations "becomes" property of the new corporation. While it is unclear from this provision whether there has been a disposition of property by the predecessor corporations or an acquisition of property by the new corporation as a result of the amalgamation, as noted above, the applicable corporate law generally suggests that there has not.

The rules in subsection 87(2) dealing with the various types of property distinguished in the Act set out the tax attributes of each type of

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[122] See, generally, David T. Tetreault and Robert F. Lindsay, "The Taxation of Corporate Reorganizations: How Are We Doing So Far?" (1995), vol. 43, no. 5 *Canadian Tax Journal* 1441-64, at 1445. Under the corporate legislation applicable in both Ontario and Canada, the new corporation is considered a continuation of the predecessor corporations: see the Business Corporations Act, RSO 1990, c. B.16, as amended (herein referred to as "OBCA"), section 178(a); and the Canada Business Corporations Act, RSC 1985, c. C-44, as amended (herein referred to as "CBCA"), section 186(a).

[123] OBCA section 178(b).

[124] CBCA section 186(b).

[125] In *Stanward Corporation v. Denison Mines Ltd.* (1966), 57 DLR (2d) 674 (Ont. CA), aff'd. (1968), 67 DLR (2d) 743 (SCC), the plaintiff sued the defendant for royalties alleged to be owing under a contract. The contract provided in part that royalties would be paid in respect of mining claims "acquired" by the defendant adjacent to mining claims it purchased from the plaintiff. The defendant amalgamated with another corporation that owned certain mining claims in close proximity to those purchased from the plaintiff; following the amalgamation, the new corporation mined exclusively the claims owned by the other predecessor corporation. The Ontario Court of Appeal found in favour of the defendant. Kelly JA, giving the judgment of the court, stated, at 681: "Returning to the view that the amalgamated companies do not form a new company but continue to subsist as one, the conclusion that there is no acquisition is, if anything, more apparent. The language of s. 96 [of Ontario's 1953 Companies Act] is in my opinion unambiguous in providing that the two amalgamating companies shall continue as one company. While it may be difficult to comprehend the exact metamorphosis which takes place, it is within the Legislature's competence to provide that what were hitherto two shall continue as one." These observations were adopted by the Supreme Court of Canada in *The Queen v. Black & Decker Manu. Co.*, [1975] 1 SCR 411.

property to the new corporation. Paragraph 87(2)(b) applies where property "described in the inventory . . . of the new corporation at the beginning of its first taxation year includes property that was described in the inventory of a predecessor corporation at the end of the taxation year of the predecessor corporation that ended immediately before the amalgamation." Where the provision applies, the inventory is "deemed to have been acquired by the new corporation" for an amount equal to the amount determined under section 10 as the predecessor corporation's closing inventory value. Paragraphs 87(2)(d) and (d.1) refer to depreciable property "acquired by the new corporation from a predecessor corporation" as a result of the amalgamation. Other capital property and partnership interests that are capital property are "acquired" by the new corporation. For eligible capital property, "the new corporation shall be deemed to be the same corporation as, and a continuation of, each predecessor corporation." Thus, there is no consistency in the language used in the provisions. However, none of the provisions refers to a "disposition" of property by a predecessor corporation to the new corporation. Further, the definitions of "disposition" and "proceeds of disposition" in subsection 13(21) and section 54 do not suggest that an amalgamation constitutes a disposition of property.

While there are inconsistencies in terminology employed in subsection 87(2), the rules are based on an assumption that the character of a predecessor corporation's property does not change as a consequence of an amalgamation. From the perspective of corporate law, this assumption is valid since the new corporation is simply a continuation of the predecessor corporations. However, it is not difficult to imagine circumstances where property characterized in one manner by a predecessor corporation is used in quite another manner by the new corporation.

For tax purposes, it is necessary to determine precisely when this metamorphosis takes place and its consequences. This determination will affect the manner in which the provisions in subsection 87(2) apply. It is therefore necessary to return to paragraph 87(2)(a) and consider the exact scope of the deeming provision contained therein and its effect on the character of property. A clear indication of its effect was given by the Exchequer Court in *Palmer-McLellan (United) Ltd. v. MNR*[126] when interpreting paragraph 85I(2)(a), the predecessor of paragraph 87(2)(a):

> Accepting that the statute requires that the appellant be treated as a new corporation for the purposes of the *Income Tax Act* such purposes, so far as relevant, are, as I see it, the measuring of its income for prescribed periods of time, including the determination of deductions to which it may be entitled, and the computation of its liability for tax. These purposes do not seem to me to require any inference to be made as to how the new corporation came into possession of whatever assets it had at the commencement of its fictitious existence. It is to be treated as a new corporation for the purposes I have mentioned but, as I see it, it is not to be treated as a new

[126] 68 DTC 5304 (Ex. Ct.).

> corporation for any other purposes and *I see in section 85I no basis for treating the assets of such a corporation as having been acquired in any other manner than that in which they were in fact acquired, that is to say, the manner in which they were acquired by the amalgamating corporations.*
>
> The new company contemplated by section 85I, simply starts off with certain assets and certain liabilities, that is to say, the assets and the liabilities of the amalgamating companies. With respect to such assets and liabilities nothing further is, as I see it, required for the purposes of the *Income Tax Act*; and *if for the purpose of characterizing some item of assets or of liability, it becomes necessary to know its history that history, as I see it, is nought but its actual history. There is no need to take the further step of assuming some fictitious transaction or event conferring the asset on the fictitious new company or visiting it with the liability. . . .*
>
> Nor do I find in paragraphs (b) to (n) of section 85I(2), which prescribe rules relating to a variety of subjects bearing on the computation of the income of an amalgamated corporation, anything which appears to me to conflict with this interpretation of section 85I(2)(a) or to render it necessary to draw the suggested inference. Indeed the fact that the legislature specifically provided for certain fictitious assumptions to be made tends to confirm that others not provided for are not to be made [emphasis added].[127]

This decision was approved by the Federal Court of Appeal in *The Queen v. Pan Ocean Oil Ltd.*[128] It is submitted, therefore, that the tax treatment of property of the predecessor corporations follows the corporate law treatment. There is no disposition or acquisition of property as a consequence of the amalgamation. The use of the term "acquired" in paragraphs 87(2)(d), (d.1), (e), (e.1), (e.2), (e.3), and (e.4) is unfortunate and potentially misleading. The wording of paragraph 87(2)(b) is preferable; it *deems* inventory of the new corporation that was inventory of a predecessor corporation to have been acquired by the new corporation at a particular cost, rather than stipulating the cost of inventory "acquired" from a predecessor corporation. The different language employed in this provision is understandable when the mechanics of the provisions are examined more closely. As discussed below, paragraph 87(2)(b) provides that the cost to the new corporation of inventory that was inventory of a predecessor corporation is deemed to be the closing inventory of the predecessor corporation. The provision does not preserve the original cost of such inventory to the predecessor corporation or any lower of cost and fair market value adjustment previously claimed by the predecessor corporation.[129] Suppose, for example, that a predecessor corporation, Pco, with a December 31 year-end, had inventory with an original cost of $100

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[127] Ibid., at 5308. Paragraphs 85I(2)(b) and (d) of the 1952 Act are virtually identical to current paragraphs 87(2)(b) and (d).

[128] 94 DTC 6412 (FCA), leave to appeal to the Supreme Court of Canada denied November 17, 1994.

[129] See the technical interpretation in Revenue Canada Views [database online], document no. 9423775, January 31, 1995, cited in Gabrielle M.R. Richards, "Amalgamations," The Taxation of Corporate Reorganizations feature (1996), vol. 44, no. 1 *Canadian Tax Journal* 241-59, at 250, footnote 45.

and a fair market value of $50 on December 31, 1995. On January 1, 1996, Pco amalgamates with another corporation to form Newco. Pco's closing inventory for the year ending immediately before the amalgamation will be $50 and the cost to the new corporation of the inventory will be $50. Assume that the property remains in Newco's inventory at the end of its first taxation year, December 31, 1996, but that the fair market value of the property increases to $75 as of that date. If no amalgamation had occurred, Pco would have been required to record the inventory at $75 for its year ending December 31, 1996, that amount being the lower of its original cost ($100) and its fair market value on that date.[130] As a consequence of the amalgamation, Newco will record the inventory at $50 in its closing inventory on December 31, 1996, since its deemed cost of $50 is lower than its fair market value. Essentially, the new corporation is not treated simply as a continuation of the predecessor corporation for the purposes of paragraph 87(2)(b). Accordingly, a deeming provision is appropriate and necessary.

In the remaining provisions of subsection 87(2) noted above, it is intended that the new corporation be placed in the same position as the predecessor corporation with regard to the particular type of property dealt with in each provision. In effect, the new corporation is stepping into the tax shoes of the predecessor corporation for these particular types of property. The result is therefore consistent with corporate law principles and the tax law principles enunciated in *Palmer-McLellan* and *Pan Ocean Oil*. Accordingly, while the use of the term "acquired" is misguided, it is of no consequence in the application of these provisions.[131]

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[130] It is doubtful whether a writeup was required before December 20, 1995. The June 20, 1996 proposals (supra footnote 31) amend subsection 10(1) to provide that inventory is valued at the lower of its fair market value and "the cost at which the taxpayer acquired the property." According to the explanatory notes, this amendment *clarifies* the operation of subsection 10(1). In *Friesen*, supra footnote 23, at 5572, Iacobucci J suggested that the reference to cost in subsection 10(1) was a reference to the property's historic cost. Revenue Canada shares this view: "Revenue Canada Panel," in *Creative Tax Planning for Real Estate Transactions—Beyond Tax Reform and into the 1990s*, 1989 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1989), 8:1-59, question 19, at 8:28. However, accounting practice does not generally require inventory that has previously been written down to be written up where its fair market value subsequently increases; in effect, the written-down value becomes the inventory's cost for future periods: see, generally, Peter E. McQuillan, "Real Estate Inventory Valuation," in *Report of Proceedings of the Forty-Fourth Tax Conference*, 1992 Conference Report (Toronto: Canadian Tax Foundation, 1993), 5:35-40, and the comments of Robert Brown, ibid., at 5:40-41. The accounting rules for real estate inventory permit, but do not require, an upward adjustment for land inventory in these circumstances: Canadian Institute of Public Real Estate Companies, *CIPREC Handbook* (Toronto: CIPREC, looseleaf), section 302.9.1. Since "cost" is not defined in the Act, it is unclear whether the term used in subsection 10(1) refers to the property's historic cost or its previous written-down inventory value. A strong argument could be made, before the June 20, 1996 amendments, that accounting practice governed the meaning of cost in subsection 10(1) and therefore no writeup was required in these circumstances. It is submitted that the amendment is more than mere clarification.

[131] However, difficulties still persist. See, for example, the terminology used in regulations 1100(2.2) and 1102(14), discussed further below.

In all of the provisions in subsection 87(2) dealing with particular types of property, it is apparent that property characterized in a particular manner in the hands of a predecessor corporation retains that character immediately following an amalgamation. With this in mind, consideration can be given to the tax consequences where property used for one purpose by a predecessor corporation is in fact used for another purpose by the corporation formed on the amalgamation.

Depreciable Property of the New Corporation

Depreciable property is specifically dealt with in paragraphs 87(2)(d) and (d.1).[132] Both of these paragraphs refer to depreciable property "acquired by the new corporation from a predecessor corporation." The implication of these provisions is that all depreciable property that a predecessor corporation acquired after 1971 is depreciable property of a prescribed class, even though the two concepts are not synonymous. Rather, depreciable property of a prescribed class is only a subset of all depreciable property acquired after 1971.

Paragraph 87(2)(d) applies to depreciable property of a prescribed class of the new corporation. The capital cost of such property to the new corporation is deemed to be its capital cost to the predecessor corporation. The provision refers to the "capital cost" of property to the predecessor corporation on the assumption that the property must have been depreciable property of the predecessor. Assuming that paragraph

[132] Paragraphs 87(2)(d) and (d.1) provide in part:

(d) for the purposes of sections 13 and 20 and any regulations made under paragraph 20(1)(a),

(i) where depreciable property of a prescribed class has been acquired by the new corporation from a predecessor corporation, the capital cost of the property to the new corporation shall be deemed to be the amount that was the capital cost of the property to the predecessor corporation, and

(ii) in determining the undepreciated capital cost to the new corporation of depreciable property of a prescribed class at any time,

(A) there shall be added to the capital cost to the new corporation of depreciable property of the class acquired before that time the cost amount, immediately before the amalgamation, to a predecessor corporation of each property included in that class by the new corporation,

(B) there shall be subtracted from the capital cost to the new corporation of depreciable property of that class acquired before that time the capital cost to the new corporation of property of that class acquired by virtue of the amalgamation . . .

(d.1) for the purposes of this Act, where depreciable property (other than property of a prescribed class) has been acquired by the new corporation from a predecessor corporation, the new corporation shall be deemed to have acquired the property before 1972 at an actual cost equal to the actual cost of the property to the predecessor corporation, and the new corporation shall be deemed to have been allowed the total of all amounts allowed to the predecessor corporation in respect of the property, under regulations made under paragraph 20(1)(a), in computing the income of the predecessor corporation.

87(2)(d) is applicable, then subject to subsection 87(2.1),[133] it will preserve the predecessor corporation's capital cost of the property in the hands of the new corporation but will limit the availability of capital cost allowance following the amalgamation to an amount based on the cost amount of such property to the predecessor. Similar to paragraph 88(1)(f) and subsection 85(5), paragraph 87(2)(d) preserves the potential for recapture if the new corporation disposes of the depreciable property for an amount greater than its undepreciated capital cost.

Paragraph 87(2)(d.1) applies, for example, to property of a farming or fishing business on which capital cost allowance has been claimed on a straightline basis under part XVII of the Regulations. This depreciation method is available only for property acquired before 1972;[134] hence, paragraph 87(2)(d.1) deems the new corporation to have acquired the property before 1972.

Problems persist with depreciable property of a predecessor corporation that remains depreciable property of the new corporation. These problems are a consequence of the fact that an amalgamation does not give rise to a disposition or acquisition of property. First, it is unclear whether the half-year rule in regulation 1100(2) applies to an amalgamation. Regulation 1100(2) applies where the amount added to the undepreciated capital cost of a class of property "in respect of a property *acquired* in the year or that became available for use by the taxpayer in the year [emphasis added]" exceeds the amount deducted from the undepreciated capital cost of that class in the year. Since the new corporation is not considered to have acquired any depreciable property as a consequence of

[133] Subsection 87(2.1) states that for the purposes of subsections 111(3) to (5.4), the new corporation is deemed to be the same corporation as, and a continuation of, each predecessor corporation. Subsections 111(3) to (5.4) are the main stop-loss rules applicable to a change in control of a corporation. Subsection 111(5.1) applies where there has been an acquisition of control of a predecessor corporation as a result of an amalgamation (see paragraph 256(7)(b)) and a prescribed class of depreciable property of a predecessor corporation is "pregnant" with a loss; that is, the undepreciated capital cost of the property in that class is greater than the fair market value of all property in that class. In these circumstances, the predecessor corporation is deemed to have deducted the excess as capital cost allowance in the year ending immediately before the amalgamation. The purpose of this provision is to prevent the use of an amalgamation to transfer property pregnant with losses by an amalgamation where control of the predecessor corporation holding the property has effectively changed as a consequence of the amalgamation. Under paragraph 111(4)(e), where the control of a predecessor corporation has been acquired as a result of the amalgamation, the corporation may elect to trigger a disposition of capital property having a fair market value greater than its cost amount in the year ending immediately before the amalgamation. For depreciable property, the election may trigger recapture under subsection 13(1), which can be used to offset the deemed capital cost allowance deduction required by subsection 111(5.1); it can also provide a "step-up" in the basis of capital property in the hands of the new corporation and therefore increase the availability of capital cost allowance deductions in the future, assuming that the property constitutes depreciable property of a prescribed class to the new corporation.

[134] Regulation 1702(1)(j).

an amalgamation,[135] arguably a precondition for applying the half-year rule has not been met and therefore it does not apply to the new corporation. Previously, regulation 1100(2.2)(c) excluded all amalgamations under section 87 from the half-year rule. This provision was revoked, along with others, in 1987 in order to block the perceived abuse of certain rollover provisions in the Act used to avoid the half-year rule. The 1987 amendments were intended to limit the exemption from the half-year rule in regulation 1100(2.2) to non-arm's-length amalgamations. However, it is arguable that, as a consequence of the *Palmer-McLellan* and *Pan Ocean Oil* decisions, the half-year rule no longer applies to any amalgamations, regardless of the combined length of time during which the new corporation and predecessor corporation owned depreciable property.

A second problem concerns the application of regulation 1102(14). This provision provides a flowthrough of the prescribed class of depreciable property in butterfly reorganizations and non-arm's-length transfers. Previously, regulation 1102(14)(b) provided the same flowthrough for all amalgamations under section 87. The application of the provision to amalgamations was also revoked in 1987 in order to block the perceived abuse of certain rollover provisions in the Act for the purpose of acquiring property entitled to fast writeoffs. However, it is now open to question whether regulation 1102(14) applies to amalgamations at all. The *Palmer-McLellan* and *Pan Ocean Oil* decisions stipulate that the new corporation has not acquired property from the predecessor corporations and that the character of an asset is its character to the predecessor corporation. Accordingly, depreciable property of a prescribed class of the new corporation should remain in the same class to which it was assigned before the amalgamation. In effect, the deletion of regulation 1102(14)(b) has failed to accomplish its objective.

Problems also arise in the interpretation of paragraph 87(2)(d) where, for example, property that was not depreciable property of a predecessor corporation is depreciable property of the new corporation, or vice versa. Part (c) of examples 1 through 4 illustrates this problem.

In example 1(c), property that is undoubtedly inventory of a predecessor corporation before the amalgamation will be considered depreciable property of the new corporation following the amalgamation. In determining the capital cost of the buildings to Cco, it is necessary to consider whether paragraph 87(2)(d) applies.[136] The only logical answer is that it

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[135] It is also unlikely that the property of a predecessor corporation would be considered to have become available for use in the year if the property was available for use throughout the year.

[136] The land component, being non-depreciable capital property to Cco, should be governed by paragraph 87(2)(e). Under that paragraph, the land is deemed to have a cost to Cco equal to the adjusted cost base of the land to Aco immediately before the amalgamation. "Adjusted cost base" is defined in section 54 and, although not limited to capital property, is used in the Act only with reference to such property. For example, construction soft costs, which are not deductible under subsection 18(2), either are added to the

(The footnote is continued on the next page.)

does not apply since the new corporation has not acquired depreciable property as a consequence of the amalgamation; rather, the inventory of Aco remains inventory of Cco as a consequence of the amalgamation. However, where Cco uses the property for the purpose of earning income from a business, the property is converted from inventory to depreciable property following the amalgamation.[137] Therefore, paragraph 87(2)(b), discussed below, applies in determining the opening inventory of Cco immediately after the amalgamation. Since the fair market value of each property exceeds its historic cost, the historic cost is added to Cco's inventory. The treatment of the property on its conversion to depreciable property is identical to its treatment in examples 1(a) and (b).

Unfortunately, this solution does not wholly eliminate the problems in interpreting paragraph 87(2)(d). In particular, the provision applies where the new corporation owns "at any time" (in subparagraph (ii)) depreciable property that was *property* of a predecessor corporation.[138] It is therefore suggested that paragraph 87(2)(d) should be amended to make it clear that it applies only where the depreciable property of the new corporation was also depreciable property of the predecessor corporation. The use of language similar to that in paragraph 87(2)(b) would accomplish this objective.[139]

The treatment in example 2(c) would be similar to that in example 2(b). As a result of the deemed year-end of Dco immediately before the

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136 Continued . . .
cost of inventory under subsection 10(1.1), if the property in issue is inventory, or form an adjustment to the cost of capital property under paragraph 53(1)(h). Paragraph 87(2)(e) does not appear to contemplate the situation where property that was inventory of a predecessor corporation is considered capital property of the new corporation. The determination of the cost of the land to Cco in example 1(c) could therefore be analyzed in a manner similar to that of the buildings, as discussed.

137 In the context of an amalgamation, there are only two points in time when this conversion may be considered to have occurred: either immediately before the amalgamation or immediately after it. Since the new corporation is considered to be a continuation of the predecessor corporations and not to have acquired their property as a consequence of the amalgamation, the conversion logically occurs immediately after the amalgamation. Therefore, Cco is considered to have changed that part of its business that was Aco's business from property development to leasing immediately following the amalgamation.

138 The technical language of paragraph 87(2)(d) would be strained beyond recognition in any attempt to apply it to depreciable property of the new corporation that was not depreciable property of a predecessor corporation. Subparagraph 87(2)(d)(i) refers to the "capital cost" of the property to a predecessor corporation, implying that the property must have been depreciable property of the predecessor corporation. Clause 87(2)(d)(ii)(A) depends on the application of subparagraph 87(2)(d)(i) in requiring an amount to be "added to the capital cost to the new corporation of depreciable property"; these two provisions stand or fall together. Finally, clause 87(2)(d)(ii)(B) does not apply since the new corporation has not acquired depreciable property "by virtue of the amalgamation."

139 It would also eliminate the concerns regarding the application of regulations 1100(2), 1100(2.2), and 1102(14) to amalgamations. The use of the term "acquired" in these regulations is consistent with the use of that term in paragraph 87(2)(d) of the Act; however, a "deemed" acquisition under paragraph 87(2)(d) ensures that the new corporation is considered to have acquired depreciable property of the predecessor corporations for all purposes under the Act and Regulations.

amalgamation, each of its buildings would be valued at $1,250,000 under subsection 10(1), which effectively increases the cost of goods sold by $750,000 in respect of each building and reduces Dco's profits for the year ending immediately before the amalgamation by the same amount (assuming that the cost of the inventory had not already been written down in a previous year).

Since the property remains inventory as a consequence of the amalgamation, paragraph 87(2)(b) requires $1,250,000 to be added to Fco's inventory for each of Dco's properties. On the conversion of each property to depreciable property following the amalgamation, $1,250,000 would become the capital cost of the property to Fco for capital cost allowance purposes. The treatment of the conversion follows that in examples 2(a) and (b).

Inventory of the New Corporation

Under paragraph 87(2)(b), property included in the new corporation's opening inventory for the year beginning at the time of the amalgamation which was included in a predecessor corporation's closing inventory in the year ending immediately before the amalgamation is deemed to have been acquired by the new corporation for an amount equal to the predecessor corporation's closing inventory determined in accordance with section 10.

The application of the provision is straightforward. It is limited to circumstances in which property is inventory of both the new corporation at the beginning of its first taxation year and a predecessor corporation at the end of its taxation year ending immediately before the amalgamation. However, there are circumstances where the new corporation does not carry on a business similar to that of a predecessor corporation, as examples 3(c) and 4(c) illustrate.

Example 3(c) concerns the situation where depreciable property of a predecessor corporation that has increased in value has become inventory of the new corporation following an amalgamation. Paragraph 87(2)(b) will not be applicable, unless it is considered that the property has been converted from depreciable property to inventory immediately before the amalgamation. As noted above, the only logical time of a conversion from depreciable property to inventory is following the amalgamation.

Paragraph 87(2)(d) applies if the change in character of the property from depreciable property to inventory occurs following the amalgamation. In this case, under paragraph 87(2)(d), Zco acquires each of Xco's properties with a capital cost of $3 million, although the amount added to the undepreciated capital cost of the applicable prescribed class will be limited to $1 million.[140] Immediately following the amalgamation, the

[140] Whether the property remains class 3 property or is included in class 1 property of Zco depends on whether regulation 1102(14) applies to amalgamations. If it does, the property remains class 3 property only if Zco and Xco are not dealing at arm's length.

property is converted from depreciable property to inventory. The solution is therefore consistent with the treatment in examples 3(a) and (b).

Example 4(c) involves property that is pregnant with a loss, in that its fair market value is less than its undepreciated capital cost. This example requires consideration of the stop-loss rules applicable on an amalgamation. A predecessor corporation essentially disappears as a separate taxpayer as a consequence of the amalgamation. It is therefore not surprising that the stop-loss rules apply in a manner similar to those affecting a winding up where the parent corporation acquires control of the subsidiary before the winding up.

As suggested in example 3(c), paragraph 87(2)(d) applies since the change in character from depreciable property to inventory occurs after the amalgamation. Before considering the application of paragraph 87(2)(d), it is first necessary to determine the effects of subsection 87(2.1)—in particular, whether subsection 111(5.1) applies on the amalgamation. If the amalgamation of Rco and Sco results in an acquisition of control of Rco, Rco will be required to deduct \$500,000[141] as capital cost allowance in its year ending immediately before the amalgamation. Then, applying paragraph 87(2)(d), Tco will acquire each property with a capital cost of \$3 million and an undepreciated capital cost of \$1,500,000. Following the amalgamation, the property is converted from depreciable property to inventory. The solution follows that in example 4(a) where Sco acquired control of Rco before the winding up.

If the amalgamation does not result in an acquisition of control of Rco, subsection 111(5.1) does not apply; that is, the pregnant loss will not be triggered immediately before the amalgamation.[142] Under paragraph 87(2)(d), Tco will acquire the property with a capital cost of \$3 million and an undepreciated capital cost of \$2 million. Immediately following the amalgamation, the property is converted from depreciable property to inventory. The solution is consistent with that in example 4(a) where Sco did not acquire control of Rco before the winding up.

A final issue to be considered in the context of an amalgamation is the treatment of depreciable (or other capital) property of a predecessor corporation that is to be sold following the amalgamation. This problem is illustrated in example 5(c). In effect, does Nco's intention to sell the property following the amalgamation suggest that the property is (or becomes) inventory before its sale or that the gain on the sale constitutes ordinary income rather than a capital gain?

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141 The difference between the property's undepreciated capital cost and its fair market value immediately before the amalgamation.

142 Proposed subsection 13(21.2) does not apply on an amalgamation since the predecessor corporations are not considered to have disposed of property as a consequence of the amalgamation. However, where subsection 13(21.2) has applied to a previous disposition of property by a predecessor corporation, the new corporation is deemed to be a continuation of the predecessor corporation for the purpose of the continued application of subsection 13(21.2) to the new corporation: proposed paragraph 87(2)(g.3).

On the basis of the decisions in *Palmer-McLellan* and *Pan Ocean Oil*, there is little doubt that the property formerly owned by Lco will continue to be depreciable property following the amalgamation since there has been no acquisition of property by the new corporation. Given this conclusion, the characterization of the profit on the sale is largely a moot point unless the proceeds of disposition differ from the fair market value of the property at the time of the amalgamation. Even if there has been a conversion of the property from depreciable property to inventory, which is unlikely, on the basis of Revenue Canada's administrative practice, Nco will determine the tax consequences of the ultimate disposition as if there had been a notional disposition at the time of the conversion. The consequences in these circumstances will be the same as those in example 3(c).[143] The fact that Lco and Nco are in the same business is irrelevant.

The simple fact that Nco intends to sell the property immediately following the amalgamation should not, however, result in a conversion of the property from depreciable property to inventory.[144] During the period of time following the amalgamation until its actual sale, the property will remain depreciable property of Nco, and Nco will be entitled to claim capital cost allowance in respect of the property if it still owns the property at the end of its taxation year following the amalgamation.[145] Whether each building is class 1 or class 3 property of Nco depends on how, if at all, regulation 1102(14) applies to amalgamations.

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[143] Depending on the particular circumstances, subsections 69(11) and (12), as amended pursuant to the June 20, 1996 legislation, supra footnote 31, may apply to deem Lco to have disposed of the property immediately before the amalgamation for proceeds equal to the property's fair market value. These provisions apply if Lco and Mco are not affiliated (as defined in section 251.1), the property is disposed of pursuant to an arrangement for sale made within three years after the amalgamation, and it is reasonable to consider that one of the main purposes of the amalgamation was to obtain the benefit of a deduction in computing income or taxable income available to Nco (including, for example, losses of Mco that Nco is entitled to carry forward following the amalgamation). If Lco and Mco were affiliated before the amalgamation, subsection 69(11) may still be applicable if this affiliation was created as part of the same series of transactions that included the amalgamation.

[144] The mere intention to sell property at a profit does not cause the disposition to be treated on income account. Numerous cases support this proposition, including *Irrigation Industries Ltd. v. MNR*, 62 DTC 1131 (SCC); *Racine, Demers and Nolin v. MNR*, 65 DTC 5098 (Ex. Ct.); and *Crystal Glass Canada Ltd. v. The Queen*, 89 DTC 5143 (FCA). The issue is whether the taxpayer had the intention, or a secondary intention, at the time the property was acquired to resell it at a profit. If the intention to resell the property was an "operating motivation" in the acquisition of the property, the profit will generally be considered on income account. If the intention to resell was not an operating motivation, the later decision to sell the property does not result in its conversion to inventory without further action on the part of the taxpayer—for example, the commencement of improvements to the property with a view to resale: see IT-218R, supra footnote 8, at paragraph 12.

[145] This rationale is consistent with the expressed views of the Department of Finance and Revenue Canada in the context of the consolidation of profits and losses in a corporate group. See supra footnotes 90 to 92 and the accompanying text.

Summary

An amalgamation poses a number of difficulties regarding the character of property owned by predecessor corporations following the amalgamation. Concerns arise not only regarding property whose character changes following the amalgamation, but also in respect of certain property that retains its character throughout. In particular:

• It is unclear how, if at all, the half-year rule in regulation 1100(2) applies to amalgamations, whether arm's length or non-arm's-length.

• It is unclear how, if at all, regulation 1102(14) applies to amalgamations, whether arm's length or non-arm's-length.

• It is unclear how paragraphs 87(2)(d) and (e) apply, respectively, where depreciable property or other capital property of the new corporation was inventory of a predecessor corporation.

Analysis

The treatment of a change in the character of property in the context of an amalgamation is, in a sense, easier to resolve than the treatment of a change associated with a winding up or a subsection 85(1) or 97(2) rollover, since an amalgamation does not involve a disposition or acquisition of property. Where the character of property differs between the new corporation and a predecessor corporation, it is clear that the change in character occurs following the amalgamation rather than as a consequence of it. The problems are therefore limited to the appropriate treatment of a conversion of property, which has already been discussed.

OTHER NON-ARM'S-LENGTH TRANSFERS

General Rule and Exceptions to the Rule

Subsection 69(1) is the general provision applicable to non-arm's-length transfers of property. It applies regardless of the character of the property to the transferor or the transferee. However, it applies only "[e]xcept as expressly otherwise provided in this Act." Accordingly, other provisions dealing with particular non-arm's-length transfers (for example, the various provisions discussed above and below) take precedence.

Under subsection 69(1), the transferor of property to a non-arm's-length person is deemed to have received proceeds equal to the greater of the actual proceeds received and the fair market value of the property transferred. The cost of the property to the transferee is determined as follows:

• if the transferee paid more for the property than its fair market value, the cost to the transferee is deemed to be its fair market value (paragraph 69(1)(a));

• if the transferee received the property as a gift, bequest, or inheritance, the cost to the transferee is deemed to be its fair market value (paragraph 69(1)(c));

• if the transferee paid less than the property's fair market value, the cost to the transferee is deemed to be the amount paid.[146]

Apart from the transactions already discussed, there are a number of other transactions involving depreciable property to which special rules apply. There is one further special rule regarding inventory, applicable where a taxpayer disposes of land inventory to his or her spouse as a consequence of the taxpayer's death.

Inter Vivos Transfer of Depreciable Property Between Spouses

Subsection 73(1) provides a rollover for capital property transferred between spouses, including a transfer to a former spouse in settlement of rights arising out of the marriage and transfers to a qualifying spouse trust. The rollover is automatic, unless the transferor elects not to have the provision apply, in which case subsection 69(1) will apply. Where a taxpayer transfers depreciable property to the taxpayer's spouse and does not elect out of subsection 73(1), the taxpayer is deemed to have disposed of the property and the recipient is deemed to have acquired the property for an amount equal to the property's undepreciated capital cost (or, where there is more than one property in the particular class, the proportion of the undepreciated capital cost of all property in the class that the fair market value of the transferred property is of the fair market value of all property in the class).[147] In effect, the transferor does not recognize any gain or loss on the transfer.

Subsection 73(2) provides that where the capital cost to the transferor of the property exceeds the deemed proceeds of disposition determined under subsection 73(1), then for the purpose of the capital cost allowance provisions, the capital cost to the transferee of the property is deemed to be the capital cost of the property to the transferor and the excess is deemed to have been deducted by the transferee as capital cost allowance in previous years. The provision is intended to prevent the conversion of what would be recapture to the transferor into a preferentially treated capital gain to the transferee.

It is clear that subsection 73(2) applies where the property transferred is characterized as depreciable property to both the transferor and the transferee. What is not clear is whether the provision applies where the property is depreciable property to the transferor but is not depreciable property to the transferee.

Example 6

Mrs. A owns two identical condominium units. She previously resided in one with her husband, Mr. A; the second she held as a rental property. Both

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[146] The third proposition is a consequence of the second. In order for the receipt of property to constitute a gift, no consideration must be paid. A sale at an undervalue is not considered a gift for tax purposes. See *Y. Gervais v. The Queen*, [1984] CTC 661 (FCTD); and *The Queen v. Littler*, 78 DTC 6179 (FCA).

[147] Paragraph 73(1)(e).

> of the properties were purchased at the same time, each having an original cost of $200,000. The fair market value of each property is currently $300,000. The rental property has an undepreciated capital cost of $30,000. Under the terms of her settlement with Mr. A following their divorce, Mrs. A agrees to transfer vacant possession of the rental property to Mr. A. Mr. A immediately takes up occupancy of the unit as his principal residence and lives there until he subsequently sells the property for $350,000.

There is no doubt that Mr. A is not entitled to claim capital cost allowance in respect of the condominium unit since he did not acquire it for the purpose of gaining or producing income from a business or property. That does not necessarily affect the determination of whether the property is depreciable property to Mr. A or the tax consequences to him on its ultimate disposition. Whether or not subsection 73(2) applies to his acquisition may affect these consequences. If subsection 73(2) is not applicable, the tax consequences are simple: Mr. A will report a capital gain on the disposition of the property of $320,000 ($350,000 less his deemed cost of $30,000) and may be entitled to the principal residence exemption under paragraph 40(2)(b) with respect to a portion of this gain.[148]

Subsection 73(2) applies where "a transferee is deemed . . . to have acquired any particular depreciable property of a prescribed class of a taxpayer." The phrase "of a taxpayer" modifies the term "depreciable property"; therefore, the character of the property in the hands of the transferor (the taxpayer) determines the application of the provision. Since the condominium was depreciable property to Mrs. A, subsection 73(2) should apply. The consequences, however, under paragraph 73(2)(a) are that "the capital cost to the transferee of the particular property" is deemed to be the transferor's capital cost. As previously noted, the term "capital cost" is not defined in the Act but is used only in reference to the cost of depreciable property. Whether subsection 73(2) is applicable poses potentially circular arguments. It is arguable that the property must be depreciable property to the transferee as well as the transferor before subsection 73(2) is applicable because under paragraph 73(2)(a), the property must have a capital cost to the transferee. Since Mr. A did not acquire the property in order to earn income from a business or property and therefore would not be entitled to a deduction under paragraph 20(1)(a), the property is not depreciable property to the transferee and therefore subsection 73(2) does not apply. However, depreciable property includes property "in respect of which the taxpayer has been allowed . . . a deduction under paragraph 20(1)(a)"; accordingly, it is arguable that the property is depreciable property to Mr. A because paragraph 73(2)(b) deems him to have claimed capital cost allowance in previous taxation years. This, of course, presupposes that subsection 73(2) is applicable in the first place.

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[148] Under subsection 40(4), for the purpose of the principal residence exemption, Mr. A is deemed to have owned the property since Mrs. A first acquired it and it is deemed to be his principal residence for any taxation year in which it was Mrs. A's principal residence. Since the property was never Mrs. A's principal residence, a significant portion of the gain will remain taxable.

Even if subsection 73(2) is applicable, it is submitted that the tax consequences to Mr. A will be the same as if the provision did not apply. The capital cost of the property to Mr. A will be deemed to be $200,000, and he will be deemed to have deducted $170,000 as capital cost allowance in preceding years. Accordingly, the property will be considered depreciable property to Mr. A since he is deemed to have deducted amounts under paragraph 20(1)(a) in previous years. Notwithstanding the fact that the property is depreciable property of Mr. A, as noted above, he will not be entitled to claim capital cost allowance since he did not acquire the property for the purpose of earning income from a business or property.[149]

It is further submitted that subsection 13(1) does not apply when Mr. A subsequently disposes of the property. Subsection 13(1) is applicable only "in respect of a taxpayer's depreciable property of a particular prescribed class." In order for subsection 13(1) to apply, it is not sufficient that the property be depreciable property to Mr. A; it must be depreciable property of a prescribed class. Because Mr. A did not acquire the property for the purpose of gaining or producing income, the property is not depreciable property of a prescribed class,[150] and subsection 13(1) is not applicable. The judgment of the Federal Court of Appeal in *Hickman Motors* supports this conclusion.[151] The effect in example 6 is that recapture is converted into a capital gain, precisely the result that subsection 73(2) is intended to prevent.

Further argument supporting this result stems from the necessary corollary if subsection 13(1) were applicable. That is, subsection 20(16) would apply in the event that the transferee disposed of the property for less than the transferor's deemed proceeds of disposition.

Example 7

Mr. B owns two identical condominium units. He previously resided in one with his wife, Mrs. B; the second he held as a rental property. Both of the properties were purchased at the same time, each having an original cost of $300,000. The fair market value of each property is currently $250,000. The rental property has an undepreciated capital cost of $280,000. Under the terms of his settlement with Mrs. B following their divorce, Mr. B agrees to transfer vacant possession of the rental property to Mrs. B. Mrs. B immediately takes up occupancy of the unit as her principal residence and lives there until she subsequently sells the property for $200,000.

If subsection 73(2) is applicable, Mrs. B will be deemed to own depreciable property with a capital cost of $300,000, and she will be deemed to have taken $20,000 as capital cost allowance in previous years. The only distinction of consequence between subsection 20(16) and subsection 13(1) is the algebraic formula; the formula in subsection 20(16) is

[149] Regulation 1102(1)(c) and the preamble of subsection 20(1) of the Act both support this conclusion.

[150] Regulation 1102(1)(c).

[151] Supra footnote 1. See also the text accompanying footnote 41.

the reverse of that in subsection 13(1). Subsection 20(16), similar to subsection 13(1), applies "in respect of a taxpayer's depreciable property of a particular class." Accordingly, if subsection 13(1) is applicable in example 6, subsection 20(16) must be applicable in example 7.

The only possible argument leading to contrary results in examples 6 and 7 is that there has been a change in use of the property transferred to the recipient spouse from an income-earning to a non-income-earning use either before or following the transfer. This change in use would trigger the application of paragraphs 13(7)(a) and 45(1)(a), which would deem the property to have been disposed of for its fair market value at that time. These provisions apply only where a taxpayer, having acquired property for the purpose of gaining or producing income, commences at some later time to use it for some other purpose.[152]

In the absence of a specific provision either deeming the transferor to have converted the use of the property from income-producing to personal use immediately before the disposition or deeming the recipient to have acquired the property for a use identical to that of the transferor, the only logical conclusion is that the properties in examples 6 and 7 are not depreciable property of a prescribed class to the transferee. If the government intended that a change in use of property should arise in these circumstances, otherwise than as a consequence of the transfer, or that the transferee in a transfer subject to subsections 73(1) and (2) should always be subject to the application of subsection 13(1) (but not subsection 20(16)) on a subsequent disposition of property, the legislation should be amended appropriately. It is submitted that subsection 73(2), as it now reads, is limited to circumstances where the property is depreciable property to both the transferor and the transferee spouse.

Other Non-Arm's-Length Acquisitions of Depreciable Property

Paragraph 13(7)(e) applies to certain non-arm's-length transfers of depreciable property.[153] The provision applies for the purpose of determining capital cost allowance to the transferee and potential recapture.

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[152] For residential rental property, it is arguable that where the transferor acquires vacant possession of the property before the transfer, the transferor has converted the property from income-producing to personal use. Similarly, if vacant possession is not obtained until after the property is transferred, it is arguable that the transferee has acquired the property for the purpose of gaining or producing income and has subsequently converted it to personal use when he or she moves into the property. Vacant possession can be acquired only in accordance with the applicable provincial laws affecting landlords and tenants (in Ontario, the Landlord and Tenant Act, RSO 1990, c. L.7, as amended). It would be anomalous if the tax results in these circumstances were driven by the fact that the property was residential rental property as opposed to other depreciable property.

[153] Paragraph 13(7)(e) incorporated proposals introduced in the May 23, 1985 federal budget. A provision applicable to all non-arm's-length transfers of depreciable property was first introduced in 1949. Subsection 20(2) of the 1948 Income Tax Act, as amended by 1949, c. 25, section 7 provided:

(The footnote is continued on the next page.)

The opening words of paragraph 13(7)(e) set out the preconditions for its application:

- the property must be depreciable property to the transferee;
- the property must have been capital property (although not necessarily depreciable property) of the transferor; and
- the transferee and transferor did not deal at arm's length.

Subparagraphs 13(7)(e)(i) and (ii) apply where the capital cost of the property to the transferee is greater than the cost or capital cost of the property to the transferor. The underlying rationale for these provisions is to prevent the transferee from claiming capital cost allowance to the extent of any proceeds of disposition received by the transferor tax-free (that is, one-quarter of the capital gain, plus, where the transferor is an individual, partnership, or trust resident in Canada, the portion, if any, of the gain qualifying for the lifetime capital gains exemption).[154] The provisions apply, according to the opening words of subsection 13(7), "for the purposes of paragraphs 8(1)(j) and (p), this section, section 20 and any regulations made for the purpose of paragraph 20(1)(a)." Accordingly, the provisions do not apply for the purpose of determining the transferee's capital gain on any subsequent disposition of the property.

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[153] Continued . . .

> Where depreciable property did, at any time after the commencement of 1949, belong to one person (hereinafter referred to as the original owner) and has, by one or more transactions between persons not dealing at arms [sic] length, become vested in a taxpayer, the following rules are . . . applicable for the purposes of this section and regulations made under paragraph (a) of subsection (1) of section 11:
>
> (a) the capital cost of the property to the taxpayer shall be deemed to be the amount that was the capital cost of the property to the original owner;
>
> (b) where the capital cost of the property to the original owner exceeds the actual capital cost of the property to the taxpayer, the excess shall be deemed to have been allowed to the taxpayer in respect of the property under regulations made under paragraph (a) of subsection (1) of section 11 in computing income for taxation years before the acquisition thereof by the taxpayer.

This provision is clearly applicable only where the property is depreciable property to both the taxpayer and the original owner. Subsection 20(2) became subsection 20(4) of the 1952 Act. No comparable provision was included in the Act implementing the 1971 tax reforms until the introduction of paragraph 13(7)(e) following the 1985 budget.

[154] As noted above, the provision was introduced with the 1985 budget, when the lifetime capital gains exemption also was introduced. Before that time, a transferee in a non-arm's-length transfer could claim capital cost allowance in respect of the portion of the capital gain excluded from tax under section 38. However, it is unlikely that any taxpayers planned their affairs to take advantage of this result since the transfer would result in a taxable disposition to the transferor. Unless the property was in a prescribed class with a very high prescribed rate (that is, 50 percent or more), the upfront tax cost to the transferor would exceed the present value of the transferee's enhanced capital cost allowance deductions.

Subparagraph 13(7)(e)(i) does not prevent the transferee from claiming capital cost allowance on the portion, if any, of the gain that is deductible under paragraph 40(2)(b), the principal residence exemption. This omission seems contrary to the underlying rationale for the provision.

Example 8

Gco owns a building (class 1) that has a capital cost of $100,000, an undepreciated capital cost of $80,000, and a fair market value of $200,000. Gco transfers the property to Hco, a non-arm's-length corporation, for $200,000. Hco uses the property in its business for a number of years and subsequently sells it to an arm's-length person for $400,000.

In example 8, Gco must include in its income $20,000 as recaptured depreciation under subsection 13(1), as well as a taxable capital gain under section 38 of $75,000 (three-quarters of $100,000). The cost of the property to Hco is $200,000; however, under subparagraph 13(7)(e)(ii), its capital cost for capital cost allowance purposes is deemed to be $175,000. Hco cannot claim capital cost allowance to the extent that Gco did not pay tax on its $100,000 capital gain. Suppose that at the time that Hco sells the property, its undepreciated capital cost is $150,000. Hco will include in its income $25,000 as recaptured depreciation under subsection 13(1), as well as a taxable capital gain of $150,000 (three-quarters of the difference between $400,000 and $200,000, its cost for capital gains purposes). The amount by which the cost to Hco exceeds its deemed capital cost under subparagraph 13(7)(e)(ii) is not subject to tax.

Subparagraph 13(7)(e)(iii) applies where the capital cost of the property to the transferee is less than the cost or capital cost of the property to the transferor. Under this provision, the transferee's capital cost of the property is deemed to be its cost or capital cost to the transferor and any excess is deemed to have been claimed by the transferee as capital cost allowance in previous years. In essence, the provision preserves the excess as potential recapture to the transferee in the event that the property is disposed of by the transferee for an amount exceeding the transferee's actual cost. Its purpose is to prevent the conversion of what would otherwise be a full income inclusion into a preferentially treated capital gain. However, its potential impact reaches beyond this purpose.

Example 9

Jco owns a building (class 1) that has a capital cost of $100,000, an undepreciated capital cost of $60,000, and a fair market value of $60,000. Jco transfers the property to Kco, a non-arm's-length corporation, for $60,000. Kco uses the property in its business for a number of years and subsequently sells it to an arm's-length person for $150,000.

Example 9 illustrates the normal circumstances in which subparagraph 13(7)(e)(iii) applies. Jco recognizes no gain or loss as a consequence of the transfer. The cost of the property to Kco is $60,000; however, under subparagraph 13(7)(e)(iii), its capital cost for capital cost allowance purposes is deemed to be $100,000, and Kco is deemed to have deducted $40,000 as capital cost allowance in previous years. Suppose that at the time that Kco sells the property, its undepreciated capital cost is $40,000. Kco will include in its income $60,000 (the $100,000 deemed cost less the undepreciated capital cost of $40,000) as recaptured depreciation under subsection 13(1); it will also have a capital gain of $50,000 (the difference between $150,000 and $60,000, its cost for capital gains purposes, less $40,000, which is excluded by the words in parentheses in paragraph 39(1)(a)).

An interesting consequence of subparagraph 13(7)(e)(iii) is that the transferee may have to include an amount in income as recaptured depreciation even if the transferor was not entitled to claim capital cost allowance while holding the property and had no deductible loss on its disposition.

Example 10

Ms B owns a yacht, used exclusively for personal pleasure. The yacht originally cost $150,000 and has a current fair market value of $100,000. Ms B sells the yacht to her brother, Mr. C, for $100,000. Mr. C is in the business of chartering pleasure craft, and the yacht is used as one of his fleet. Mr. C subsequently sells the yacht for $150,000.

In example 10, Ms B cannot claim a capital loss on the sale of the yacht since it constituted personal-use property to her. However, the preconditions for the application of subparagraph 13(7)(e)(iii) are met since the yacht is depreciable property to Mr. C and was capital property to Ms B. The capital cost of the yacht to Mr. C, for capital cost allowance purposes, is therefore deemed to be $150,000, and he is deemed to have deducted $50,000 as capital cost allowance in preceding years. Even if Mr. C deducts no further capital cost allowance in respect of this property, he will be required to include $50,000 in his income as recaptured depreciation under subsection 13(1) when the yacht is subsequently sold (ignoring his other properties that may be in the same class as the yacht).

The application of subparagraph 13(7)(e)(iii) in the circumstances set out in example 10 is unwarranted. Paragraph 13(7)(e) was added as a consequence of the 1985 budget. The May 23, 1985 notice of ways and means motion, accompanying the budget, set out in clause 7 the basis for the new provision:

> That a taxpayer who has acquired depreciable property of a prescribed class in a non-arm's length transaction after May 22, 1985 be treated, for the purposes of the rules relating to capital cost allowance, as having acquired the property at the transferor's *capital cost* and, where such capital cost exceeds the taxpayer's actual cost, the excess be treated as capital cost allowance previously claimed by the taxpayer [emphasis added].

The terminology used in this statement is confusing. The ways and means motion was intended to cover all the circumstances in which paragraph 13(7)(e) now applies. The supplementary information released with the 1985 budget clearly indicates that the rationale behind subparagraph 13(7)(e)(i) was the introduction of the lifetime capital gains exemption.[155]

[155] Canada, Department of Finance, 1985 Budget, Supplementary Information and Notice of Ways and Means Motions on the Budget, May 23, 1985, 8: "For non-arm's-length transfers of depreciable property, the purchaser's capital cost will equal the vendor's. This change recognizes that, with the introduction of the capital gains exemption, there is a significant incentive to increase capital cost and generate capital cost allowance deductions in this manner. . . . For capital gains purposes, the purchaser's capital cost will be his actual capital cost." The supplementary information makes no specific reference to the policy rationale underlying subparagraph 13(7)(e)(iii).

In the context of subparagraphs 13(7)(e)(i) and (ii), the precondition that the property be capital property of the transferor and not necessarily depreciable property makes sense.

A disposition of either depreciable or non-depreciable capital property can give rise to a capital gain, one-half of which (at that time) was not taxable with the remainder potentially qualifying for the capital gains exemption. However, the extension of subparagraph 13(7)(e)(iii) to non-depreciable capital property of the transferor is unwarranted. If the transferor was entitled to claim capital cost allowance in respect of the property, there is some justification for an anti-avoidance measure requiring a non-arm's-length transferee to "step into the shoes" of the transferor in order to prevent the transferee from converting what would otherwise be fully taxable recapture into a preferentially taxed capital gain. However, where the transferor was not entitled to claim capital cost allowance in respect of the property, the rationale for the application of the provision disappears. There is no need to preserve recapture if no capital cost allowance was claimed. Accordingly, subparagraph 13(7)(e)(iii) should be limited to circumstances where the property was also depreciable property of the transferor.[156]

Transfer of Depreciable Property as a Consequence of the Death of a Taxpayer

Further difficulty arises with respect to depreciable property of a taxpayer that is disposed of as a consequence of the taxpayer's death. A disposition to a spouse or spouse trust must be considered separately from other transfers on death because of the special rules applicable in these circumstances.

Where a taxpayer has died, subsections 70(5) and (6) apply with respect to most capital property owned by the taxpayer at the time of death. Under subsection 70(5), a taxpayer is deemed to have disposed of each capital property immediately before the taxpayer's death for proceeds equal to its fair market value at that time, and the beneficiary is deemed to have acquired the property at a cost equal to that fair market value. Subsection 70(6), the main exception to the general rule, provides for an automatic rollover of capital property transferred to a spouse or spouse trust as a consequence of the taxpayer's death. Under subsection 70(6.2), the legal representatives of the deceased can elect not to have the automatic rollover apply, in which case the transfer to the spouse is dealt with under subsection 70(5).

Where the property of the deceased taxpayer is depreciable property of a prescribed class and the capital cost of such property exceeds the deemed proceeds of disposition on death, paragraph 70(5)(c) provides that, for the purpose of the capital cost allowance provisions in the Act, the capital

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[156] The provision introduced in 1949, supra footnote 153, better reflects the purpose of subparagraph 13(7)(e)(iii) suggested in the notice of ways and means motion.

cost of the property to the recipient beneficiary is deemed to be that of the taxpayer, and the excess is deemed to have been deducted as capital cost allowance in preceding years. The provision is similar in purpose and effect to subparagraph 13(7)(e)(iii).[157]

The main difference between the two provisions is that the precondition for the application of paragraph 70(5)(c) is that the property must have been depreciable property of the deceased taxpayer and not merely capital property. Paragraph 70(5)(c) applies to all transfers on death. It may be inferred from the underlying rationale for the provision—to preserve recapture in the event that the property later increases in value—that the government views a deceased and the beneficiaries of his or her estate as being non-arm's-length.[158] As in the case of subsection 73(2), it is not clear whether the property must be depreciable property to the beneficiary before paragraph 70(5)(c) applies or whether the property is depreciable property of the beneficiary as a consequence of the provision's application. Even if the provision is applicable, similar problems arise in respect of the application of subsections 13(1) and 20(16) when the beneficiary subsequently disposes of the property if the beneficiary did not acquire the property for the purpose of earning income from a business or property.

Where depreciable property of the taxpayer is disposed of to the taxpayer's spouse or a spouse trust, paragraph 70(6)(e) has a similar effect to that of subsection 73(2) in the context of an inter vivos transfer of depreciable property to a spouse or spouse trust.[159]

Transfer of Land Inventory as a Consequence of the Death of a Taxpayer

Generally, there is no deemed disposition of inventory as a consequence of the death of a taxpayer. Accordingly, the taxpayer is not deemed to have disposed of inventory at its fair market value immediately before his or her

[157] Paragraph 13(7)(e) specifically excludes transfers on death. While subparagraph 13(7)(e)(iii) has its counterpart in paragraph 70(5)(c), there is no provision governing transfers on death that has an effect similar to that in subparagraph 13(7)(e)(i).

[158] The justification for paragraph 70(5)(c) will be considered in more detail below under the heading "Analysis."

[159] The distinction between the two is the determination of the cost of the property to the recipient spouse where the transferor spouse owned more than one depreciable property in the same prescribed class. For inter vivos transfers, paragraph 73(1)(e) determines the cost to the recipient on the basis of the proportion that the fair market value of the transferred property bears to the fair market value of all property in the prescribed class. For transfers on death, paragraph 70(6)(d) bases the cost to the recipient on the "cost amount" to the transferor, which is based on the proportion that the capital cost of the transferred property bears to the capital cost of all property in the prescribed class. The use of fair market values in paragraph 73(1)(e) gives rise to higher compliance and administrative costs since all property in the particular class must be valued. There does not appear to be any significant justification for the distinction, and it is submitted that the formula used in paragraph 70(6)(d) should apply in both provisions.

death. When the estate disposes of such property to the beneficiary, the beneficiary will acquire the property at a cost equal to its fair market value.[160]

The one exception to the general rule applies to land inventory. Upon the death of a taxpayer, he or she is deemed to have disposed of land that was included in the inventory of a business of the taxpayer for proceeds equal to the land's fair market value.[161] The beneficiary will acquire the land at a cost equal to the land's fair market value. A rollover is provided for transfers of land inventory to a deceased taxpayer's spouse or a spouse trust. If the property vests indefeasibly in the spouse or trust within 36 months following the taxpayer's death, the taxpayer is deemed to have disposed of the land for proceeds equal to its cost amount immediately before the taxpayer's death and the spouse is deemed to have acquired the land at a cost equal to those proceeds.[162] Land inventory for these purposes includes land held by the deceased taxpayer in an adventure or concern in the nature of trade.[163]

Paragraph 70(5.2)(d) does not deem the property to be inventory to the spouse or trust even though the cost of the property is deemed to be the deceased taxpayer's cost. The character of the property as land inventory to the deceased is not determinative of its character in the hands of the estate or the beneficiary.[164] With regard to the beneficiary, there is no presumption that the property constitutes inventory solely on the basis of its character as such in the hands of the deceased. The general view is that the gain realized on the subsequent sale of the land will normally be on capital account.[165] Subsection 23(1) will not apply to the subsequent disposition of the land by the spouse.[166] In effect, paragraph 70(5.2)(d) may have the effect of converting what would otherwise be an income inclusion to the deceased spouse into a capital gain of the beneficiary.

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[160] Paragraph 69(1)(c).

[161] Paragraph 70(5.2)(c).

[162] Paragraph 70(5.2)(d).

[163] As originally proposed, the provision would have applied to "land that was included in the inventory of a business *carried on* by the taxpayer [emphasis added]." Arguably, the provision would not therefore have applied to land held as an adventure or concern in the nature of trade since an adventure does not constitute "carrying on" a business: *Tara Exploration and Development Co. Ltd. v. MNR*, 70 DTC 6370 (Ex. Ct.). Since paragraph 70(5.2)(d), as enacted, applies to land inventory "of a business of the taxpayer," and since the definition of a business in subsection 248(1) includes an adventure or concern in the nature of trade, land held as an adventure falls within the ambit of the provision.

[164] *McLeod v. Minister of Customs & Excise* (1925), 1 DTC 73 (Ex. Ct.).

[165] Wolfe D. Goodman, "Estate Planning—Before and After Tax Reform" (October 1975), 2 *Estates and Trusts Quarterly* 313-21, at 317; A.F. Sheppard, "Income Tax Planning in the Administration of Estates," in *Report of Proceedings of the Twenty-Eighth Tax Conference*, 1976 Conference Report (Toronto: Canadian Tax Foundation, 1977), 762-95, at 777-78; and William I. Innes, "The Tax Treatment of Accrued Gains on Inventory at Death" (December 1992), 12 *Estates and Trusts Journal* 122-61, at 125, footnote 11, at 158-59.

[166] Subsection 23(1) provides that proceeds from the sale of inventory by a taxpayer following cessation of the taxpayer's business are still treated on income account.

Summary

There are a number of technical problems with the provisions governing non-arm's-length transfers of property that involve either a rollover or an attempt to preserve certain characteristics of the property following its transfer. These problems include the following:

- It is not clear how, if at all, subsection 73(2) applies where the recipient spouse does not acquire the transferred property for the purpose of earning income from a business or property.
- Subparagraph 13(7)(e)(iii) should not apply where the property was non-depreciable capital property of the transferor.
- It is not clear how, if at all, paragraphs 70(5)(c) and 70(6)(e) apply if the beneficiary does not acquire the bequeathed property for the purpose of earning income from a business or property.
- The rollover provided in paragraph 70(5.2)(d) may have the effect of converting ordinary income into a capital gain.

Analysis

The various non-arm's-length transfers discussed in this section may be divided into two broad categories: the rollover provided for transfers to a spouse or spouse trust, either inter vivos or on death, and the rest.

Spousal Rollovers

The primary concern with the spousal rollovers arises where the recipient does not acquire the property for the purpose of gaining or producing income. The rollover provided under subsection 73(2) and paragraph 70(6)(d) has the effect of converting recaptured depreciation into a capital gain; the rollover under paragraph 70(5.2)(d) may have the effect of converting an income inclusion into a capital gain. These results are not appropriate. The spousal rollover should not permit a recharacterization of the tax treatment of gains or losses that would have arisen had there been a taxable disposition or deemed disposition at fair market value, rather than a rollover.

The transferor spouse could be treated as having converted the property to personal use immediately before the transfer. This conversion would give rise to a deemed disposition at fair market value of both capital property (whether depreciable or non-depreciable)[167] and inventory.[168] The only exception applies to capital property that becomes the principal residence of the taxpayer, where the taxpayer can elect out of the deemed disposition;[169] however, this election is not available where the taxpayer has claimed capital cost allowance on the property. For example, the election would not be available to Mr. B in example 7. The

[167] Subsection 45(1) and paragraph 13(7)(a).

[168] *Sharkey v. Wernher*, supra footnote 99.

[169] Subsection 45(3).

effect of the conversion in these circumstances is that no rollover is provided.

Alternatively, the spousal rollover could be treated in a manner consistent with the proposals for the other rollovers discussed previously. Under this alternative, the character of the property would not change as a consequence of its transfer. If the property was inventory or depreciable property to the transferor, it would be so characterized in the hands of the transferee. Where the purpose for which the transferee acquired the property was personal use, the property would be treated as having been converted to personal use immediately following the rollover. As indicated above, this conversion would give rise to a deemed disposition by the transferee at fair market value immediately after the rollover. The effect is to immediately nullify the rollover treatment. The only distinction between these two approaches is who pays the tax on the deemed disposition, assuming that the attribution rules do not apply.

The only other solution is to carve out an exception to the deemed disposition rules in subsection 45(1) and paragraph 13(7)(a) as well as the jurisprudence applicable to inventory. The exception would create a notional as opposed to a deemed disposition at fair market value following a spousal rollover, with the deferral of tax liability until the recipient spouse disposed of the property in a taxable disposition.

Other Non-Arm's-Length Transfers

Paragraph 13(7)(e) is an anti-avoidance provision. It does not apply to arm's-length transfers; it applies only to non-arm's-length taxable dispositions of property. Subparagraphs 13(7)(e)(i) and (ii) ensure that the transferee of property cannot claim capital cost allowance on the non-taxable portion of the transferor's capital gain. Subparagraph 13(7)(e)(iii) is intended to preserve recapture if depreciable property of the transferor has a fair market value below its original cost, thus preventing the conversion of an income gain into a capital gain in the event that the property subsequently increases in value.

As anti-avoidance provisions, they should be drafted precisely, and their scope should be limited to the abuse that they are intended to eliminate. The existing provisions are clear and precise, but too broad in their potential application. They could include a tax-avoidance purpose test, although that would create uncertainty and generate costly and largely unnecessary litigation. As suggested previously, the scope of subparagraph 13(7)(e)(iii) extends beyond the evil that it addresses. The provision should be amended so that it applies only where the transferred property is depreciable property to both the transferor and the transferee.

The provisions applicable to depreciable property on the death of a taxpayer are open to greater criticism. Paragraph 70(5)(c) is similar in effect to subparagraph 13(7)(e)(iii); however, there is no provision corresponding to subparagraph 13(7)(e)(i). The lifetime capital gains exemption is equally available to deceased resident individuals in their terminal return as to other resident individuals. If paragraph 70(5)(c) is considered necessary, there ought to be a provision applicable on death similar in effect to subparagraph 13(7)(e)(i).

More important, paragraph 70(5)(c) applies on the death of a taxpayer, an event not generally associated with abusive tax-avoidance activity. It is difficult to justify treatment of deemed dispositions on death in a manner different from the treatment of arm's-length dispositions. The only distinction is that no consideration is paid in the former circumstance. That fact alone does not justify preserving recapture, since there is clearly no tax-avoidance motivation in a transfer of property on death.

CONCLUSIONS

Many of the problems illustrated in this article stem from two basic features of the income tax legislation: the separate regime governing capital gains and capital losses, and the inventory valuation rules. The design of more effective rules governing the changing character of property in corporate reorganizations and various non-arm's-length transfers of property is extremely difficult if these features are to be preserved.

The lower inclusion rate for capital gains and capital losses and the restricted use of capital losses cause a number of difficulties where the character of property changes either in a rollover or in other transactions where the Act specifically seeks to preserve certain characteristics of the property following the transfer. The requirement in section 10 that a taxpayer value inventory at the lower of cost and fair market value results in the recognition of losses before the actual disposition of inventory.[170] The inventory valuation rules have been adopted from ordinary principles of commercial accounting. However, they form a significant departure from the realization principle, one of the basic principles of income taxation, and their use for tax purposes has been strongly criticized.[171]

It would be relatively easy to remove the problems stemming from the changing character of property if the Act were amended to make capital gains and losses fully subject to tax, with capital losses deductible from all sources of income, and to require that inventory be valued at its original cost. However, these amendments are highly unlikely, and it would therefore be of little practical use to base any recommendations for change on their adoption.

The rollover provisions considered in this article generally presume that property will retain its character as a consequence of the rollover, although this is not necessarily the case. If the character of the property changes, unintended tax consequences may arise when the property is subsequently disposed of. The underlying rationale for rollover treatment must be considered in the context of any proposals for change. Writing in

170 The same result can arise where the alternative method in regulation 1801 is utilized.

171 Arnold, supra footnote 17, at 332-33.

the context of proposals for capital gains tax in New Zealand, Krever and Brooks note five somewhat overlapping rationales for rollover treatment:[172]

1) continuity of interest;
2) involuntariness of the disposition;
3) ability to pay;
4) economic efficiency; and
5) the furtherance of social policy goals extrinsic to the tax system.

One or more of these rationales may underlie the various rollovers discussed in this article. None is wholly satisfactory. Ultimately, Krever and Brooks note that

> even though when enacted [rollover provisions] might reflect a fine balancing of economic advantage and disadvantage, over time (like all tax concessions) they are more likely to reflect the balance of political power than the application of policy criteria.[173]

The rollover treatment accorded to various corporate reorganizations may be justified under a continuity of interest argument as well as on the ground of economic efficiency.[174] The former, according to Krever and Brooks, may justify corporate reorganizations "only when, although the form of the shareholder's investment has changed, the substance has not."[175] On this basis, rollover treatment is justified only if the character of the taxpayer's property is the same before and after the exchange. Arguably, subsection 85(1) and 97(2) rollovers should not be available where the taxpayer transfers depreciable property or inventory in exchange for shares or a partnership interest that constitutes capital property. It may be further argued that the rollovers should be limited to circumstances where the transferor controls the transferee.[176] Similarly, it may be argued that the automatic rollover for section 87 amalgamations and section 88 windups should not be available where the character of the property is different following the transaction.

Rollover treatment given to corporate reorganizations involving related taxpayers may be justified on the basis that the corporate group

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172 Rick Krever and Neil Brooks, *A Capital Gains Tax for New Zealand* (Wellington: Victoria University Press for the Institute for Policy Studies, 1990), 122-30.

173 Ibid., at 122-23. The introduction and later withdrawal of various proposals in the 1981 budget, supra footnote 113, provide a good illustration of this point.

174 See also Paul B. Singer, "The Rollover Provisions in Respect of Corporate Reorganizations Provided Under the Income Tax Act: Efficiency and Equity as Policy Considerations" (1983), vol. 31, no. 4 *Canadian Tax Journal* 569-614.

175 Supra footnote 172, at 126.

176 This limitation is easier to justify for a subsection 85(1) rollover than for a rollover under subsection 97(2). In the absence of subsection 97(2), taxpayers could capitalize partnerships only with cash or assets that have not appreciated in value. Since a partnership is treated as a transparent entity with respect to the disposition of partnership property, there is little need for a control requirement in subsection 97(2).

constitutes a single economic unit and thus intragroup transfers should not give rise to immediate tax consequences. On this basis, the rollover under section 88 is justified since the parent and subsidiary corporations are necessarily related, and the rollover need not be restricted to circumstances where the parent will use the property acquired on the winding up in a manner similar to its use by the subsidiary. However, the rollover under section 87 should be available only where the predecessor corporations are related. In addition, subsection 85(1) rollovers are justified only where the transferor controls (or is related to) the transferee following the transfer.

If the rationale for rollover treatment is economic efficiency—in other words, if the immediate recognition of tax would distort the operation of the marketplace so that assets would not be used in the most efficient manner—a more generous approach to all corporate reorganizations may be justified. The fact that the transfer of property in corporate reorganizations yields no cash also may justify rollover treatment.

The rollover treatment available to interspousal (and certain intergenerational) transfers may be rationalized on a number of bases. The most often-cited basis is the recognition of spouses (and families) as a single economic unit, even though each spouse is generally treated as a separate economic unit for tax purposes. The lack of cash generated on such transactions, as well as the administrative difficulty in monitoring interfamily transfers, also may justify rollover treatment. Finally, where property is transferred to a spouse in settlement of marital rights, the transfer may be considered involuntary and therefore deserving of rollover treatment.

This brief overview demonstrates the wide range of justifications that underlie the rollover treatment given to various transactions or events in the Act. Without first choosing the appropriate theory for rollover treatment for a particular transaction, one cannot satisfactorily determine the appropriate scope of the rollover and, in particular, the treatment of property that changes character following the transfer.

Related to the theory for rollover treatment is the effect that a rollover should have for tax purposes. If the purpose of a rollover is to *defer* the incidence of tax, it may be argued that a notional disposition should occur at the time of the rollover at fair market value, but the payment of tax should be deferred until the ultimate disposition of the property.[177] On the other hand, the purpose of the rollover may be to defer the recognition of a disposition of property for tax purposes, rather than simply defer the incidence of tax on the disposition.[178] The distinction relates to the

[177] A related issue is whether the quantum of tax owing as a consequence of the notional disposition should be determined in accordance with the rules in effect at the time of the rollover or the rules in effect at the time of the ultimate disposition of the property. These rules may involve not only the rate of tax charged, but also the inclusion rate of any gain or loss involved.

[178] This effect may be intended where, for example, the rollover involves taxpayers that are considered to be a single economic entity.

separate regime applicable to capital gains and losses. If capital gains were fully included in income and capital losses were deductible from all sources of income, the effect of the rollover would be identical whether it was considered a deferral of the tax consequences of a disposition or a deferral of the disposition itself.[179]

Whatever the rationale and intended effect of rollover treatment, a rollover should not have the effect of recharacterizing the tax treatment of gains or losses that would have arisen had there been a taxable disposition or deemed disposition at fair market value, rather than a rollover. Where the property involved in a rollover retains its pre-rollover character, the provisions in the Act present few difficulties in theory or practice. Most of the statutory rollover provisions apparently presume that property characterized in a particular manner before the rollover will necessarily be characterized in the same manner following it—even though, as the examples used throughout this article illustrate, this may not be the case.

The character of property should be preserved through a rollover, and any existing uncertainty should be rectified through statutory amendment. Where the use of the property by the transferor differs from that of the transferee, the change in use should be treated as occurring immediately following the rollover. The current Act does not deal with changes in the use of property from one income-earning use to another. The enactment of statutory provisions applicable to such changes in use would kill two birds with one stone.

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[179] Consider the rollover provided under paragraph 70(6.2)(d). Suppose that a taxpayer dies holding land inventory with a cost of $100,000 and a fair market value of $500,000. The property vests indefeasibly in the taxpayer's spouse within 36 months after the taxpayer's death. The property is characterized as capital property to the surviving spouse, and the spouse ultimately sells it for $350,000. If the rollover is intended to defer the incidence of tax, a notional disposition should arise at the time of the transfer, giving rise to a notional income inclusion of $400,000. If effect is given to the notional disposition when the spouse sells the property, the spouse must include $400,000 in income and recognize a $150,000 capital loss. The capital loss cannot offset the income inclusion and will not be deductible at all if the spouse has no capital gains in that year. If, on the other hand, the purpose of the rollover is to defer the recognition of a disposition, the sale by the beneficiary gives rise to a $250,000 profit, which will be treated as a capital gain. The tax consequences in this example would be identical if capital gains and losses were fully included in income and capital losses were deductible against all sources of income.