TAX FOR THE Owner-Manager

Editor: Thomas E. McDonnell, QC

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THE FAIRNESS PROVISIONS: JUDICIAL REVIEW

Persuading a court to overturn a ministerial decision to deny a fairness application has proved to be extremely difficult. The recent decisions in *Edison* and *Dollard Investments Limited* (FCTD 2001) are noteworthy exceptions to the usual rejections of appeals of this kind.

The taxpayers were reassessed tax, penalties, and interest in respect of their 1991 to 1993 taxation years. They applied to the St. John's Tax Services Office for relief of the penalties and interest under the fairness provisions of the Act (subsection 220(3.1)). The Appeals officer charged with the review recommended to the chief of Appeals that the application be denied. The chief approved the recommendation, signed the documents prepared by the officer, and notified the taxpayers that their requests were denied. His letter advised them that they could seek administrative review of the denial by putting their "concerns in writing to the Director of the Newfoundland and Labrador Tax Services Office."

The taxpayers duly requested a review. It was considered by a review committee composed of five assistant directors of the local Tax Services Office, among them the chief of Appeals who had made the initial decision. The review committee unanimously recommended the appeals be dismissed, and on this advice the acting director of the CCRA in St. John's did so.

The taxpayers applied to the court for a review of this decision. The issue was whether the CCRA followed the rules of natural justice and procedural fairness in denying the application. In particular, the court considered whether the taxpayers' "legitimate expectation" of fairness in the processing of the application had been breached. The court reviewed the process that led to the decisions and said that the existence of the fairness process itself created a legitimate expectation that the appeal process would proceed independently of the original decision maker. It held that the process followed in this case was inadequate.

Information Circular 92-2 sets out the CCRA's policy on the application of the fairness provisions. The court concluded that the taxpayers were legally entitled to expect that the guidelines in the circular would be followed. In particular, they were entitled to believe that a second review of a negative "fairness" decision would be impartial and made independently of the original decision maker. In allowing the application, the court said: "It is in the failure of the [minister] to follow his own published procedural guidelines that I find a breach of the duty of fairness owed to the [taxpayers] under the rules of natural justice and procedural fairness."

The court ordered that the applications for fairness relief be reconsidered by another Tax Services Office. The court did not direct the minister to allow the fairness applications per se, because that was beyond the jurisdiction of the court.

Practitioners will want to consider the implications of this case in any matter involving an application under the fairness provisions. The decision emphasizes the importance of identifying the process by which the fairness decision was made. This may raise difficult procedural issues. For now, the lesson from this case seems to be that a taxpayer should challenge any decision by the minister to deny a fairness application in order to be sure that the process followed was legally appropriate.

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In This Issue

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LATE-FILED SECTION 216 RETURN

The decision in *Wright* (TCC 2001), a recent case heard under the informal procedure of the Tax Court of Canada, has implications for non-residents holding rental property in Canada and their agents.

The taxpayer was a non-resident who owned an interest in a rental property in Canada. As such, he was liable under part XIII of the Act to pay tax based on the gross amount of rents received. Tax under part XIII must be withheld when collected. The taxpayer's agent failed to do so.

Under section 216 of the Act, a non-resident may elect to file an income tax return and be taxed under part I of the Act. This allows the taxpayer to claim expenses against the gross rents and, if an individual, to pay tax at graduated rates. The part I return must be filed within two years.

In this case, the taxpayer filed his part I return after the statutory deadline and requested that it be accepted by the CCRA. In *Kutlu* (TCC 1997), a case with similar facts, the CCRA was compelled by the Federal Court Trial Division to accept a late-filed section 216 return on the basis that subsection 220(3) provides that the minister may accept a late-filed return and that it was improper in the circumstances for the minister to refuse to do so.

After a prolonged period of wrangling, the minister finally accepted Wright's late-filed return. However, the CCRA then assessed the taxpayer for interest in respect of the tax under part XIII that should have been withheld and paid by the taxpayer's agent during the time the rent was collected, up to the time the part I return was filed.

At first blush, it seems reasonable that taxes that should have been withheld, but were not, should at least bear some interest. However, the taxpayer argued that the filing of a part I return under section 216 precludes any liability under part XIII. Section 216 clearly states that the taxpayer, by filing the return, brings himself under the rules of part I *in lieu of* those in part XIII. Thus, since there is no part XIII liability, there is no basis for assessing interest. The court agreed that logically no interest can be assessable in respect of an amount that is not owing, and allowed the appeal.

The *Wright* and *Kutlu* decisions put the CCRA in a difficult position with regard to late-filed returns under section 216. *Wright* was heard under the informal procedure, and thus is not a binding precedent. However, the legal argument is compelling and, together with *Kutlu*, may be persuasive should a similar case arise.

The CCRA has stated that it is currently reviewing its administrative position with regard to the acceptance of late-filed section 216 returns. *Wright* may accelerate this process and perhaps require the CCRA to seek legislative changes.

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PURIFICATION TRANSACTIONS

Advisers to owners of a small business corporation (Opco) may often suggest that non-active business assets be removed from the corporation so that a subsequent disposition of the corporation's shares will qualify for the capital gains exemption (CGE). While this so-called purification transaction can often be effected on a tax-free basis, there are pitfalls. The following fairly typical examples illustrate some of the issues that should be considered here.

Case 1. X is the only shareholder of Opco. While there is no buyer for the shares in sight, X's adviser suggests that the non-qualifying assets be removed in a series of transactions that will crystallize X's CGE.

Case 2. X is the only shareholder of Opco. An offer has been received from an unrelated buyer. A purification transaction is recommended prior to the sale.

Case 3. X and Y, unrelated parties, each own 50 percent of Opco. They are considering a combined purification-crystallization transaction. No buyer is in sight.

In each case, assume that Opco would be a qualified small business corporation but for the ownership of "investment" assets. A simplified balance sheet for Opco (adjusted to fair market values) shows the following:

Goodwill	$ 800,000	(tax value nominal)
Investments	$ 200,000	(tax value zero)
Equity	$1,000,000	

Consider the following purification strategies.

1) In cases 1 and 2, X transfers 20 percent of his shares in Opco to a newly formed Holdco, in exchange for preferred shares of Holdco retractable at $200,000, and common shares. The parties elect a transfer price under section 85 equal to X's cost. In case 3, X and Y each transfer 20 percent of their shares to a Holdco on similar terms.

2) Opco rolls the investment assets to Holdco in exchange for preferred shares having a retraction amount of $200,000. The parties make a section 85 election at Opco's cost. In all cases, the paid-up capital of the shares is set at an amount that does not bring section 84.1 into play.

3) Opco then purchases for cancellation its common shares held by Holdco with a $200,000 non-interest-bearing demand promissory note.

4) Holdco redeems its preferred shares held by Opco, transferring the $200,000 promissory note as consideration.

5) The intercompany note is cancelled.

After the completion of these transactions, the non-qualifying assets are in Holdco and the shares of Opco qualify for the CGE.

The tax consequences seem to be as follows.

In cases 1 and 3, the CGE is crystallized by X (X and Y) exchanging their "old" Opco common shares for a combination of new Opco common and preferred shares at an appropriate elected amount. In case 2, X then completes the sale of the Opco shares to the third party.

As a consequence of the purchase for cancellation (step 3) and the share redemption (step 4), Holdco and Opco are deemed to receive dividends. The issue is whether these dividends are to be treated as dispositions of capital property under subsection 55(2).

In case 1, paragraph 55(3)(a) applies, and the dividends are not treated as capital gains under subsection 55(2).

Note that in case 2, since the series of transactions contemplated the sale of the Opco shares to an unrelated party, the paragraph 55(3)(a) exemption does not apply. The intercorporate dividend is therefore subject to subsection 55(2) and is taxed as a capital gain. (On the assumed facts, there is no relief on the basis of safe income or the payment of part IV tax.)

In case 3, even though X and Y are not crystallizing their CGEs in contemplation of a share sale to a third party, the CCRA takes the position that paragraph 55(3)(a) does not apply to shelter the dividends because one or the other (or both) of X and Y is (are) unrelated to Holdco and has (have) acquired a significant increase in the shares of Holdco as a part of the relevant series of transactions. On a technical basis, it is difficult to contest the CCRA's position on the assumed facts.

A final caution: even where the corporation involved in the purification-crystallization transactions is owned exclusively by members of the same family, the paragraph 55(3)(a) exemption may not apply by reason of subparagraph 55(5)(e)(i), which deems brothers and sisters not to be related for purposes of section 55.

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Owner-Manager Compensation 2: Deferred Profit-Sharing Plans

Editor's note: This is the second in a planned series of notes by Mr. Belley on owner-manager compensation.

Section 147 of the Act sets out the rules for deferred profit-sharing plans (DPSPs). In overview, these rules allow an employer to make tax-deductible payments to a trust (of whom the employer can be a trustee) for the benefit of its employees and former employees, who will not be taxable until they receive payments from the plan. While this is usually after retirement, it may be earlier if the plan documents so provide (flexibility is of the essence). Though the owner-manager cannot be a member of the plan (paragraph 147(2)(k.2)), a DPSP remains a flexible tool, both as a tax-advantaged mechanism to reward employees and as a way to manage the taxable income of a private corporation. Cases on the topic are rare, but several technical interpretations (TIs) are worth discussing.

Only a for-profit employer can register a DPSP with the CCRA: a non-profit organization cannot do so (TI 9603366). The employer may choose the basis of funding the plan, which may be based on employee performance. However, the plan must specifically provide that payments into it are to be allocated and segregated in the year of payment to each individual beneficiary for whom the amount is paid. A commitment is required: a promise to contribute does not result in vested contributions (TI 2000-0041245).

The trustee of the plan must invest the plan assets in "qualified investments" (QIs). QIs include shares, stock options, notes, bonds, debentures of Canadian corporations and shares of foreign corporations listed on a prescribed exchange, annuities, and money, whether Canadian or foreign (section 204). Interestingly enough, especially for private corporations, a DPSP may invest in the employer corporation's shares (TI 9821195), subject to certain conditions pertaining to transferability and minimum earnings. In effect, the employer may benefit from tax-assisted contributions from its employees. However, it has been held that DPSPs established for the de facto benefit of the controlling shareholders of the employer will not be recognized: *Goldstein* (TRB 1973). Thus, notes, bonds, debentures, and similar obligations of a contributing employer are not QIs (TI 9606285). In this respect, if an employer managing the funds is found liable in damages for losses attributable to poor investments, damages payable to the plan are not included in the income of the beneficiaries. Neither the employer nor the employee is considered to have made a contribution to the plan (TI 705055). However, if a DPSP receives a non-QI but reinvests it in a QI within a reasonable time, it will not be considered to have acquired a non-QI (TI 9606285).

DPSP contributions are subject to the contribution limits now in effect for retirement plans generally. A beneficiary of a DPSP will have his RRSP contribution room reduced by the amount of the employer's contribution to the DPSP on his behalf. However, where a beneficiary has a pension adjustment reversal arising from termination in the year from a DPSP, the adjustment restores RRSP contribution room (TI 9915786). A beneficiary under a DPSP may transfer part of his entitlement to his RRSP and avoid taxation on withdrawals of funds from the DPSP. Although there is no rollover provision allowing the transfer of funds from a DPSP to a spouse's RRSP, the result can be achieved indirectly through the employee's RRSP, with the blessing of the CCRA (TI 9803455). The DPSP rules are quite flexible. Most important, they allow the employee discretion in deciding when to withdraw funds from the plan—and, thus, when income will be taxable. The plan may invest in shares of the employer, thus providing a useful source of financing for the business. Finally, there is the benefit of creating a pooled fund for investment, thereby providing the plan beneficiaries with the opportunity to attract professional management for their funds.

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Rectification: SCC Denies Leave in Juliar

On May 24, 2001, the SCC dismissed the CCRA's application for leave to appeal the decision of the Ontario Court of Appeal in *Juliar* (Ont. CA 2001).

In that case, the Ontario court granted a rectification order permitting the parties to undertake a share sale to replace a promissory note delivered as consideration for the sale of shares in an Opco for shares of a Holdco purchaser, thereby avoiding the application of section 84.1. The decision of the Ontario Court of Appeal therefore stands in that case.

We understand that as a result of the *Juliar* decision, the CCRA has developed a draft interim policy with respect to rectification matters, the main elements of which are likely to be as follows:

- The CCRA does not have the authority to amend contracts between parties.
- The CCRA will not adjust filings or elections except to correct clerical or administrative errors in accordance with paragraph 16 of *Information Circular* 76-19R3, or as permitted by statute. The CCRA will not agree to abide by after-the-fact changes to a contract to change the basis of an assessment without the benefit of a court order.
- Auditors must assess on the basis of the facts present at the time of the audit. Parties to a contract should notify the minister by a letter to the director of the Tax Services Office if they intend to seek rectification via a court order. Taxpayers may protect their interests by filing a notice of objection. If notice is served in this way, the notice of objection may be held in abeyance until the matter of rectification is settled. If an order for rectification is issued, the minister will deal with the notice of objection accordingly.
- The CCRA may oppose an application for rectification where it is not satisfied that the original intentions of the parties are being respected. This will include amendments to achieve after-the-fact tax-planning results. The CCRA may choose not to oppose an application for rectification where the amendments are integral to achieving the original intentions of the parties.

Assuming that the CCRA proceeds with the policy as outlined above, the following points should be considered:

- Generally, the CCRA is now unlikely to accept corrective amendments to an existing agreement, absent a court-ordered rectification.
- If a potential rectification issue arises as a consequence of an assessment, consider filing a notice of objection or appeal, pending a decision to proceed with a rectification application.
- What steps are necessary to ensure that the CCRA is bound by a rectification order? In *Dale* (FCA 1997), an order allowing the granting of supplementary letters patent creating a class of preference shares to perfect a section 85 election was held to be binding on the minister notwithstanding that he was not a party to the proceeding. It is not clear whether the reasoning in *Dale* will automatically apply in other rectification situations. Consequently, always consider serving the minister with notice of the rectification application. This may be the best way of ensuring that he is bound by any order subsequently received. Since the rules relating to rectification may vary by province, counsel should be consulted regarding the specific procedure to be adopted.

■ Because rectification is a matter of provincial jurisdiction, the circumstances in which rectification will be granted may also vary by province.

■ The new CCRA policy addresses situations where the taxpayer is in the midst of the audit process. What should taxpayers do if the error is discovered before audit? In such cases, it may be prudent to consider making a voluntary disclosure so that the CCRA has sufficient facts on which to base a decision whether or not to oppose a rectification application.

It should be emphasized that this is a draft interim policy and may be subject to change before it is finalized.

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The Alberta-Resident Trust

Editor's note: Income tax rates vary across Canada, depending on where the income is earned. This article and the next ("Recent Amendments to the Alberta Corporate Tax Act") indicate some factors to be considered when the situs of a taxable amount is moved to Alberta.

An inter vivos trust is taxed at the highest combined federal-provincial rate applicable to an individual. This rate varies by province, from a low of 39 percent in Alberta to a high of 48.72 percent in Quebec. An Alberta-resident trust may be used to reduce the tax otherwise payable on non-Alberta-source income by an individual who is resident outside the province and is taxed at the top rate.

The top rates in the 10 provinces in 2001 are shown below. The tax saving attributable to shifting ordinary income to an Alberta-resident trust ranges from 6 percent to 9.72 percent, depending on the province in which the beneficiary resides.

British Columbia	45.70
Alberta	**39.00**
Saskatchewan	45.00
Manitoba	46.40
Ontario	46.41
Quebec	48.72
New Brunswick	46.84
Nova Scotia	47.34
Prince Edward Island	47.37
Newfoundland	48.64

There is no statutory rule that determines the residence of a trust. The leading court case on the point is *Thibodeau* (FCTD 1978), which held that the residence of a trust is the place where the trust carries on its business and its central management and control is located. For a trust to be considered resident in Alberta, the majority of trustees should reside and carry on the activities of the trust in that province.

The following examples show how the income tax benefits of an Alberta trust vary depending on the type of investment income.

Example 1: Interest. Assume that Mr. X contributes $2,500,000 to a family trust resident in Alberta. The income and capital beneficiaries of the family trust are Mr. X's adult children. They reside in Manitoba and are in the top tax bracket. Assuming an 8 percent rate of return on investment, annual interest income is $200,000.

Estimated Manitoba tax: $200,000 @ 46.40%	$92,800
Estimated Alberta tax: $200,000 @ 39.00%	$78,000
Annual tax savings	$14,800

Example 2: Dividends. Assume that Mr. X owns 100 percent of Opco, a small business corporation. Mr. and Mrs. X are in the top tax bracket. Mr. X exchanges his common shares for preferred shares in the course of an estate freeze. A discretionary family trust resident in Alberta subscribes for a new class of common shares of Opco. The income and capital beneficiaries of the family trust are Mr. X, Mrs. X, and their minor children, all of whom are residents of Ontario. Annual dividends of $100,000 are paid by Opco to the family trust.

	Ontario resident	*Alberta trust*
Annual dividend	$100,000	$100,000
Provincial tax rate (net of dividend tax credit)	31.34%	24.08%
Estimated tax	$ 31,340	$ 24,080
Annual tax savings		$ 7,260

Example 3: Capital gains. Assume that Mr. X owns capital property (Opco shares) with a $5,000,000 unrealized gain. Mr. and Mrs. X reside in British Columbia and are in the top tax bracket. Mr. X transfers his Opco shares to a spousal trust resident in Alberta at his cost under subsection 73(1). The spousal trust subsequently disposes of the shares. The trustee elects to pay tax on the capital gain in the trust pursuant to subsection 104(13.2).

	BC resident	Alberta trust
Capital gain	$5,000,000	$5,000,000
Taxable portion	50%	50%
Taxable capital gain	2,500,000	2,500,000
Provincial tax rate	x 45.70%	x 39.00%
Estimated tax	$1,142,500	$ 975,000
Tax savings		$ 167,500

There are many other ways to use Alberta trusts. Careful planners will be mindful of the possible application of the income attribution rules in sections 74.1 to 74.5 and subsection 75(2). Consider too the possible application of any applicable provincial anti-avoidance rules. The recent Alberta amendments that may affect tax-deferred transfers are discussed in the following article, "Recent Amendments to the Alberta Corporate Tax Act." With proper planning, an Alberta trust can be a very useful tool for reducing income tax.

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Recent Amendments to the Alberta Corporate Tax Act

Recent amendments to the Alberta Corporate Tax Act (ACTA) provide that taxpayers electing under subsections 85(1), 85(2), and 97(2) of the federal Income Tax Act (ITA) must file a copy of the prescribed federal form with Alberta. This is a significant change in Alberta tax-compliance procedures. Prior to the amendments, a copy of the federal form was required provincially only if the federal and provincial elected amounts were different.

Taxpayers subject to ACTA are now required to file a copy of federal form T-2057, T-2058, or T-2059 (within the time limits that apply under the ITA). Alberta has indicated that the filing requirements imposed by the amendments will not be enforced in respect of any property transfers that occurred prior to May 31, 2001. No other forms need to be filed in Alberta, provided that the Alberta and federal elected amounts are the same.

If an Alberta elected amount differs from the federal, both a prescribed Alberta election form and a copy of the prescribed federal election form are required to be filed. The copy of the prescribed federal election form must be filed with Alberta within the time limitations that apply for filing under the ITA. For the Alberta election to be valid in these circumstances, both the transferor and the transferee must be a "qualified party," which means that a person must have an Alberta "allocation factor" of at least 90 percent for the taxation year in which the transfer occurs. (The allocation factor is obtained by dividing taxable income allocated to Alberta by the total taxable income of the corporation or partnership.) The transferee must also be a qualified party throughout each of its taxation years that commence in the 36 months ("the 36-month period") subsequent to the end of the taxation year in which it acquires the property.

Other points that should be noted:

- If the Alberta elected amount is different from the federal, there may be restrictions on the Alberta elected amount.
- The amendments suggest that the Alberta election is not to be filed until after the end of the 36-month period. Alberta has indicated that it will accept earlier-filed elections, with the proviso that appropriate adjustments will be made later if the transferee fails to be a qualified party during the full 36-month period.
- Pending publication of new prescribed election forms, taxpayers may file a copy of the federal election form together with a letter noting the differences in the elected amounts.
- The amendments specify that the penalty provisions of ITA subsections 85(1), 85(2), and 97(2) apply for Alberta tax purposes. However, the penalties payable to Alberta are one-half the amounts in the ITA.
- Though the Alberta Personal Income Tax Act has not been amended for transfers of property by individuals, the wording of the amendments may be broad enough to include certain transfers of property by individuals.
- Alberta Revenue has stated that *Information Circular* CT-2R1, "Filing Requirements," will be amended to provide assistance to taxpayers with regard to the amendments.

The amendments will make it more difficult for tax planners to give certain types of income and gains an Alberta situs so as to take advantage of the lower rates applicable there. Nonetheless, possibilities for effective Alberta-based planning remain open for the careful adviser.

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Trust and Corporation Affiliated: A One-Hat Principle?

In a recent technical interpretation, the CCRA says that subsection 40(3.6) will apply to deny a capital loss on the redemption of a trust's shares in a corporation where a sole trustee controls the corporation through shares held personally (document 2000-0024775, February 23, 2001). One scenario described in the document involves a qualifying spouse trust that controls two companies. The spouse has died, triggering recognition of accrued gains. A son is the sole surviving trustee of the trust. He owns in his own right all the other voting shares in the two companies. If the trust shares are redeemed, he will control the companies. Once he does so, he and the corporation are affiliated persons: subparagraph 251.1(1)(b)(i). Technically, for the stop-loss rule to apply, the trust and the company must be affiliated immediately after the disposition triggered by the redemption. The CCRA, apparently relying on subsection 251.1(4), takes the position that the son as sole trustee is affiliated with himself as the person controlling the companies, thus causing the trust to be affiliated with the corporation after the redemption and resulting in the loss denial.

The CCRA refers to three technical interpretations issued in 1999 (0010805, 0010825, and 0015705) for the following principles:

1) An estate that has more than one executor, none of whom is affiliated with the others, and that does not itself have control over a corporation that is controlled by a related group consisting of the executors, is not normally affiliated with the corporation because it is not a person described in (a), (b), or (c) of the definition of "affiliated person." This assumes that under the deceased's will, decisions must be made by at least a majority of the directors.

2) If Mr. A owns all of the voting common shares of A Co and an inter vivos trust of which he is the sole trustee owns all the non-voting preferred shares, any loss on the redemption of the preferred shares owned by the trust will be denied under subsection 40(3.6). Because Mr. A owns all the voting shares of A Co, he is affiliated with A Co by virtue of subparagraph 251.1(1)(b)(i). Further, as sole trustee of the trust, Mr. A is the legal owner of those shares. By virtue of paragraph 251.1(4)(a), Mr. A as trustee is affiliated with himself as the controlling shareholder of A Co. Therefore the amount of any capital loss arising on the redemption of the preferred shares is denied under subsection 40(3.6).

The principle in point 1 above is set out in documents 1999-0010805 and 1999-0010825, and is consistent with the CCRA's past positions, often described as the "two-hat" doctrine. The second principle, that a person acting on his own behalf is affiliated with himself as trustee, is set out in document 1999-0015705 and appears to be the basis for the February 23, 2001 interpretation.

Technical Interpretation 1999-0015705 (March 2, 2000) and the apparent erosion of the two-hat doctrine are reviewed by Hugh Woolley in 2000 *British Columbia Tax Conference* (available through the Foundation's library). He describes conversations with Finance and CCRA officials which suggest that while they may agree that the result described in point 2 above is inappropriate, there is not yet agreement on how the matter should be rectified. This most recent interpretation by the CCRA strongly suggests that it will continue to administer the law on the basis of its published interpretations, even though the results may be anomalous.

Pending a legislative amendment or administrative clarification, planners who seek to trigger capital losses on the redemption of shares following death should ensure that control of the corporation after the redemption is not held by a sole trustee, or by an affiliated group of trustees.

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Section 17: A CCRA Update

The possible application of section 17 in several scenarios involving cross-border loans was discussed with CCRA officials at an APFF-sponsored conference in Montreal on May 16, 2001. The following points will be of interest to Canadian corporations with US or other foreign operations.

Scenario 1. A Canadian corporation (Canco) owns all of the shares of FA 1. FA 1 is a US corporation, formed to acquire all of the shares of FA 2. FA 2 is also a US corporation; it derives all of its income from an active business conducted there. Canco makes a non-interest-bearing loan to FA 1 to enable it to finance the purchase. Immediately after the acquisition, FA 1 and FA 2 merge. The merger was part of the acquisition plan; therefore, FA 1 did not anticipate receiving dividends on the FA 2 shares, but rather expected to earn business income from FA 2's assets.

The CCRA was asked whether subsection 17(8) will apply to exempt the loan from the application of subsection 17(1) in view of the requirement in the subsection that the borrowed money be used to earn income from an active business. The CCRA said that the exemption would apply in such a case.

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Scenario 2. A Canadian corporation (Canco) owns all of the shares of FA 1. FA 1 is a US corporation and derives all of its income from an active business conducted in the United States. Canco makes a non-interest-bearing loan to FA 1 to enable it to pay a dividend to Canco.

When asked whether subsection 17(8) will apply in these circumstances, the CCRA said that it will not apply, because the loan proceeds were not used for the purpose of earning income from an active business. The same result would follow if the loan was used to redeem capital rather than to pay the dividend. The CCRA did not offer to reconcile this view with its administrative position regarding the application of paragraph 20(1)(c) set out in *Interpretation Bulletin* IT-80.

The CCRA was asked whether subsection 17(8) would apply in a situation in which FA 1 used the loan proceeds to repay a bank debt. The CCRA officials were prepared to be more flexible in such a case. They said that the answer depended on the initial use of the borrowed funds by FA 1: if the initial use was for the purpose of earning income from an active business, the subsection 17(8) exemption would apply.

Scenario 3. A Canadian corporation (Canco) owns all of the shares of FA 1. FA 1 is a US corporation and owns all of the shares of FA 2, another US corporation. Neither FA 1 nor FA 2 earns income from an active business. Canco makes a non-interest-bearing loan to FA 1, which FA 1 on-lends to FA 2. FA 2 uses the funds to purchase all of the shares of another US corporation, FA 3. FA 3 derives its income exclusively from an active business conducted by it in the United States. Subparagraph 17(8)(a)(ii) applies to the loan from Canco to FA 1. FA 2 and FA 3 merge.

When asked whether subsection 17(8) will apply to the Canco loan to FA 1 after the merger, the CCRA confirmed that subsection 17(8) should apply in such a case, noting that clause 95(2)(a)(ii)(B) would have applied to exempt interest on the loan from FA 1 to FA 2 from inclusion in FAPI if interest had been charged on that loan.

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Interest Deductibility on a Leveraged Buyout: IT-315

A common acquisition structure uses a new corporation that borrows funds to acquire the shares of the other corporation (Targetco). After the acquisition, the two corporations are combined by means of an amalgamation or a winding up. Generally, *Interpretation Bulletin* T-315 indicates that the combined entity may deduct the interest expense on the money borrowed to acquire Targetco. It now appears that the CCRA may have refined its administrative policy in this regard.

At the 1998 APFF Congress, the CCRA stated that its administrative position as outlined in IT-315 will be limited to cases in which the transactions are between persons dealing at arm's length, where the purchasing corporation acquires control of all or substantially all of the shares of Targetco, and where the transactions do not result in an avoidance of tax or an undue tax advantage.

The requirement that the taxpayer acquire control of Targetco is based on the argument that the borrowing of funds to acquire the shares of a company that subsequently will be combined with the purchaser is essentially the same as the borrowing of funds to acquire the assets of that company directly. Although this is apparently the current position of the CCRA, some practitioners believe that it does not reflect the weight of the decided cases on this subject.

IT-315 has not been amended to reflect the additional conditions on interest deductibility expressed at the 1998 APFF Congress. However, in recent discussions, the CCRA has indicated that these conditions do represent its position and will be applied when determining the deductibility of interest on funds borrowed to acquire shares in a Targetco that is then combined with the acquiring corporation.

Practitioners should be aware of these additional conditions, especially where a corporation borrows to acquire shares of another corporation representing less than control, and it is intended that the two corporations will be merged subsequent to the acquisition. In such a case, the CCRA's current position may result in the denial of the interest deduction subsequent to the merger of the two corporations.

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