TAX FOR THE Owner-Manager

Editor: Thomas E. McDonnell, QC

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EXPANDING INTO THE US

A Canadian corporation (Canco) generally conducts business in the United States in one of three ways.

1) Canco has no permanent presence in the United States. It solicits US customers through US advertising, but ships its products directly from Canada.

2) Canco does not have a permanent presence in the United States, but sends employees there to solicit business, install products, perform after-sales service, etc.

3) Canco has a permanent presence in the United States.

When Canco's operations fall into category 1, the income generated from its US activities is considered to be Canadian-source income and thus not taxable by the US authorities under the Internal Revenue Code (IRC). When Canco's operations fall into category 2 or 3, income from the US activities is usually taxable under the IRC. However, because of the provisions of the Canada-US tax treaty, Canco's US income will be taxable in the United States only if Canco has a permanent establishment (PE) there as that term is defined in the treaty. (Note that the various states are not bound by the treaty; this article does not deal with state tax issues.) Nevertheless, Canco is subject to US disclosure requirements, which, if ignored, can result in significant penalties.

The PE definition in article V of the treaty goes beyond mere physical presence. Article V(5) provides that a person other than an independent agent is deemed to be a PE if such a person "has, and habitually exercises in that State, an authority to conclude contracts." Therefore, if the owner-manager of Canco regularly concludes contracts in the United States, Canco has a PE there.

Conversely, article V(7) provides that carrying on business in the United States through a broker, a general commission agent, or another independent agent will not create a PE in the United States as long as such persons are acting in the ordinary course of their business.

Article V(6) provides that the use of a facility in the United States for the purpose of storage, display, or delivery of goods or merchandise is not a PE; nor is the maintenance of a stock of goods or merchandise for the purpose of storage, display, or delivery.

Although the lack of a PE in the United States means that Canco is not taxable there, category 2 operations will result in some of Canco's income being considered to have a US source; therefore, it will not be eligible for the Canadian small business deduction (SBD). Bonusing down to the small business level will not render all of Canco's income eligible for the SBD. To allow the income to be bonused down to zero, consideration should be given to conducting category 3 operations in a separate Canco that does not conduct any Canadian business.

Category 3 operations will result in Canco's being taxable in both the United States and Canada. The US-source income will not be subject to provincial tax, but the federal abatement is not available. US taxes may include branch tax (subject to a lifetime exemption of Cdn $500,000). Although Canco will be entitled to a foreign tax credit, there is a risk that the full foreign tax credit will not be available because of differing Canadian and US rules of income computation. This may make it necessary to conduct category 3 operations through a US corporation unless significant startup losses are anticipated.

If a US Opco is used, consider inserting a US Holdco between Canco and the US Opco. With proper structuring, US Opco profits can be distributed to the US Holdco free of US tax, thereby providing protection against creditors of US Opco should that business fail.

If a US corporation is used and the income is from the provision of services, then, to the extent that the services are performed by the Canadian-resident owner-manager, the income of the US corporation is deemed to be passive income (paragraph 95(2)(b) of the Act). The income is then taxed to the Canadian parent as foreign accrual property income (FAPI) even if it is not repatriated to Canada.

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In This Issue

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RECTIFICATION: THE JULIAR SAGA CONTINUES

This topic was discussed in an earlier issue (see Brian J. Wilson, "Rectification: SCC Denies Leave in Juliar," *Tax for the Owner-Manager*, October 2001, at 24) in the context of a draft CCRA policy statement on rectification issues. Of particular interest was the CCRA's statement that it wanted notice of any application to the court for a rectification order.

In Nova Scotia, at least three applications following the approach in *Juliar* were made during 2001. In the first application, a reassessment had been issued and an appeal to the Tax Court of Canada filed. After that, an application for rectification was made. The CCRA was notified of the application but did not participate in the proceedings.

In the second application, the issue of notice to the CCRA was raised by the justice who heard the application. In that situation, no reassessments had been issued and no audit had been commenced by the time the application for rectification was made. The court ruled that the CCRA was a "potential stakeholder" only, not an "active stakeholder," and it was therefore not necessary to advise the CCRA of the application.

In another recent application, the issue of notice to the CCRA was again raised by the justice who heard the application. No reassessment had been issued and no audit had been commenced. After hearing submissions relating to the issue, the justice ruled that notice was not necessary, and the order for rectification was granted.

In September 2001, at the Canadian Tax Foundation's annual conference in Vancouver, Ian S. MacGregor, QC, the assistant deputy attorney general of Canada, advised that it was his personal view that the Crown should be notified in any *Juliar*-type applications. He also indicated that there were two situations in Montreal where orders had been granted, and that the Crown was applying to have those orders overturned.

In what appears to be one of those applications, a decision dated September 26 was issued. Although we do not have full details, it appears that an order of rectification was made relating to some details of an amalgamation, and the Crown later applied to have the order reviewed on the basis that it was an interested party. The court said that the Crown had no right to receive notice, and that the justice

> was therefore satisfied on the proof presented that the motion was well-founded. Indeed, the very interest in avoiding adverse tax consequences that prompts the fisc of Canada to now attack [the] judgment was what expressly motivated the motion for rectification.
>
> The interested parties discovered that the omission of distinguishing features of the two classes resulted in a significant tax liability for [the taxpayer] even though it had been their intention, from the beginning, to avoid such a consequence.
>
> It would be unfair and contrary to the fundamental principles of our system of income tax that the treasury should frustrate licit contractual arrangements entered into by tax payers in good faith simply because they would result in less tax revenue.
>
> Therefore, even though the Canadian tax authorities have assessed [the taxpayer] on the basis of the previous share values, it was available to the amalgamating companies to correct an obvious mistake, even though doing so is detrimental to the position the tax authorities have adopted in relation to the said taxpayer.

Apparently, the Crown has not appealed this decision.

Roy Shultis, the deputy assistant commissioner in the Income Tax Rulings Directorate, Policy and Legislation Branch of the CCRA, said at the annual conference: "At this time, there is no plan for legislative change with regard to these orders. The threshold for getting a rectification order is quite high and the CCRA is relying on provincial courts to maintain that standard" (quoted in *Tax Topics* no. 1544, dated October 11, 2001).

A good argument can be made that the Crown is not automatically entitled to notice because of the essential nature of a rectification order. Rectification is an equitable remedy; in granting the order, the court is confirming that the parties agreed to the terms of their contract at the date of execution. Subsequently, they discover that the written documents do not reflect the agreed terms. If the court agrees, it does not *vary* the terms of the contract at a later date; rather, it gives effect to the legal arrangements *originally agreed to* by the parties. In these circumstances, it is arguable that the CCRA has no right to notice of the application and no right to be heard as part of the proceedings.

In summary, it appears that the ability to effect some corrective action where mistakes were made in the way in which a share transfer was documented may give taxpayers some justified relief. Regardless, whenever a mistake is discovered, it should be analyzed immediately to determine what remedies may be available to reduce the impact of the mistake. Relevant limitation periods, and the possibility of a voluntary disclosure, should be considered.

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GAAR Not Applicable to the ITA Regulations

In two recent decisions, *Rousseau-Houle* (2001) and *Fredette* (2001), the TCC held that subsection 245(2) does not apply when the issue is the application of the Income Tax Act regulations. The questions arose with respect to the application of regulation 1100(11) in the context of the financing of interests in rental property partnerships.

In *Rousseau-Houle*, the taxpayer personally financed the purchase of a rental property and then contributed it to a partnership in exchange for participation units. In *Fredette*, the taxpayer and his spouse borrowed to purchase a rental property and later transferred it to a partnership in exchange for additional partnership units.

The CCRA reassessed the taxpayer on the basis that the formation, existence, and financing of a partnership, and its later acquisition of a rental property, constituted a series of transactions that was primarily undertaken to obtain a tax benefit and thus was subject to the GAAR. Regulation 1100(11) limits the amount of capital cost allowance (CCA) allowed in respect of a rental property to the amount of income earned from the property. By financing the acquisition cost outside the partnerships, each taxpayer was able to claim a larger amount of CCA than would have been allowed if the interest expense had been incurred at the partnership level.

Archambault J found that the financing arrangements were clearly avoidance transactions in the context of each case. He then asked whether the avoidance transactions resulted directly or indirectly in an abuse having regard to the provisions of the Act read as a whole. The notion of a misuse of a provision of the Act was not considered because the court relied upon the French version of the Act, which, unlike the English version, does not refer to "a misuse" of a section.

Archambault J relied upon the clear and specific wording of subsection 245(4) in holding that subsection 245(2) does not apply to an issue involving the regulations. He pointed out that the only provision of the Act that could have been abused in these circumstances was paragraph 20(1)(a), which specifically allows the right to claim CCA in respect of a property. He noted that the tax benefits in the present cases could only contravene regulation 1100(11), but not paragraph 20(1)(a). Subsection 245(4) clearly refers to "the provisions of this Act read as a whole." No reference is made to the regulations. Does the term "the Act" include the regulations? After a thorough review of administrative law principles and the interpretive principles adopted by the SCC in *Friesen* (1995) and *Singer* (1941), he held that the term "the Act" does not include the regulations adopted thereunder. He noted that when Parliament desired to refer to the regulations in references to "the Act," it did so expressly in at least 20 different sections.

The court seems to have relied upon the appellant's counsel's argument, which differentiated the legislative from the executive power while distinguishing the Act from the regulations for the purposes of the GAAR. It is therefore the provisions of the Act that govern. In the context of the GAAR, if there is no abuse of the relevant provision of the Act, there is no room to look to the regulations in support of a GAAR assessment.

Not surprisingly, the Crown has appealed (A-245-01, Federal Court of Appeal).

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The Quest for Origins: Commencement of an Active Business

Whether a business is active or not is a question that has vexed legislative drafters and courts for many years. The notion of an "active" business is an important threshold for various tax incentives in the Act, such as the small business deduction and the capital gains exemption. The case reports are littered with the bleached bones of earlier attempts to restrict tax incentives to "active" businesses (as opposed to passive income-earning endeavours) in such places as the foreign investment property income rules (derailed by *Canada Trustco Mortgage Company*, FCTD 1999) and the small business deduction cases (see *Rockmore*, FCA 1976). The latest instalment in this ongoing judicial saga is *Hudon* (FCA 2001).

Hudon involved the capital gains exemption for qualified shares of a small business corporation. The capital gains exemption is a densely technical section of the Act that relies on a web of terms, some specific to the capital gains exemption and others applicable generally in the Act. In order to qualify for the capital gains exemption, the shares that are sold must be shares of a "small business corporation" as defined in the Act. To qualify, the corporation that issued the shares must carry on an "active business" as defined in the Act. At this point, the definitions become general rather than technical. An active business is defined simply as a business that is not a specified investment business (that is, a business that earns primarily passive investment income such as rents or royalties) or a personal services business (essentially, an incorporated employee). There is no specific rule in the Act to determine what level of activity constitutes a business, or when a business has been commenced. It was this question that lay before the Federal Court of Appeal in *Hudon*.

M. Hudon was one of a number of shareholders of a company called Arnaud Properties. Arnaud Properties owned two classes of properties: some land and buildings, and shares of a subsidiary called Hall River Power Corporation. Hall River in turn owned certain hydroelectric assets and hydroelectric development rights on the Rivière Ste-Marguerite. All parties agreed that the shares of Hall River constituted more than 90 percent of the value of the assets of Arnaud Properties.

Between 1973 and 1975, Arnaud Properties sold some 40 building lots. While it had sold a few lots after 1975, its business plan was to develop the hydroelectric rights owned by Hall River so as to be able to offer cheap electricity as an incentive to prospective purchasers of its lots. To this end, it expended a great deal of effort to be able to develop Hall River's hydroelectric rights. For its business plan to succeed, it had to sell power to customers other than purchasers of its lots: one such prospective purchaser was Hydro-Québec. None of these efforts met with success. Initially it was blocked by a Hydro-Québec policy that prevented private electricity producers from selling electricity to third parties; once this policy was changed, it was unable to conclude an agreement with Hydro-Québec on a price for the electricity it would sell. In 1989, all but one of the shareholders of Arnaud Properties sold their shares to a third party for $2 million. The purchaser was ultimately successful in negotiating a price agreement with Hydro-Québec. The vendors claimed the capital gains exemption to shelter the capital gains on their shares. The CCRA denied the deduction on the grounds that Arnaud had not carried on an active business in the 24 months prior to the time of the sale. It said that Arnaud Properties had carried out steps preparatory to the carrying on of a business, but had not actually commenced carrying on a business. The TCC agreed (1999).

The shareholders appealed to the Federal Court of Appeal, which overturned the decision of the TCC. It said that the TCC had taken entirely too narrow a view of when a business commenced. Writing for the court, Desjardins J concluded that a company would not be carrying on business if it had just been incorporated and had not yet commenced operations, or if it had become dormant and carried out no operations other than to hold its annual meeting and file its corporate returns to avoid the forfeiture of its charter. Within those boundaries, it appears that any level of activity, even if it never reaches fruition as a business that produces income, will qualify as an active business.

While the result of the decision is reassuring, a criticism and a caution are warranted. First, the criticism: Desjardins J initially quoted recent SCC jurisprudence to the effect that words used in the Act are to be given their ordinary meaning in their grammatical context. She cited a passage from *Ludco Enterprises Ltd.* (SCC 2001), which held that in the absence of clear statutory language judicial innovation is undesirable, and that courts must be cautious before finding an unexpressed legislative intention when dealing with clear provisions of the Act. However, rather than following this guidance, at the end of her decision Desjardins J supported her conclusion by citing a statement of the capital gains exemption's purpose by the minister of finance at the time of its introduction. This recourse to purposive analysis is unnecessary if, as she had already concluded, the plain and ordinary meaning of the term "active business" includes a business such as that carried on by Hall River.

Second, the caution: Hall River expended a great deal of energy, time, and money to achieve its goal of developing its hydroelectric assets. This clearly impressed both the Tax Court judge (albeit not enough to cause him to allow the appeal) and the FCA. A subsidiary issue before the FCA was whether it was open to the court to disturb the Tax Court's finding that Hall River was not carrying on a business. The FCA sidestepped this issue by finding that the determination of whether a business is an active business is a question of mixed fact and law, not simply a question of fact. However, determining whether a business is an active business in any particular case will remain primarily a question of fact. Without good evidence of a consistent business plan and activity in support of that plan, it may be difficult to convince a court that a company without income is carrying on an active business.

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Employee Versus Independent Contractor 2

Editor's note: This topic was discussed in the April 2001 issue, and a number of lower court decisions *were cited. It is instructive to compare the approach taken in those cases with the comments of the SCC in this case.*

In *671122 Ontario Ltd. v. Sagaz Industries Canada Inc*. (2001), the Supreme Court of Canada reviewed in detail the existing common law tests for determining whether a person is an employee or an independent contractor. The *Sagaz* decision arose in the context of a claim for vicarious liability. The SCC held that certain parties had entered into an independent contractor relationship that did not make one party vicariously liable for another party's wrongdoing.

At paragraphs 33 to 45 of his reasons for judgment, Major J reviewed four tests that have been used by judges over the years to determine whether an individual is an employee or an independent contractor. These tests are (1) the control test, which asks who has the right to give instruction as to the manner in which the work is to be performed; (2) the entrepreneur test, which asks who has control of the work, the ownership of tools, the chance of profit, and the risk of loss; (3) the organization test (also known as the integration test), which asks whether the person who provides the services is in business on his own account; and (4) the enterprise test, which asks a number of questions, the most important of which is whether the "employer" controls the actions of the worker.

After reviewing the above tests, Major J stated the following in paragraphs 46-48 of his reasons for judgment:

> In my opinion, there is no one conclusive test which can be universally applied to determine whether a person is an employee or an independent contractor. . . . The central question is whether the person who has been engaged to perform the services is performing them as a person in business on his own account.

Thus, there is no one test that can be applied in all cases to determine whether an individual is an employee or an independent contractor. Instead, one must examine all the relevant factors and then ask the key question: "Whose business is it?" In *Sagaz*, Major J concluded that the impugned party was in business for himself (that is, he was an independent contractor). Further, Major J stated that, absent extraordinary circumstances, the relationship of "employer and independent contractor is not one which attracts vicarious liability."

For taxpayers, the decision in *Sagaz* changes nothing and everything. Judges have repeatedly stated that the determination of whether a worker is an employee or an independent contractor depends on all the relevant facts of a situation. In this regard, the decision in *Sagaz* represents nothing new.

At the same time, the CCRA has administratively regarded the four factors that were reviewed in *Sagaz* as determinative of whether an individual is an employee or an independent contractor (see Guide RC 4110, "Employee or Self-Employed?"). After the decision in *Sagaz*, it appears that although examination of these factors may be relevant, treating them alone as determinative is likely too narrow an approach: it is incumbent on the CCRA and the courts to examine all relevant factors.

It remains to be seen how the CCRA and the courts will respond to the decision in *Sagaz*. It appears that, at a minimum, a broader spectrum of factors must now be considered by the CCRA and the courts in determining employee versus independent contractor status. Note that a similar multi-factoral analysis has long been used by the US Internal Revenue Service, which has stated that approximately 20 factors should be considered (see IRS Revenue Ruling 87-41).

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Owner-Manager Compensation 3: Individual Pension Plans

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

Registered pension plans (RPPs), contemplated in section 147.1 of the Act and regulation 8500, are associated with public corporations and are usually maintained pursuant to a collective agreement. However, a specific kind of RPP—the individual pension plan, or IPP (regulation 8515)—may be registered with the CCRA for the owner-manager (TI 9218566) as a tax-assisted retirement and compensation planning vehicle that is not subject to attachment by creditors (unlike most RRSPs: see *Scotia McLeod*, Quebec Court of Appeal 2001).

An IPP can be established for one member who may be related to the employer. Since the interests of only one member need be considered, it is possible to tailor the plan to meet the member's preferences in terms of investment strategy for the plan's funds (see regulations 8502(h) and 8514(1)). Compare this with "qualified investments" ("Owner-Manager Compensation 2: Deferred Profit-Sharing Plans," *Tax for the Owner-*

Manager, October 2001, at 23), surplus management (the plan document can specify that the surplus belongs to the member, reimbursements being benefits received from the plan: TI 2000-0014745), retirement options (nothing prohibits an IPP from having several contribution and benefit options: TI 9221586), and beneficiaries (including same-sex partners—TI 9830080—but excluding spousal or testamentary spousal trusts—8m17920).

Both the employer and the member will contribute to the IPP fund, but contributions cannot be made by an estate (TI 9729705). To be deductible under paragraph 8(1)(m) and subsections 147.2(1) and (4), contributions must be on account of current or past services; the amounts are determined by the terms of the plan document (*Squires*, TCC 1991) on the basis of actuarial valuations. As a matter of uniformity, the contribution limits are designed as a part of an integrated system, taking into account RRSPs, DPSPs, and other tax-assisted pension vehicles (*Vivian*, TCC 1995). Interestingly, actuarial calculations depend on the age, compensation, expected benefits, date of retirement, and other specific characteristics of the sole member only, and there are no predetermined annual limits as there are for RRSPs.

When determining the contributions, all amounts included in income from employment and adjustments or irregular amounts of compensation are taken into account (TI 9231281), including termination pay (TI 9307845) and amounts received under a wage-loss replacement plan that is taxable under paragraph 6(1)(f) (TI 9231285). But retiring allowances (ITR 2000-0047343) and early retirement offers for payments in lieu of notice to be contributed to a plan may not be included in the calculations (TI 9520916 and TI 9326076).

In contrast to RRSPs or DPSPs, the funds cannot be removed from the plan before retirement or termination. They must be held in trust for the retirement of the member, who will be taxed upon receiving benefits from the plan at retirement. Apart from the trust, other vehicles may also be suitable, including insurance contracts and pension corporations (IC 72-13R8). But "notional accounts," where in-house funding is made and where the assets are available to the general creditors of the employer, are not pension benefits and are taxable upon receipt (ATR 9909123).

In addition to annual contributions, a catch-up contribution may be made immediately after the member's retirement in order to adjust the benefits (see TI 9608095). This is a way to provide for 11th-hour adjustments. Otherwise, if the member does not wish to pay a catch-up contribution, any additional benefits must be funded through a reduction in lifetime retirement benefits (TI 9431086). When adjustments are paid only for a fixed term, an examination of the purpose of the adjustment and the term is essential in determining whether these adjustments are acceptable (TI 9533236). But ad hoc adjustments permitted by the regulations can be implemented without amendment to the plan document (TI 9205095).

The ideal IPP provides for maximum pension benefits in order to maximize the tax advantages of custom-made contributions. However, given the complexity of IPPs (especially the actuarial valuations), the compliance burden, and the long-term commitment required, high-income owner-managers may well be in the best position to take advantage of such plans.

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Section 84.1 Update

Editor's note: We understand that a majority of the lawsuits against tax professionals involve a misunderstanding of the rules in section 84.1. See "Section 84.1: Don't Get Caught by It" in the January 2001 issue for an example of the way in which the section may apply in unanticipated circumstances. This note is a timely reminder of the need to consider the possible application of the section in any share reorganization involving related parties.

Finding a way in which to personally access corporate funds on a tax-free basis is an age-old problem in tax planning. In executing corporate reorganizations, one technique is to transfer shares of an Opco to a second corporation. In certain cases, funds may be extracted—but only up to a point.

One of the most overlooked and misunderstood provisions of the Income Tax Act is section 84.1, which prevents an individual from using a corporate share transfer to create tax-free access to funds.

When an individual transfers shares of one company ("the subject company") to another company ("the transferee"), section 84.1 may apply where two conditions exist: (1) the individual does not deal at arm's length with the transferee, and (2) the transferee is connected with the subject company immediately after the transfer.

There are two possible consequences to the individual: a deemed dividend or a reduction in paid-up capital (PUC) in the class of newly issued shares. A deemed dividend arises where non-share consideration is received from the transferee in excess of the individual's adjusted cost base (ACB) of the subject company's shares. Where shares are issued by the transferee, their PUC is reduced so that it does not exceed the ACB of the subject company's shares. Section 84.1 ensures that the total of PUC and non-share consideration issued by a transferee does not exceed the ACB of the subject shares.

For the purposes of section 84.1, the ACB must be adjusted to ensure that it represents only the "hard cost" of the original shares. In other words, to the extent that the ACB of the subject shares is represented by V-day value in excess of cost, or is increased by a capital gains exemption claimed by the individual or a non-arm's-length person, it must be reduced.

The rules in section 84.1, therefore, make it difficult for an individual to draw funds out of a corporation on a tax-free basis unless the funds represent a repayment of the hard cost of the shares. However, there may be times when section 84.1 does not apply and the transfer of shares to a new corporation is advisable.

For example, where shares are inherited from a deceased taxpayer (other than a spouse), the ACB to the survivor is generally equal to the value of the shares at death. The redemption of these shares, however, is likely to be taxable to the survivor as a deemed dividend, because PUC is not increased on death. A transfer to a new company will allow the transferee to issue new shares to the survivor with a PUC equal to the new increased ACB. These shares could then be redeemable on a tax-free basis.

Section 84.1 does not apply in arm's-length transactions. Where a minority shareholder wishes to receive corporate funds as part of a buyout, a simple redemption of shares will trigger a deemed dividend. Alternatively, the individual could sell the shares to a holding company owned by the remaining shareholders. This would allow possible access to the capital gains exemption and tax-free corporate funds.

There are those who attempt to circumnavigate section 84.1 by asking a non-related individual to set up a corporation to purchase shares of a subject company. The transferee pays for the shares using the corporate funds of the subject company. The CCRA may argue that the two parties are not dealing at arm's length even though they are non-related, or it may invoke the GAAR. A review of recent Tax Court cases is advisable before any aggressive planning is undertaken to avoid section 84.1.

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"All or Substantially All": The 80% Solution?

The term "all or substantially all" is generally considered by the CCRA to mean at least 90 percent of whatever is being measured (see, for example, *Interpretation Bulletin* IT-63R5, paragraph 8). The phrase is used extensively in the Income Tax Act and the Excise Tax Act, but is not defined. Its scope was considered in several recent Tax Court decisions.

In *Eberle* (TCC 2001), the court held that using a company-owned truck about 80 percent of the time for work-related purposes constituted "all or substantially all" of the use of the vehicle for the purposes of the standby charge provision. In two GST decisions, the court also held that 80 percent constituted "all or substantially all" (*McKay*, 1999-4273 (GST) I, October 20, 2000, and *Ruhl* (96-3597 (GST) I, December 5, 1997).

The term "all or substantially all" is used in many parts of the two acts. For example, in the Income Tax Act, it is used

- in subsection 6(2) when calculating the automobile standby charge,
- in subsection 13(28) in determining when a property becomes available for use,
- in section 22 in determining when an election can be filed for accounts receivable on the sale of the property of a business,
- in subsection 37(8) when calculating eligible SR & ED expenditures,
- in subsection 88(2) when applying the rules on the winding up of a Canadian corporation,
- in subsection 110.6(1) in the definition of "qualified small business corporation share,"
- for the purposes of the definition of "qualified small business corporation share" in subsection 110.6(14), and
- in the definitions of "automobile," "grandfathered share," "small business corporation," and "term preferred share" in subsection 248(1).

In the Excise Tax Act, the term "all or substantially all" is used frequently:

- in various definitions in subsections 123(1) and 156(1),
- in subsection 167(1) when determining whether tax is payable on a supply of the assets of a business,
- in section174 in connection with travel and other allowances, and
- in subsection 191(9) when determining the time of substantial completion of a residential complex.

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These are only some examples of the use of the term "all or substantially all" in the two statutes. If, as it appears, the Tax Court is moving away from the 90 percent test to some lower number, that decision will have widespread effect. For example, in terms of the new civil penalty rules (section 163.2), tax return preparers may want to consider whether they are "bound" to follow the 90 percent administrative rule, or whether they are free to file on the basis of some lower percentage, without incurring the new penalties.

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Interest Deductibility: New CCRA Policy?

In the *Trans-Prairie Pipelines* case (Ex. Ct. 1970), the taxpayer paid interest on a series of debentures issued to redeem an existing class of preferred shares. The issue in the case was whether the interest paid on the debentures was deductible under former paragraph 11(1)(c) as money borrowed to earn income from a business. (For the purposes of this discussion, the former paragraph is identical to current paragraph 20(1)(c).)

The facts in *Trans-Prairie* were straightforward. When the company was incorporated in 1954, some $700,000 of its capital was raised with an issue of preferred shares. In 1956, the company raised an additional $300,000 by way of an issue of common stock and $700,000 in new debentures. The original preferred shares were then redeemed out of the proceeds of the refinancing. The company was assessed on the basis that, strictly speaking, the interest paid on the portion of the new money used to redeem the preferred shares was not paid on money borrowed to earn income from a business.

In what has come to be regarded as a landmark decision, Jackett P held that the interest was deductible. In his view (not appealed), the "use" test in former paragraph 11(1)(c) was to be applied on the basis of what the original capital was used for in the business. He decided that the money raised on the initial issue of preferred shares was used to earn income from the business and that the money used to redeem the preferred shares was used to replace that capital. On this basis, he held that the new money was used to earn income from the business, and the interest paid thereon was deductible. In effect, the new borrowed money replaced the initial capital that was raised to finance the business and the interest paid on the borrowing was therefore deductible.

In 1972, the CCRA issued *Interpretation Bulletin* IT-80, "Interest on Money Borrowed To Redeem Shares, or To Pay Dividends." In essence, the CCRA said that it would follow the *Trans-Prairie* decision, and that interest paid on money borrowed to redeem preferred shares and to pay dividends would also be deductible– in the latter case, provided that the amount of the dividends did not exceed the taxed retained earnings of the payer corporation.

All well and good. However, following the recent decisions of the SCC in *Ludco* and *Singleton* (2001), the CCRA has indicated that it is reviewing its administrative policy on the deductibility of interest paid on borrowed money in a number of circumstances.

We understand that as of October 2001, officials in the Income Tax Rulings Directorate are reviewing their current administrative policy on the deductibility of interest paid on money borrowed to pay dividends and to reduce paid-up capital. Although the issues are under review, the CCRA has said that it has not yet decided to modify any of its existing practices with respect to interest deductibility. It has invited interested taxpayers to submit comments on the relevant issues, should they wish to do so. Submissions should be sent to Brian Darling and Paul Lynch of the Financial Industries Division of the CCRA, 16th floor, 320 Queen Street, Ottawa, ON K1A 0L5, or faxed to (613) 957-2088.

The Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants has written to the Rulings Directorate, making the case that no change in the existing policy is appropriate. In the meantime, tax practitioners should be aware that the current CCRA policy on interest deductibility is under substantial review.

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