TAX FOR THE Owner-Manager

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The Stop-Loss Rules: 1

When advising clients, practitioners must take into account the provisions of the Income Tax Act that limit a taxpayer's ability to claim losses in specific situations; these are commonly referred to as the "stop-loss" rules, and they are especially relevant in light of current economic conditions.

The stop-loss rules are sprinkled throughout the Act. The main provisions are:

- section 40 (non-depreciable capital property);
- subsection 13(21.2) (depreciable property);
- subsections 14(12)-(13) (eligible capital property);
- subsections 18(13)-(16) (non-capital shares, bonds, and inventory);
- subsection 69(11) (dispositions at less than fair market value); and
- subsection 112(3) (shares sold by a corporation).

The "superficial loss" rule is closely related to the stop-loss rules. A superficial loss is triggered on the disposition of property if the disposing taxpayer or an affiliated person acquires the same or identical property during a period that begins 30 days before or ends 30 days after the disposition and such a person owns the property at the end of the 30-day period (paragraph 40(2)(g) and section 54).

The stop-loss provisions generally serve to suspend the denied loss in the transferor's hands; however, there are several notable exceptions. For instance, the specific provisions for non-depreciable capital property in subsections 40(3.3) and (3.4) of the Act apply only to dispositions by corporations, partnerships, or trusts. Thus, transfers of non-depreciable capital property by individuals are not caught, and the transfer of a denied loss to the transferee is permitted. This strategy is particularly useful in present market conditions. If an individual owns an investment with a pregnant loss and has a spouse or common law partner who can make immediate use of it or deduct it at a higher marginal tax rate, the rules may be used to shift the loss to that person.

A second exception applies to losses on related-party debt (where the debtor, creditor, and transferee are all related). The provisions in paragraph 40(2)(e.1) do not include identical-property or holding-period tests. Accordingly, the denied loss is transferred to the transferee through the addition of the loss to the adjusted cost base (ACB) of the debt in the transferee's hands (paragraphs 53(1)(f.1) and (f.2)).

Another important consideration is the denial of losses on shares and the trapping of the losses in the transferor's hands. When the transferor disposes of shares to an affiliated corporation (for example, on redemption), the amount of the denied loss is added pro rata to the ACB of any shares still held by the transferor in the affiliated corporation. If the transferor no longer holds any shares, the loss is permanently denied.

A capital loss on the sale of shares by a corporation is reduced by the amount of dividends received by the corporation unless the dividends qualify as "excluded dividends": to qualify, the dividends must be received on shares that have been owned for more than 365 days, and the corporation must own less than 5 percent of any class of shares of the payer corporation. The exclusion rules with respect to the dividends apply on a dividend-by-dividend and share-by-share basis. (See subsection 112(3) and related provisions.)

Too often, the stop-loss rules are not given appropriate consideration in estate situations. If an estate is affiliated with a corporation, a capital loss that would otherwise arise on a redemption of those shares is denied. In determining whether an estate is affiliated

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with a corporation, it is important to consider whether the estate has de facto control over the company (TI 2000-006250, March 6, 2001, and TI 2000-0024775, February 23, 2001) and whether the executor owns other shares of the corporation (TI 1999-0015705, March 2, 2000). The TIs are not entirely consistent with one another, but they should be carefully considered in estate situations.

With appropriate planning, it is possible to avoid the application of the stop-loss rules to estates—for example, by separating the loss on the shares from voting control, having the voting rights cease on death, or interposing a holding company. In each instance, the objective is to ensure that the estate does not have voting control after the loss is realized. It is essential to consider the CCRA's positions with respect to the estate as a separate taxpayer (subsection 104(2)) and the implications of the executor's holding other shares in the corporation.

We have not discussed the life insurance stop-loss rules in this article; however, these rules should also be considered in all cases involving the use of insurance proceeds (see subsections 112(3.2) and (3.3)).

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The Stop-Loss Rules: 2

Editor's note: The preceding article deals with certain aspects of the stop-loss and superficial loss rules. This article focuses on a number of additional examples that illustrate the operation of those rules where the transfer involves shares held as capital property.

Given today's depressed stock market, the transfer of portfolio shares either as part of a corporate reorganization or in an attempt to realize losses must be handled carefully to ensure that those losses don't vanish.

There are a number of situations in which a taxpayer may wish to transfer a stock portfolio. For example, a substantial investment by an individual in US shares may be subject to US estate tax if the shares are owned on death. One way to sidestep this problem is to transfer the portfolio to a Canadian holding company. Another example involves the "purification" of a small business corporation so that the taxpayer can access the capital gains exemption by transferring a share portfolio from an operating company to a holding company. Or an individual may wish to crystallize accrued losses on shares in order to shelter capital gains in the current or a previous year, but still retain economic ownership of the shares.

If a stock portfolio is to be transferred to a related party on a tax-efficient basis, the potential impact of the stop-loss rules must be considered. Those rules will affect losses in different ways, depending on the circumstances.

Transfer by an Individual to a Corporation

The superficial loss rules generally deny the recognition of a capital loss where a taxpayer disposes of capital property and an affiliated party acquires it or identical property within 30 days of the disposition and holds it after that time. An individual is affiliated with a corporation if the individual or his spouse controls it. In that event, the corporation adds the amount of the denied loss to the ACB of the property received. A transfer of a stock portfolio with both gains and losses may be effected on a tax-deferred basis using elections under section 85 of the Act. The gain shares are transferred at an elected amount equal to ACB. In the case of the loss shares, the elected amount cannot exceed the fair market value of the shares. The individual's loss on the transfer of those shares is denied but added to the corporation's ACB of the shares.

Transfer by a Corporation

The superficial loss rules do not apply if the transferor is a corporation and the transferee is an affiliated person. (Corporations are affiliated if they are controlled by the same person or by affiliated persons.) In that case, the losses are suspended in the transferor's hands until the property is sold to an arm's-length party. At that time, the loss is realized, but it may only be deducted by the transferor. A capital loss may be of little use unless the transferor realizes capital gains from other sources in the future.

Depending on the nature of and the reasons for the reorganization, there may be a number of solutions to the problem. The transferor can retain a portion of the portfolio to ensure that future gains will be realized in amounts sufficient to offset the losses. Another answer is to retain the stock portfolio and transfer other assets to the new corporation.

Transfer Between Individuals

A transfer between affiliated individuals is subject to the superficial loss rules discussed earlier. The definition of "affiliated individuals" is restricted to persons who are spouses. Thus, a parent, for example, can transfer shares with accrued losses to a child and realize the losses for tax purposes.

A planning opportunity exists if one spouse has accrued gains and the other has losses. The spouse with losses can transfer the loss assets in a manner that attracts the superficial loss rules but avoids the attribution rules (say, by transferring the loss assets for fair market value cash consideration). The ACB of the loss shares is thereby transferred to the recipient spouse, and the ensuing loss may be netted against any gain on the appreciated shares.

Transfer to an RRSP

Specific rules deny the recognition of a loss when capital property is transferred to an RRSP. In effect, the tax benefit of the loss is lost forever, since the RRSP is tax-exempt. To avoid this result, consider selling the shares on the open market and repurchasing them immediately thereafter in the RRSP. The superficial loss rules will not apply. The CCRA may consider the application of the GAAR in such a case. However, if the RRSP delays the purchase of the shares for at least 30 days to circumvent the superficial loss rules, the CCRA does not seem to believe that the GAAR should be applied.

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Associated but Not Related: An Important Distinction

It is very common for corporations to be related but not associated for income tax purposes; for example, Husband's 100 percent owned corporation is related to, but is not associated with, Wife's 100 percent owned corporation. It is unusual—but not impossible—for two corporations to be associated but not related.

Assume that two Canadian-controlled private corporations, A Co and B Co, are owned by two unrelated individuals, X and Y. X owns 60 percent of A Co and 50 percent of B Co, while Y owns 40 percent of A Co and 50 percent of B Co.

By definition (paragraph 256(1.2)(a) of the Income Tax Act), X and Y constitute a group vis-à-vis each of A Co and B Co for associated-corporation purposes. Also by definition (subparagraph 256(1.2)(b)(i)), A Co and B Co are controlled by the same group and are therefore associated. Are A Co and B Co also related?

Subparagraph 251(2)(c)(i) provides that A Co and B Co are related if they are both controlled by the group made up of X and Y. Because there is no definition of the term "group" for purposes of the related-corporation provisions, one must look to the jurisprudence to determine whether X and Y are indeed a group that controls each of A Co and B Co. *Southside Car Market Ltd.* (FCTD 1982) held that if one member of a group controls a corporation, that person, not the group, is considered to control. Therefore, X (not the group X and Y) controls A Co and the group X and Y controls B Co. Thus, A Co and B Co are not related corporations.

The obvious question is whether or not this unusual result has significant practical consequences. Unfortunately, it does.

Assume that A Co carries on an active business entirely in Canada and operates out of premises leased from B Co. Assume further that all or substantially all of A Co's assets are used in its active business, and that the real estate owned by B Co constitutes all or substantially all of its assets. Are the shares of both A Co and B Co qualified small business corporation (QSBC) shares? If the answer is yes, the proceeds of disposition of the shares will be eligible for the capital gains exemption.

To be a QSBC share, a share must first be a share of a small business corporation (SBC). A Co is undoubtedly an SBC, but is B Co? The SBC definition in subsection 248(1), as it applies in these circumstances, requires that all or substantially all of B Co's assets be used in its active business or in an active business carried on by a related corporation. Subsection 129(6) provides that the rental income earned by B Co from A Co is deemed to be active business income, *but only for the purposes of subsection 129(6) and section 125*, not for the purposes of the SBC definition. Therefore, B Co is not an SBC because (1) it does not carry on an active business for purposes of the SBC definition and (2) its real estate is not used in the active business of a related corporation (the business carried on by A Co) because A Co and B Co are not related. As a consequence, B Co's shares are not QSBC shares.

It is not clear whether this result was intended: certainly if both corporations were owned 50-50 by X and Y, they would be related (subparagraph 251(2)(c)(i)) and the shares of B Co would be QSBC shares.

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Capital Gains Exemption: The "Business" Requirement

The capital gains exemption for qualified small business corporation shares (QSBCSs) can be an important retirement-planning tool for the owner-manager. In policy terms, the exemption is intended to encourage small entrepreneurs to risk their capital in new ventures with the expectation that some of that capital will be returned tax-free on the disposition of the shares, usually on retirement or death. It is unfortunate that the conditions of qualification for the exemption are very technical and difficult to understand.

The CCRA has commented on the scope of the exemption several times during the past year. Generally, most of these comments confirm the application of the statutory requirements. TI 2001-0086895 (January 14, 2002), however, is worth noting—not because it sets out new policy, but for its affirmation of a longstanding policy on the date when business commences.

An essential requirement for QSBCS status is that the corporation be a CCPC all or substantially all of the fair market value of the assets of which are used in or attributable to an active business carried on primarily in Canada. What level of activity is required to support a finding that a business is being carried on? In the TI, the CCRA confirms the approach to this question set out 25 years ago in IT-364, "Commencement of Business Operations."

The CCRA's view on when a business commences is based on two criteria. First, the activity must be undertaken as a regular part of an income-earning process or as an essential preliminary thereto. Second, there must be a "fairly specific" concept of the type of activity to be carried on, and an organizational structure must be in place sufficient to undertake at least the essential preliminaries of that activity. The CCRA notes that these requirements apply whether or not the activity is to be a continuing one or a single transaction in the form of an adventure in the nature of trade. It also says that a mere review of business opportunities, such as the collection of information, will not be considered the carrying on of a business, per se, in the absence of serious or reasonably continuous efforts to begin or carry on normal business operations. For a recent decision in which these issues were canvassed, see *Harquail* (FCA 2001).

The income-earning requirement should be considered in light of the comments on reasonable expectation of profit in *Stewart* (SCC 2002). In addition, while the requirement that a business structure be in place may seem appropriate in theory, in practice it can turn out to be a vague and sometimes discretionary test, and thus may be of little real guidance in determining whether a particular level of activity qualifies as a business. That said, the TI is generally helpful in that it indicates that the CCRA is applying established approaches rather than developing additional criteria in this area. It also reminds us that the availability of the capital gains exemption in a particular case may involve an examination of the income-earning history and organizational structure of the corporation involved.

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Repricing Stock Options: An Update

When a corporation issues a stock option to an employee and the fair market value of the option shares subsequently declines, the option no longer provides its intended incentive. Accordingly, the corporation may consider reducing the exercise price of the shares to current fair market value. The way in which the repricing is effected can have adverse tax consequences for the employee.

On the exercise of an option, paragraph 110(1)(d) of the Act provides for a deduction of 50 percent of the taxable benefit realized by the employee, provided that the option exercise price is not less than the fair market value of the shares at the time the option was granted. If a corporation simply reduces the exercise price of an existing option, the paragraph 110(1)(d) deduction is lost. (If the issuing corporation is a CCPC at the time the option is granted, a similar deduction is available under paragraph 110(1)(d.1) regardless of the fair market value of the shares on the grant date, provided that the shares are held for two years following the exercise of the option.)

Many corporations have avoided the adverse income tax implications noted above by cancelling outright the existing option and replacing it with a new option that has a reduced exercise price. Provided that this exchange meets certain conditions (set out in subsection 7(1.4)), the substitution of the new option can occur on a tax-deferred basis and the paragraph 110(1)(d) deduction will remain available to the employee in the future. However, there may be accounting issues to be dealt with as a consequence of such an exchange, and corporations will have the administrative burden of cancelling and reissuing options that are, in the end, the same options as those originally issued except for the reduced exercise price.

It appears that the CCRA and the Department of Finance have recognized the accounting and administrative burdens imposed on a corporation in such a situation. In a letter dated July 13, 2001, the Department of Finance stated that it is prepared to recommend that the Act be amended to ensure that an employee is not disqualified from claiming the paragraph 110(1)(d) deduction because of a reduction in the option exercise price, provided that the reduction could have been accomplished by way of an exchange of options to which subsection 7(1.4) would have applied. Finance has recommended that this amendment, if adopted, apply to reductions in the exercise price occurring after 1998.

In recent technical interpretations (TI 2001-0105023, January 8, 2002, and TI 2001-0096795, March 6, 2002), the CCRA indicated that it supports these proposed changes. It also stated that it would not make reassessments based on the current wording of paragraph 110(1)(d) before the changes in question are adopted, except in situations that involve abusive tax planning. The CCRA has also invited taxpayers who could benefit from the stock option deduction in its current or amended state to contact their Tax Services Office when they claim this deduction. Until the amendment is actually in force, this may be a prudent course of action.

This is all good news for corporations and their employees. A corporation will now be able to reduce the option price of an existing employee stock option without the accounting implications and administrative burden associated with an exchange of options, and employees will continue to benefit from the paragraph 110(1)(d) deduction.

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Deemed Residence Issue

Now that the provinces and territories have adopted a tax-on-income approach and are beginning to develop their personal income tax statutes, the potential for differences between federal and provincial legislation increases. The following examples illustrate an existing difference that affects persons who are deemed resident in Canada under a federal, but not a corresponding provincial, rule.

Example 1: Ms. X is a member of the Canadian Armed Forces and is a resident of Canada and Saskatchewan until July 31, 2002, on the basis of common law principles. (See IT-221R3, "Determination of an Individual's Residence Status," for a review of some of these principles.) Her only income is from employment, and she is taxable at the highest marginal rate; she is resident in a non-treaty country after July 31.

Ms. X is deemed a Canadian resident throughout 2002 for federal purposes (paragraph 250(1)(b) of the Act). Ms. X is taxable in Saskatchewan on income earned up to July 31. Her income earned from August 1 to December 31 is subject to a federal surtax of 48 percent of the federal tax otherwise payable as income not earned in a province (subsection 120(1)). This is because Saskatchewan does not tax her as a deemed resident of the province after July 31. Note that if Ms. X *were* deemed to be resident in Saskatchewan after July 31, she would be taxed at a provincial marginal tax rate of 15.5 percent. Since she is not, she is taxed at the additional federal rate of 13.92 percent (29 percent of 48 percent). This results in a 1.58 percent marginal tax saving to Ms. X because of the difference between the federal and provincial provisions.

Example 2: Assume the same facts as in example 1, except that Ms. X is resident in Ontario until July 31, 2002.

Ontario has lower personal tax rates than Saskatchewan. If Ms. X were still resident in Ontario after July 31, she would be taxed at the highest provincial marginal tax rate of 11.16 percent. However, as explained above, Ms. X is taxed at an additional federal rate of 13.92 percent, resulting in an additional tax *payable* of 2.76 percent.

Depending on the magnitude of the income figures, the tax impact in both examples could be significant. Since the calculation is an annual one, the impact increases the longer Ms. X lives outside Canada but is deemed to be a resident for federal purposes.

A similar analysis can be done for anyone who sojourns in Canada for more than 183 days, or who was at any time in the year an ambassador, minister, or servant of the federal or provincial governments or a dependent of such a person (subsection 250(1)).

Interestingly, Alberta and Quebec import the federal deemed residency rule, so the difference noted above does not occur in those provinces. There may be other provinces or territories that do so; we have not reviewed all the legislation with this question in mind.

It is important to note that some tax preparation software programs do not properly factor in this residency issue. Using either of the two examples above, some programs levy the 48 percent federal surtax throughout the entire year instead of half the year. One must, in effect, calculate two tax returns for Ms. X using this software: one for the part of the year in which she is resident in both Canada and Ontario/Saskatchewan, and another for the part of the year in which she is deemed resident for federal but not for Ontario/Saskatchewan purposes.

A tax practitioner should not assume that a particular province automatically imports the federal residency provision. As can be seen from these examples, an incorrect assumption can result in incorrect tax filings and a significant loss of taxpayer dollars.

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Canadian Parents Financing US Subs: Alert

The received wisdom in the United States is that the root cause of the "corporate inversion" trend is the complex domestic tax laws that place US-based companies at a competitive disadvantage in international markets. This belief has prompted policy makers and government officials to revisit US international taxation policy in both its form and its substance. As a result, the US Treasury Department made recommendations to Congress aimed at levelling the playing field with respect to the taxation of US-based and foreign-based companies. At the same time, the US Senate was moving ahead with similar tax legislation.

On July 11, 2002, intentions translated into action when Bill Thomas, the chair of the House Ways and Means Committee, introduced a wide-ranging bill, the American Competitiveness and Corporate Accountability Act, in the House of Representatives. The bill's impact on the bottom line of many Canadian companies could be catastrophic.

The proposed amendments to IRC section 163(j) (the "earnings-stripping rules") are of particular importance to Canadian companies that have US operations. At present, IRC section 163(j) limits the deductibility of certain interest paid to a related party if the payer's debt-equity ratio exceeds 1.5:1 and its net interest expense exceeds 50 percent of its adjusted taxable income. When interest is disallowed, the rules provide for an indefinite carryforward. Although the current rules are already problematic for many Canadian companies owing to the recent downturn in the US economy and the resulting decrease in adjusted taxable income, the bill substantially tightens the section 613(j) limitations in several ways: (1) the existing 1.5:1 debt-equity ratio safe harbour is eliminated; (2) the 50 percent interest limit is lowered to 35 percent; (3) the carryforward period on disallowed interest is no longer indefinite but instead is limited to five years; and (4) the carryforward of excess limitation is eliminated.

In addition, the proposed amendments put forward a new rule that disallows related-party interest to the extent that the US subsidiary of a foreign parent is more highly leveraged than the overall worldwide corporate group.

This new disallowance rule will require a series of calculations. For example, if a worldwide group has $500 of total external debt and assets having a total adjusted basis of $1,000, for a debt-asset ratio of 50 percent, and the US affiliated group has $75 of total debt ($45 unrelated and $30 related, all at a 10 percent interest rate) and assets having a total adjusted basis of $100, for a debt-asset ratio of 75 percent, then the US affiliated group will be regarded as overleveraged by 25 percentage points, or $25. By reason of a related-party-first ordering rule, the entire $2.50 of interest on this $25 will be disallowed. More specifically, under the calculation provided in the new rule ($75 – [$100/$1,000 × $500]), the US affiliated group will have $25 of disproportionate debt. The disproportionate domestic related-party indebtedness percentage will be $25/$30, or 83.33 percent. Of the US affiliated group's $3 of interest incurred on its $30 of related-party debt, 83.33 percent of this interest, or $2.50, will be disallowed. If the US affiliated group's $30 of related-party debt had consisted of three $10 loans at interest rates of 8, 9, and 10 percent, for total related-party interest of $2.70, then the amount disallowed would have been 83.33 percent of $2.70, or $2.25 (effectively, an application of the average related-party interest rate of 9 percent to $25 of disproportionate related-party debt).

Imagine, for the sake of argument, that a foreign-based parent of a US subsidiary has issued equity rather than debt. In this case, the new disallowance rule will result in a complete denial of an interest deduction to the US subsidiary on all related-party debt. Worse, the proposed amendments make no distinction between a direct loan granted by a foreign parent and an unrelated loan that is guaranteed by any means by the foreign parent. Standing alone, IRC section 163(j) as proposed could expose many legitimate debt transactions to disallowance. No one should underestimate how quickly the US Congress can act when necessary, especially when the action favours its constituency. The proposed amendments are not trivial, and Canadian companies, whatever their size, should immediately review any US financing they have in place before the proposed amendments are signed into law.

The proposed amendments will apply to taxation years ending after July 10, 2002 and beginning before the first taxation year to which the amendments generally apply. The amount disallowed under IRC section 163(j) will not exceed the amount of any disqualified interest for the year on debt incurred after July 10, 2002.

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Partner's Duty To Account to Partnership

A recent decision of the Ontario Court of Appeal (*Rochwerg v. Truster*, 2002) deals with the scope of the fiduciary obligation between members of a partnership. The decision emphasizes that the obligation is a broad one and requires a partner to account to his firm for any benefits received from a source outside the partnership even when there is no bad faith or misconduct on the part of the partner.

R joined the RTZ partnership of chartered accountant on January 1, 1993. Before he joined the RTZ firm, R had a longstanding professional relationship with the T group of companies. The T group became clients of RTZ on January 1, 1993 as a consequence of R's becoming a member of the firm. There was no written partnership agreement between R and the other partners in RTZ; consequently, the relationship between the partners was governed by the provisions of the Ontario Partnerships Act.

In 1995, the shareholders of T decided to take the company public and to hire a different firm of accountants to do their audit work. R became a director of T on July 8, 1995, and the RTZ firm continued to do consulting work (but not the audit) for the company. As a director of T, R was entitled to participate in a stock purchase plan at a pre-IPO price, and he acquired other options to purchase shares. R informed his partners of his appointment as a director of T, and it was agreed that his director's fees would be paid to the firm. He did not disclose his right to acquire stock under the purchase plan, or the option arrangements.

R subscribed for 8,000 shares under the stock purchase plan on July 24, 1995; he paid a subscription price of $4.95 per share. (Title to the shares was taken in his wife's name.) He thereupon became entitled to options to acquire an additional 12,000 shares at $0.01 per share; he exercised the options on October 25, 1995 at a cost of $120. R withdrew from the RTZ partnership on July 31, 1996. During the period from September 29, 1995 to September 17, 1999, R's wife disposed of 5,700 shares. The issue in the case was whether R was liable to account to his former partners for the benefits attributable to the share purchase plan.

Section 29 of the Ontario Partnerships Act provides that a partner must account "to the firm for any benefit derived by the partner without the consent of the other partners from any transaction concerning the partnership or from any use by the partner of the partnership property, name or business connection." The Court of Appeal overturned the decision of the trial judge and held that R was liable to account to the partnership. The rights that he obtained under the share arrangements were "benefits" within the meaning of section 29. These benefits were the result of transactions "concerning the partnership," even though these transactions were outside the scope of the RTZ partnership and were not entered into in competition with the firm. The court gave a very broad meaning to the phrase "concerning the partnership." In effect, it said that if there was a "link" of some kind between the transaction and the firm, the transaction "concerned the partnership." Here, the link was the fact that T was a client of the firm at the time the share and option arrangements were completed. It was immaterial that R's relationship with T predated his joining the partnership and that there was no bad faith on his part in not disclosing the arrangements to his partners at the time; it was enough that he benefited from them. Accordingly, he was liable to account for the profit.

Leaving aside the possible complication attributable to the fact that the shares acquired under the stock purchase plan were registered in the name of R's wife, and assuming that R reported and paid tax on the capital gain realized on the disposition of the 5,700 shares, does R have a right to a refund of that tax? What if the year in which he reported the gain is statute-barred for reassessment? What happens when the remaining 2,300 shares are sold? Is the effect of the judgment that R has no obligation to report a gain? What about the partners of RTZ? Can they treat the amount awarded to the firm as a non-taxable windfall? None of these tax questions were addressed by the Ontario court, but advisers may wish to consider them in other cases.

It is clear from the judgment that members of a partnership owe each other a very broad duty to account for benefits obtained from any transaction "concerning the partnership," however tenuous the connection may appear. Recall that the partners in this case did not have a written partnership agreement. A clear lesson from the case is the importance of an agreement that deals specifically with a partner's right to receive benefits from arrangements made outside the normal business of the firm.

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GAAR UPDATE

Imperial Oil Limited (TCC 2002) is the latest case (as at August 27) to consider the GAAR. The planning that was at issue in the case will not be of direct interest to most owner-managers of private corporations: the specific issue in the appeal was the application of the large corporations tax (LCT) provisions (part I.3 of the Act). However, like most GAAR decisions, the case is interesting because it indicates what sort of planning the minister currently thinks is offensive, and what the court thinks is the proper basis for a GAAR assessment.

In this case, the impugned transactions were investments in wholly owned subsidiaries of two chartered banks. The court found that the investments involved a "tax benefit" and were "avoidance transactions" (subsections 245(1) and (3)), but there was no misuse of a section or abuse of the provisions of the Act read as a whole (subsection 245(4)). The appeal was allowed.

Under part I.3, a corporation's taxable capital is defined to be its capital less its "investment allowance" for the year. The allowance includes a loan to another corporation *other than a financial institution*. Accordingly, the purchase of debt issued by a non-financial institution qualifies for the allowance; the purchase of debt issued by a chartered bank does not.

The wholly owned subsidiaries of the banks were not financial institutions for part I.3 purposes. They made substantial short-term loans ($500 million) to Imperial Oil. The loans were guaranteed by their parents and remained outstanding over the taxpayer's year-end. Apart from the GAAR, the loans were deductible for LCT purposes. The minister sought to apply the GAAR to disallow a substantial portion of the deductions.

The court found that there was a tax benefit and that the loans could not reasonably be considered to have been undertaken primarily for a purpose other than to obtain the tax benefit. In reaching this conclusion, the court was influenced by the fact that two major Toronto legal firms had given opinions on the question whether the wholly owned subsidiaries were "financial institutions." (They both agreed that they were not.) The fact that opinions were sought, the court said, probably indicated that the loans were structured for capital-tax-avoidance purposes. This left the question whether the transactions were outside the GAAR by reason of the misuse/abuse exception in subsection 245(4).

As to misuse, the court held that the object and spirit of part I.3 was to allow a deduction from capital for loans to another corporation, on the theory that the other corporation would include the amount of the loans in its taxable capital. There was no evidence to suggest that the borrowers did not do so. Therefore, a denial of the deduction would result in double taxation of the loans, contrary to the intent of the sections involved.

As to the abuse of the Act as a whole, the court said that it was only necessary to consider the provisions of part I.3. For essentially the same reason it gave with respect to the misuse issue, the court said that there could be no abuse when the deduction sought was necessary to avoid double taxation of capital. The court also noted that the taxpayer did not create a new "tax shelter subsidiary" or enter into a new partnership to achieve its purpose of capital-tax reduction.

Key to the court's analysis on both points is the assumption that the bank subsidiaries paid capital tax on the loans. No evidence was led on this point. One might speculate whether the subsidiaries managed their respective LCT liabilities so as not to pay the tax. If so, this might explain why the minister bothered to raise the assessment at all.

The case stands for the proposition that structuring a deduction to obtain a tax advantage will not, without more, support a "misuse or abuse" argument. Each case will turn on its own facts. Taxpayers will be better able to resist a GAAR assessment if they do not create new entities to facilitate their planning. (Compare *OFSC Holdings Ltd.* [FCA 2001; leave to appeal denied 2002] on whether it is relevant that the taxpayer was aware of the tax-planning steps taken by the other party to the transaction.) As well, the "scheme of the Act" argument will likely be affected by the court's view of whether (or not) there is tax leakage when the tax positions of both parties to the transaction are considered.

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