TAX FOR THE Owner-Manager

Editor: Thomas E. McDonnell, QC

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Payment for Non-Competition Covenant Not Taxable

On March 11, 2003, the Court of Appeal issued a judgment (*Manrell*, docket A-662-01) to the effect that a payment received as consideration for entering into a non-competition agreement as part of a sale of shares of a business is not taxable as a disposition of "property."

The facts in *Manrell* are straightforward. The taxpayer agreed to sell his direct and indirect share interests in three operating companies to an arm's-length buyer. A condition of the share purchase agreement was that he enter into a separate agreement not to compete with the businesses of the operating companies after the sale. The issue in the case was whether the amount paid to him for the covenant was taxable as a disposition of "property."

"Property" is defined broadly in section 248 to include "a right of any kind whatever." The taxpayer argued that "right" means a right of such a nature that the holder can compel someone else to pay money for it, or a right to exclude all competing claimants to the same right. The "right" here, he argued, did not have that character: it was nothing more than the freedom to carry on a particular business. This is a personal liberty, not a right.

The Crown argued that Manrell's knowledge of the businesses being sold was a valuable asset to him, one he could have exploited by starting up in competition with the purchaser but for his covenant not to do so. There was an inextricable link between the value of his non-competition agreement and the payment to him for the shares. It therefore was appropriate to treat the payment as proceeds of disposition of property, the property being his right to compete.

The Crown's argument prevailed in the Tax Court (2002). The court said that the definition of "property" is sufficiently broad to describe the sort of interest given up by a shareholder who is party to a non-competition agreement. It cited with approval a comment to this effect in *Fortino* (TCC 1997).

The Court of Appeal disagreed, and allowed the appeal. "Property" in section 248 is limited to a right that is, or entails, an exclusive and legally enforceable claim. Although a person may give up something in agreeing not to compete, and this something may be thought of in a general way to be some sort of "right," it is a right that is shared by everyone who wants to start up a business. As such, it is not the sort of right contemplated by the section. In short, whatever the "right" may be said to be, it is not "property."

At the time of writing, it was not known whether the Crown will seek leave to appeal to the Supreme Court. It will not be surprising if application is made, given that non-competition payments are a common feature of share sale arrangements. If the Court of Appeal's judgment stands, it also will not be surprising if the Department of Finance announces an amendment to bring such payments into the taxing net. For now, however, it appears that such payments will be received free of tax.

In the meantime, a vendor of shares should consider insisting that a portion of the sale price be allocated to a non-competition covenant, assuming that there is real value to the purchaser in having such a covenant. If the parties are at arm's length on this point, their determination should go a long way in settling the reasonableness of the allocation if the matter is raised by the CCRA. If the parties do not deal at arm's length, some independent evidence of value should be obtained at the time of the transaction to minimize problems in the future.

Usually, there will be no basis for the purchaser to deduct any part of the payment allocated to the covenant. The payment will not add to the adjusted cost base of the shares acquired. In limited circumstances, it might qualify as an eligible capital expenditure (ECE), provided that the cost is incurred to earn income from

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the purchaser's business. In this regard, note that the definition of "eligible capital expenditure" in subsection 14(5), while it refers to an outlay "on account of capital," does not expressly require that the payment be made to acquire "property." So the *Manrell* decision is not a bar to a deduction on the ground that an ECE applies only to an outlay on account of a capital *property*. However, the requirement that the payment be made to gain or produce income from the purchaser's business will often be a practical bar to any claim for an ECE deduction.

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Eco-Gifts: Administrative Policies and Statutory Amendments

An ecological gift is a gift of ecological property—that is, land that the minister of the environment has designated as ecologically sensitive or of importance to Canada's environmental heritage. The Act does not define "ecological property" and "ecological gift." However, paragraph 110.1(1)(d) and subsection 118.1(1) both refer to certain properties that may, upon disposition in favour of the donees described below, give rise to a deduction in the computation of taxable income (for corporations) or to an income tax credit (for individuals). The donees are the federal and provincial governments, a municipality in Canada, or a registered charity, one of whose main purposes is the conservation and protection of Canada's environmental heritage, that is approved by the minister of the environment in respect of the gift (for greater certainty, a list of approved certification authorities is published by Environment Canada at http://www.cws-scf.ec.gc.ca/ecogifts/appendix3_e.htm).

The December 20, 2002 technical bill proposes to clarify what constitutes an ecological property in Quebec by indicating that, in the case of a servitude, it must be a "real servitude" under the Civil Code of Quebec.

Various agreements between the minister and the provincial and territorial governments provide, inter alia, for the designation of several representatives of the minister who are authorized to certify the ecological value of the property. In most instances, these representatives are senior public servants who work for a regional division of the Department of the Environment of the province in which the ecological property to be donated is located.

A variety of lands have been pre-identified by provincial governments as qualifying for Environment Canada's purposes. For example, Ontario has identified, inter alia, significant wildlife or fish habitats (including prairies, cliffs, Great Lakes coastal habitats, and old-growth forest areas); significant rivers, streams, shorelines, valleys, wetlands, and woodlands; areas used for long-term scientific study; and certain sites designated by statutes. The Quebec list includes, inter alia, natural spaces that serve as buffers between development zones and environmentally sensitive sites; habitats that contribute to the preservation of biodiversity; degraded natural sites that stand a good chance of being restored within a reasonable time; and various habitats designated by provincial or municipal legislation or regulation.

In addition to certifying the ecological value of a property to be donated, the minister must also certify its fair market value (FMV). Under procedures set out in subsections 118.1(10.2) and following of the Act, a taxpayer may request that a valuation be made by the minister. However, on an administrative basis, Environment Canada has stated that the donor should submit an assessment of the FMV of the ecological property and guarantee that it was made by professional valuators by means of generally accepted valuation techniques.

The Act currently provides that the amount of the deduction or tax credit that may be claimed upon the donation of an ecological property is equal to the certified FMV of the property. However, the technical bill proposes, under new subsection 248(30), to replace this amount with an "eligible amount"—the amount by which the FMV of the property that is the subject of the gift exceeds the "amount of the advantage," if any, in respect of the gift. The amount of the advantage will be defined under new subsection 248(31) as the total value of all property, service, compensation, or other benefit that the donor (or a person who does not deal at arm's length with him or her) has received (either immediately or in the future, absolutely or contingently) as partial consideration for the gift.

Although the above rules might be seen as a restriction on the opportunity to take advantage of the eco-gift legislation, proposed subsection 248(32) will provide partial relief by stipulating that the existence of an advantage will not, in and by itself, disqualify a transfer from being a gift if the amount of the advantage does not exceed 80 percent of the FMV of the transferred property or if the transferor of the property establishes to the satisfaction of the minister of national revenue that the transfer was made with the intention of making a gift.

Finally, upon a disposition or a change in use of an ecological property by a designated donee that is a charity or a municipality, a special tax equal to 50 percent of the FMV of the property may be imposed upon the donee pursuant to section 207.31 of the Act if the disposition or change in use occurred without the authorization of the minister.

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The Foreign Investment Entity Proposals

(Editor's note: The proposed foreign investment entity rules are extensive in their scope and may apply unexpectedly in a range of situations. This article provides a list of circumstances in which advisers should be alert to the possible application of the new rules. See also "FIEs: Going in Circles?" Canadian Tax Highlights*, November 26, 2002, at 83.)*

On October 11, 2002, the Department of Finance released proposed legislation in respect of foreign investment entities (FIEs). (Earlier versions of the proposals were released on June 22, 2000 and August 2, 2001.) The 2002 FIE proposals will replace existing section 94.1 of the Act, which deals with offshore investment fund property. The proposed rules represent a marked departure from the rules in that section: they are much broader in scope, they essentially eliminate the tax purpose requirement of the old provision (which, in Finance's view, contributed to its ineffectiveness), they are difficult to interpret, and they can apply in many unexpected situations. The proposed rules may also overlap section 17 and the foreign accrual property income (FAPI) regime, which in some situations could lead to double taxation.

The proposed FIE legislation should be considered in *any* situation in which a Canadian-resident person holds an interest in a non-resident entity (NRE). An NRE is a corporation or trust not resident in Canada for the purposes of the Act, or a non-Canadian legal entity. An "entity" includes an association, corporation, fund, joint venture, partnership, syndicate, or trust.

The proposed FIE rules will apply to all interests that a Canadian-resident person holds in an NRE, unless the interests are specifically excluded. A taxpayer subject to these rules will be deemed to have income on an annual basis in respect of the NRE interest calculated under one of three regimes:

1) the default, or "prescribed rate regime" (generally, where deemed income is calculated by applying prescribed rates to the deemed cost of the FIE interest);
2) the "mark-to-market" regime (generally, where changes in the market value of the FIE interest are annually taken into income—mandatory in certain instances and elective otherwise); or
3) the FAPI regime (generally, where the FIE rules increase the FAPI of a controlled foreign affiliate in certain circumstances).

A Canadian-resident taxpayer should consider the potential application of the proposed rules if the taxpayer holds

1) shares of a non-resident corporation (including a foreign affiliate or controlled foreign affiliate);
2) units of a mutual fund, income fund, pooled fund, or real estate investment trust if such trusts are not resident in Canada for the purposes of the Act;
3) an interest in a non-resident joint venture, syndicate, association, partnership, or organization;
4) an interest in an NRE that "tracks" property owned by the particular NRE or any other NRE; or
5) an interest in a foreign insurance policy.

For example, consider the case of a private Canadian corporation that owns a US operating subsidiary that invests excess cash in shares of a FIE. Under the old rules, the Canadian corporation may not have been taxed on the growth in the value of the investments before an actual realization occurred. Under the new rules, the growth in value may be taxed in Canada on an annual basis.

The proposed FIE rules will apply to a Canadian-resident taxpayer commencing in a particular taxation year that begins after 2002 (assuming that the taxpayer holds an interest in an NRE at the end of the NRE's taxation year that ends after 2002 in that particular taxation year).

Although the proposed FIE rules are complex and compliance may be difficult and costly, failure to comply with the rules could be even more costly. All taxpayers with foreign investments should carefully review the proposals.

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Corporate Attribution and Estate Freezes: A Hidden Trap

The corporate attribution rules in subsection 74.4(2) tax an individual ("the transferor") who transfers or lends ("transfers") property, directly or indirectly, to a corporation, if one of the main purposes of the transfer can reasonably be considered to be to reduce the income of the transferor and to benefit a "designated person." (A transfer by a corporation brings the rules into play only if the corporate transferor has, in turn, received a transfer from an individual in a "back-to-back" arrangement designed to circumvent the rules: subsection 74.2(6).)

A designated person is any of the spouse of the transferor, a non-arm's-length person under age 18, and a niece or nephew of the transferor under age 18.

If a trust is a shareholder of the transferee corporation, the rules do not apply if the trust indenture provides that beneficiaries who are designated persons cannot obtain the use of any of the income or capital of the trust while they are designated persons, and the trust does not make a preferred beneficiary election in favour of a designated person.

The rules apply during any period throughout which the designated person owns (in broad terms) 10 percent or more of the shares of the transferee corporation, the transferor is resident in Canada, and the transferee corporation is not a "small business corporation" (subsection 248(1)). (An exception exists if the designated person is a spouse or common law partner who is living apart from the transferor because of a breakdown of the relationship.)

Where the rules apply, the transferor is deemed to receive an amount as interest. That amount is computed by multiplying the outstanding amount of the consideration received on the transfer by the prescribed interest rate applicable during the relevant period(s). The amount is reduced by any interest actually received in respect of the transfer and five-fourths of dividends (other than section 84 deemed dividends) received on shares received as consideration for the transfer or as repayment of the loan.

The rules are punitive. The benefit amount is imputed regardless of whether the transferee corporation earns income. Furthermore, the transferee corporation is not entitled to a deduction.

If the transferor guarantees a loan to the transferee corporation in lieu of making a loan directly, subsection 74.5(7) deems the guarantor to have made the loan. Generally, this should not be a practical problem because the commercial rate of interest paid by the borrower will usually exceed the prescribed rate.

There is a trap hidden in the rules: as described below, a garden-variety estate freeze can bring the rules into play.

A subsection 85(1) rollover of shares or other assets to a corporation in return for retractable preferred shares obviously triggers the rules if designated persons are "specified shareholders" of the transferee corporation. Less obviously, a section 86 freeze can also do so.

In the usual section 86 freeze, the common shares held by the freezor are converted into retractable preferred shares; designated persons then subscribe for new common shares. There does not *appear* to be a transfer of property to the corporation by the freezor. Unfortunately, subsection 84(9) clarifies that, in these circumstances, the freezor is *deemed* to have disposed of the common shares to the corporation.

In light of the above, if it is possible to do so, an estate freeze should be effected by converting an operating company or investment company (Freezeco) into a holding company (Holdco) rather than by transferring the shares of Freezeco into Holdco or by exchanging common shares in Freezeco for retractable preferred shares. In other words, Freezeco should use subsection 85(1) to transfer its assets into a new operating company or investment company (Newco) in return for retractable preferred shares. The family members who are intended to benefit from the freeze can then subscribe for common shares in Newco. In this way, no actual or deemed transfer of property by the freezor will trigger the operation of the rules.

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REOP AFTER STEWART

Before *Stewart* (SCC 2002), it was difficult to reconcile the many court decisions in which the "reasonable expectation of profit" (REOP) test was applied to deny the deduction of expenses incurred in connection with an activity alleged to be a business. In *Stewart*, the SCC stated that REOP was not to be applied as a stand-alone test, especially when no personal use of business property was involved. Justices Iacobucci and Bastarache articulated a new pursuit-of-profit test for these cases.

In the months since *Stewart*, the TCC has had occasion to consider that new test. However, business owners and practitioners alike have been anxiously waiting to see how, or whether, the CCRA would vacate pre-*Stewart* assessments based on REOP. The recent decision in *Hunter* (TCC 2002) is instructive.

Hunter is one of the first post-*Stewart* farm loss cases to come before the court. The CCRA disallowed losses associated with farming activities for the years 1993-1996 on the basis that those activities had no REOP. After *Stewart* was released, taxpayers' counsel asked the CCRA to admit the existence of a bona fide business. In doing so, counsel was simply attempting to "get the reasonable expectation of profit issue off the table" so as to avoid costly litigation. The minister declined the request, the matter proceeded to trial, and the court allowed the deduction of the full amount of the farming losses.

In awarding costs of $22,000 to the taxpayer, Judge Bell was critical of the CCRA for failing to obtain pertinent information readily available from the taxpayers, and intimated that the CCRA was simply unwilling to make a decision as to whether there was a bona fide business or not. Even though a brief reading of the *Stewart* decision would have led one to the inevitable conclusion that the taxpayers in *Hunter* were involved in a bona fide business for which (at the least) restricted farm losses could have been deducted, the CCRA was unwilling to make that determination. Rather, the CCRA elected to place the onus on the taxpayer, who was then required to bring substantive evidence before the court so that a judge could determine the matter.

What are the implications for a taxpayer who is fighting a pre-*Stewart* assessment based on REOP? Although each case will have to be reviewed on its own merits, counsel should at least consider serving the Crown with a rule 130 notice to admit the REOP. If the Crown responds positively and makes the admission, this may be sufficient to dispose of the case. If the Crown refuses and the taxpayer is successful at trial, the Crown's refusal will be a factor to be considered by the court in making an order for costs.

In a general way, the minister's conduct in *Hunter* should not be seen as indicating a general intention to disregard the implications of the *Stewart* decision. To the contrary, in draft *Income Tax Technical News* no. 25 (October 30, 2002), the CCRA stated that it will no longer apply the REOP test to determine whether an activity constitutes a business. However, the CCRA did not comment on how it might deal with the matter when a pre-*Stewart* assessment is outstanding because of a notice of objection or appeal. In light of *Hunter*, it is to be expected that the CCRA will now be more forthcoming in admitting the existence of REOP in appropriate cases. Taxpayers will want to keep this in mind in pre-trial discussions.

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Audit Requirements and Tax Evasion: Alert

The CCRA has extensive powers of enforcement to ensure that taxpayers comply with the Income Tax Act. These include the power to inspect (subsection 231.1(1)) and the power to require a person to provide information or documents (subsection 231.2(1)). The information gained in the exercise of these powers may result in the assessment of tax, interest, and regulatory penalties, and in tax-evasion charges (section 239). Because the improper exercise of these powers may infringe on a taxpayer's rights, tax advisers should carefully monitor CCRA audit information requests.

To what extent may the CCRA use its audit powers in connection with an investigation or prosecution under section 239 without violating a taxpayer's Charter rights? In *Jarvis* (2002), the Supreme Court of Canada laid out the applicable principles and then applied them in a companion case, *Ling* (2002). A key issue in both cases was the extent to which evidence collected pursuant to or as a result of the CCRA's exercise of its powers should be excluded in a prosecution for tax evasion.

In *Jarvis*, the court ruled that where the *predominant purpose* of a CCRA inquiry is or becomes the determination of penal liability under section 239, (1) the audit powers can no longer be used; (2) criminal investigatory techniques must be adopted; (3) Charter protections apply; and (4) the taxpayer must be provided with proper notice.

The SCC confirmed that evidence obtained in the valid exercise of the CCRA's audit function can be used in a criminal prosecution. It also noted that the predominant-purpose test did not prevent the CCRA from conducting parallel criminal investigations and administrative audits. Apparently, the predominant-purpose test applies independently to each parallel investigation. The SCC did not clearly specify how information obtained pursuant to audit powers could be used in the parallel criminal investigation, although it said that there must be a degree of separation between the CCRA's audit function and its investigative function. Unfortunately, the SCC did not elaborate on this point. As a result, it is unclear how taxpayers are to be protected if the CCRA does not follow the *Jarvis* principles.

The predominant-purpose test is fact-driven. Often the key facts will not be known before charges are laid; this makes it difficult for a taxpayer to protect his or her Charter rights in the course of an audit or investigation. In *Jarvis*, the auditor and the special investigator failed to follow the CCRA's existing procedures. The SCC commented that the auditor's conduct was not praiseworthy and in some cases appeared deceptive, yet such behaviour did not appear to affect the court's decision. If there are no consequences for inappropriate behaviour on the part of CCRA employees, how will a taxpayer's rights be protected?

The subsequent decision in *Kligman* (FCTD 2003) is instructive. In that case, several individuals and corporations asked the court to quash CCRA requirements to provide information and documents relating to donations made by them to certain organizations. Mr. Justice Beaudry, applying *Jarvis*, concluded that the predominant purpose of the investigation was the prosecution of the applicants for tax evasion. He held that the Charter rights of the individual applicants would be violated if they were forced to comply with the requirements. Section 24(2) of the Charter did not apply because there was no evidence to exclude. Even though a breach of the Charter had not yet occurred, Mr. Justice Beaudry relied on section 24(1) of the Charter (which gives a court the authority to provide a just and appropriate remedy in the event of a Charter breach) to quash the requirements issued to the individual applicants. The corporate applicants were not entitled to Charter protection. This aspect of the judgment has been appealed.

Tax advisers will have to pay close attention to the actions of the CCRA during an audit to try to assess whether and when the predominant purpose or the audit becomes a probable prosecution. In certain cases, it may be advisable to ask the CCRA to state in writing the purpose of the audit or investigation. *Kligman* indicates that a timely application for judicial review of the CCRA's exercise of its audit powers should be considered in an appropriate situation.

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Partnerships Versus Joint Ventures: The "Separate Person" Concept

(Editor's note: This is the first of a planned series of articles on the tax consequences of carrying on business in partnership. This article deals with the question whether an activity is being carried on in a partnership or in some other type of relationship—for example, a joint venture.)

When two or more taxpayers engage in commerce together outside of a corporation, are the taxpayers carrying on business in a partnership or are they participating in a joint venture? The Income Tax Act contains a detailed scheme for the taxation of partnerships, but is virtually silent on the tax consequences of participating in a joint venture.

Although the terms "partnership" and "joint venture" appear in the Act, neither term is defined there. Whether a particular activity constitutes one or the other must be decided under the applicable provincial or territorial partnership acts.

In the case of a partnership, the basic test is whether the participants are carrying on business in common with a view to profit (*Backman*, SCC 2001). A joint venture is a contractual agreement whereby the parties to the contract provide property or services for the purposes of a particular business undertaking. For a general discussion of the attributes of a joint venture, see *Laxton* (FCA 1989) and *Baillargeon* (TCC 1992). In *Laxton*, the court pointed out a number of differences between a partnership and a joint venture. A joint venture cannot contract in its own right; only its members may do so. Obligations cannot be incurred by it, but only by its members. It may neither sue nor be sued in a separate capacity. A lender must look for redress not to the joint venture but to its members.

If the parties to a commercial arrangement are in partnership as a matter of the general law, then for income tax purposes paragraph 96(1)(a) provides that the income, etc. of the members is to be determined as if the partnership were a separate person.

Therefore, when a partner contributes property to a partnership, the partner is deemed to have disposed of that property at fair market value (subsection 97(1)) unless the partners elect to treat the transfer on a tax-deferred rollover basis under subsection 97(2).

Even though subsection 97(1) does not expressly state that a partnership is a separate person, the basic rule in paragraph 96(1)(a) leads to that conclusion because the transfer of property affects the computation of the taxpayer's income. If the parties were carrying on a joint venture rather than a partnership, the taxpayer who contributed the property would not incur an automatic deemed disposition of the property.

Clearly, it may often be desirable to do business in a joint venture rather than in a partnership. Consider, for example, a situation in which one participant in the business is a non-resident of Canada. In a partnership, none of the members could elect to contribute property with accrued gains on a tax-deferred basis pursuant to subsection 97(2) because, under subsection 102(1), the partnership would not be a Canadian partnership by virtue of one member's non-resident status. In a joint venture, by contrast, each participant would retain its own assets; no deemed disposition of property (and tax thereon) would occur because no participant "transfers" property to the joint venture.

Because a joint venture is not a separate person, each participant in the joint venture is considered to carry on its own business separate from the business(es) carried on by the other joint venturer(s). One consequence of this characterization is that a joint venture, unlike a partnership, does not, technically speaking, have its own fiscal year-end. However, for administrative purposes, the CCRA may allow the joint venture to adopt a fiscal year-end that is separate from the year-ends of the individual members of the joint venture (subject to paragraph 249.1(1)(a)). (See the 1989 Conference Report, question 40, at page 45:23.)

Another consequence of the characterization is that the provisions of the applicable partnership act do not apply to the parties to the joint venture. Thus, the coventurers are not automatically jointly and severally liable to creditors for the debts of the venture; they only become so if they contract on this basis with the creditors. Also, the provisions of the partnership acts that deal with such matters as the right to share in profits and the fiduciary nature of the relation between partners do not apply. While these attributes of partnership are not usually important when the issue involves the income tax consequences of the relationship, they can be of vital importance in the general business and commercial context.

In subsequent articles in this series, we will consider in detail some of the income tax ramifications of carrying on business in partnership in a number of domestic and international situations.

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Matching Principle Not Determinative

In *Ferro* (TCC 2003), the Tax Court held that the objective of determining the "truer picture" of the taxpayer's income overrides the "matching of income and expense" principle and any other accounting principles for computing income. The "truer picture" language is taken from the decision in *West Kootenay Power and Light Company Limited* (FCA 1992), cited by the court in *Ferro*. In *Canderel* (SCC 1998), the Supreme Court used the phrase "more accurate picture" instead of the phrase "the truer picture." The difference in wording does not appear to be material.

Mr. Ferro practised exclusively as a personal injury lawyer in motor vehicle accident cases. He conducted his practice entirely on a contingency basis—that is, his fee was charged as a percentage of the damages ultimately recovered by an injured person. No fee was payable if there was no recovery. He also funded all of the costs of a case, including disbursements and any costs resulting from an adverse decision. The client was never required to pay a penny to prosecute a case; Mr. Ferro covered all the costs.

Cases usually were resolved in two to four years, and typically Mr. Ferro spent a good deal of money during the life of the case. That money was to be recouped when the matter was finally resolved and if the result was favourable.

Mr. Ferro elected under section 34 of the Act to exclude his work in progress for the years under appeal. However, he deducted as current expenses the amount of disbursements incurred in those years. The minister disallowed the deduction of those amounts: she said the disbursements should be regarded as amounts receivable to be included in the appellant's income in each year—in effect, offsetting the amounts claimed as expenses in respect of the disbursements. The minister relied on wording in the appellant's financial statements, which characterized the outstanding disbursements as "unbilled disbursements receivable from clients."

Mr. Ferro maintained that the amounts paid were deductible expenses and not receivables because they were neither receivable from nor payable by the clients in the years in question. He alone was responsible for paying the amounts.

Judge Teskey decided the case in favour of Mr. Ferro and stated that the "matching principle" is no longer a determining factor in measuring income for tax purposes. As well, the accounting treatment adopted by a taxpayer for financial statement purposes will not determine whether an amount has the character of income. Rather, the amount must be looked at in the context of the business affairs of the taxpayer to determine the "truer picture" of his income. In this case, it was clear that Mr. Ferro was paying out the money in order to support the lawsuits, that the expenses were true expenses laid out once and for all, and that they did not need to be "matched" with any expected recovery. Rather, when a payment was received on the resolution of a case, the entire amount would be included in Mr. Ferro's income at that time.

The decision is an example of a court's refusing to follow the matching principle when it does not result in an "accurate" picture of the taxpayer's income, as computed by applying income tax principles. It is also a useful example of a court's not feeling bound by the characterization of an amount in the taxpayer's financial statements. Occasionally, an amount will be recorded as income (as here) or claimed as an expense (a contingent reserve, for example) in the financial statements. This case is a useful reminder that such characterizations are not necessarily binding for income

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tax purposes, although (as happened here) it may be necessary to go to court to make the point.

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Working with Limited Partnerships

Certain sections of the provincial limited partnership acts apply automatically unless the members of the partnership expressly agree to the contrary. Section 24 of the Ontario Limited Partnerships Act, for example, establishes a scheme for distributing assets on the dissolution of the partnership where the partners have not clearly provided for a different method in their partnership agreement. This section was applied recently by the Ontario Court of Appeal in *Byers et al. v. KPMG (as Receiver for CanEnerco Limited)* (Ont. CA 2002).

In *Byers*, CanEnerco, as general partner, contributed 14.9 percent of the partnership assets, but was entitled to 62.5 percent of the profits. Article 12 of the limited partnership agreement provided that on dissolution of the partnership the general partner was to distribute the available assets "in accordance with the interest of the partners." CanEnerco argued that this provision entitled it to share in the available assets on the basis of its percentage share in profits and not by reference to its percentage share of assets contributed to the partnership.

The question, therefore, was the meaning of the phrase "in accordance with the interest of the partners" in article 12 of the agreement. Did "interest" mean the percentage of contributions (14.9 percent), or the percentage share in profits (62.5 percent)?

The court noted that section 24 of the Limited Partnerships Act provides for a distribution of assets on the dissolution of a partnership by reference to original contributions and entitlements to profits, starting with the limited partners, "unless the partnership agreement or a subsequent agreement provides otherwise." The issue came down to the question whether article 12 of the agreement was sufficiently precise to create a priority based on entitlements to profits so as to override the provisions of section 24.

The trial court held that it did not, and the Court of Appeal agreed. The phrase "in accordance with the interest of the partners" in article 12 was ambiguous. Accordingly, the scheme of distribution set out in section 24 took priority.

Although *Byers* is not a tax case, the judgment is worth noting in view of the widespread use of partnerships in tax-planning arrangements. Often, the tax advisers involved in the planning will not be responsible for drafting the terms of the partnership agreement. But they should be aware that their clients' interests will be governed by the terms of the applicable partnership act unless the partnership agreement clearly provides to the contrary. As this case illustrates, it pays to read the fine print.

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