TAX FOR THE Owner-Manager

Editor: Thomas E. McDonnell, QC

Volume 4, Number 4, October 2004

De Facto Control: An Update

The principle of de jure control is well understood, but de facto control (subsection 256(5.1)) is a relatively new addition to the Income Tax Act. Until recently, few cases analyzed the scope or application of this provision. The number of new cases, however, strongly suggests that de facto control is now on the CRA's radar screen. Some cases have reached the Federal Court of Appeal level: of the four decided cases, two are in the taxpayer's favour. As well, the topic was discussed by the CRA at the Canadian Tax Foundation's 2004 annual conference.

Silicon Graphics (2002 FCA 260) is the most important of the four decisions because it contains the most detailed reasoning. Silicon US, a US public corporation, was in de facto control of the taxpayer by virtue of a loan it made to the taxpayer. The loan terms included provisions that effectively placed Silicon US in control of the taxpayer's finances. In addition, the taxpayer was dependent on Silicon US because the taxpayer's software operated only on Silicon US hardware during the years under appeal. The FCA clarified that subsection 256(5.1) applies to one's ability to exercise influence over the persons who have legal control of a company, not to one's ability to influence the day-to-day management and operation of the business.

In *Mimetix Pharmaceuticals Inc.* (2003 FCA 106), a non-resident corporation owned 50 percent of the taxpayer's voting shares. The taxpayer was administered by the non-resident. The non-resident funded the taxpayer in a manner found to be inconsistent with a commercial relationship. The TCC found that in the circumstances the non-resident exercised a form of economic controlling influence covered by subsection 256(5.1). The FCA upheld that finding and dismissed the taxpayer's appeal.

In *9044-2807 Quebec Inc.* (2004 FCA 23), two corporations were found to be associated with a third corporation: the economic dependence of the two corporations on the third was such that the decision-making power over those who had de jure control resided with the third corporation. The court was no doubt influenced by the family relationships between the shareholders of all three corporations.

The latest case is the "Giant Tiger" decision, *Lenester Sales Ltd.* (2004 FCA 217). It confirms that most franchise arrangements will not be caught by subsection 256(5.1), even if the franchisor exercises a significant degree of economic and management control over the franchisee. In *Lenester*, the minister argued that two franchisee companies were associated on the basis that Giant Tiger, the franchisor, exercised de facto control over both of them. The companies were only two of 80 or 90 Giant Tiger franchisees, and the pattern was essentially the same for all of them. Giant Tiger selected a person to operate a franchise. After the operator underwent a training period, Giant Tiger sold 501 shares in an existing company incorporated by Giant Tiger to the operator for nominal consideration; Giant Tiger retained ownership of the remaining 499 shares. The operator became a full-time employee of the company. The company had two directors, one appointed by Giant Tiger and the other appointed by the operator. The bank accounts for the franchisees were "pooled" with those of Giant Tiger. Giant Tiger performed the purchasing functions for all the franchisees.

Following the test set out in *Silicon Graphics*, the Tax Court in *Lenester* found that the franchisor did not have the "clear right and ability to effect a significant change in the board of directors or the powers of the board of directors or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors." On this basis, the court found as a matter of fact that the franchisor did not control the franchisees. The court also found that the franchise arrangements fell within the specific exception for franchises set out in subsection 256(5.1). The FCA dismissed the Crown's appeal.

In This Issue

CTF ACEF
Canadian Tax Foundation
L'Association canadienne d'études fiscales

These four decisions may seem somewhat inconsistent, but it is clear that the FCA has accepted the test in *Silicon Graphics* (set out above) for de facto control. The CRA also accepts this test, but whether the test is met will always be a question of fact. *Lenester* tells us that—at least in the case of franchise arrangements—one can exercise a significant degree of economic control over a company without causing the company to run afoul of the de facto control test.

Jennifer J. Smith
Ernst & Young LLP, Ottawa

Donated Art: Fair Market Value and Personal-Use Property

Frank Klotz (2004 TCC 147) is an important test case dealing with the valuation of donated art. In 1999, Mr. Klotz was a participant in a program called "Art for Education." Under the program, one of the promoters acquired prints from various artists or dealers at prices of US $50 or less, incurred various expenses in connection with the program, and resold the prints to the program participants for prices ranging from Cdn $290 to $320 per print.

Mr. Klotz purchased 250 prints created by 30 artists for $75,000 from the promoter on December 28, 1999; on December 30, 1999, he donated the prints to Florida State University. He received a charitable donation receipt for $258,400 and claimed a charitable gift tax credit based on that amount. The prints were shipped directly to the university; Mr. Klotz did not select the prints, never saw the prints, and never had possession of them. He argued that each of the prints was worth about $1,000, according to appraisals that he had obtained.

The CRA disallowed Mr. Klotz's claim on the basis that the fair market value of the prints was at most $300 per unit, or $75,000 in aggregate, which was the amount that he had paid the promoters. The Crown argued that the prints were not personal-use property. (The appellant was assessed penalties under subsection 163(2) of the Income Tax Act, which the Tax Court held did not apply.) If the donated art was not personal-use property, the appellant would lose the benefit of subsection 46(1) and realize a capital gain on each donated print equal to the excess of its fair market value over his cost. (This subsection was subsequently amended as a result of the 2000 federal budget to deny its benefits to property that is part of a donation scheme. The latest proposed changes to the rules governing charitable donations are found in the revised draft legislation released by the Department of Finance on February 27, 2004.)

The court considered two possible alternative meanings of "personal-use property." Under one approach, capital property falls into two categories—(1) "income property" (inventory, land, depreciable property or eligible capital property used in a business or to earn income, and property used or held for an income-earning purpose, whether the income was from property, business, employment, or any of the specifically enumerated sources in the Act) and (2) everything else, which would be personal-use property. The alternative approach, espoused by the Crown, was that personal-use property could qualify as such only if it was actually used or enjoyed by the taxpayer. Under this approach, capital property falls into three categories—income property, property physically possessed and used or enjoyed personally by the taxpayer, and everything else.

Bowman ACJ rejected the Crown's approach for four reasons. (1) The words after "includes" in the definition of personal-use property in section 54 broaden the meaning of the term, and it is not appropriate to also use them to restrict the meaning of the term. (2) The first approach set out above is more consistent with the scheme of the Act. (3) The second approach would lead to a practical anomaly. For example, jewellery inherited by a taxpayer and held in a safety deposit box would not be personal-use property; however, if the taxpayer wore the jewellery, it would be. (4) The definition of "listed personal property" in section 54 merely indicated that prints were capable of being personal-use property. The Tax Court concluded that the prints were personal-use property under either approach and noted that one method of using property was to give it away.

This decision, if upheld on appeal, will be of considerable assistance to the CRA. The Tax Court's interpretation of the meaning of "personal-use property" could be important in determining whether a particular property (such as a residence), jewellery or art, or an animal (such as a racehorse) is an income property or personal-use property for the purposes of the Act.

Readers who are interested in the issues raised in *Klotz* may wish to refer to the more recent decision in *Nash* (2004 TCC 651). In that case, Bell J held that the donated art was personal-use property. The court also held that the fair market value of the donated art was the value determined by the appraiser rather than the donor's cost (the latter amount being substantially less than the appraised value).

Philip Friedlan
Toronto

Income or Capital Account: A New 365-Day Test?

One of the most basic questions in Canadian income tax law is whether a gain on the sale of property is on income or capital account. If the gain is realized other than in the ordinary course of a business, but is part of an adventure in the nature of trade, it will be on income account: *Taylor* (56 DTC 1125 (Ex. Ct.)). Whether or not a gain on securities realized by a taxpayer not in the business of dealing in securities is part of an adventure in the nature of trade depends on the facts and circumstances of each case. Generally, the courts have been reluctant to find that a gain realized in the course of an isolated transaction, however short the holding period, is on income account: *Irrigation Industries* (62 DTC 1131 (SCC)). There, notwithstanding that the taxpayer purchased speculative securities with the intention of realizing a profit—and did realize a profit within four months from the date of acquisition—the court held that the gain was on capital account. The court specifically rejected as relevant the fact that the securities were acquired with the intention of disposing of them at a profit as soon as there was a reasonable opportunity of so doing.

It is not uncommon for a successful entrepreneur to sell his business and invest the sale proceeds in publicly traded securities. In such a case, the entrepreneur may seek advice from a broker or other person knowledgeable in the securities market. The adviser may recommend the initial purchase of several securities and may suggest that the initial positions be liquidated or added to as market conditions dictate. Such a course of conduct may suggest to the CRA that the taxpayer is acting in respect of his securities portfolio in the same manner as a dealer in securities would do. Accordingly, the CRA would tend to assess any gains realized on income account: see *Interpretation Bulletin* IT-479R, "Transactions in Securities," February 29, 1984, paragraph 10.

IT-479R is provocative for a number of reasons. In paragraph 11(c), the CRA says that if a taxpayer "has some knowledge of or experience in the securities markets," this will be a factor that may indicate that a gain on a securities transaction is on income account. In the same vein, paragraph 17 indicates that where the taxpayer has used special information not available to the public to make a quick profit, there is a presumption that the gain is on income account. And paragraph 15 says that all gains and losses realized by a corporation whose prime activity is trading in securities are considered to be on income account, notwithstanding that the corporation does not hold itself out to the public as a dealer in securities.

How relevant is the length of time between the purchase and the sale of a security in determining the character of a gain or loss on its sale? Beyond noting that when securities are owned "only for a short period of time" there is an indication that the taxpayer is carrying on a business of trading in securities (paragraph 11(b)), the interpretation bulletin is silent on what length of time is determinative in this regard. However, the CRA may be moving to impose a 365-day ownership test as an administrative rule for determining the character of a gain. This was the basis for the reassessments in *Strassburger* (2004 TCC 614).

In *Strassburger*, the corporate taxpayer realized substantial funds on the sale of its primary business interests and invested them in a portfolio of marketable securities. By the end of its 1996 tax year, the portfolio was worth about $5.8 million. During the 1996 tax year, the taxpayer realized profits on 52 sales of securities held for periods of less than 365 days, and profits on 32 sales of securities held for periods in excess of 365 days. All of the gains on these transactions were reported as capital gains. The minister assessed on the basis that the gains on securities held for periods of less than 365 days were on income account. He included in this category additional securities in companies held for more than a year if the additional securities were sold within 365 days of purchase.

Rip J allowed the taxpayer's appeal. On the evidence, the activities in question were not those of a trader in securities. He said that "the arbitrary decision that the shares held 365 days or less were on revenue account and those held more than 365 days were on capital account was arbitrary and without any reasonable basis." There was no indication in the reasons whether the 365-day rule applied by the CRA in this case reflected a new internal policy or whether it was just the decision of the assessor on the facts of the case.

In our experience, the CRA is becoming more aggressive in seeking to tax gains on securities, especially when the taxpayer is a corporation. At the assessing level, if the holding periods are relatively short (less than a year), it is assumed that the corporation is trading in securities, despite the weight of other factors such as the source of the funds used, the nature of the securities purchased, the investment philosophy employed, and the reasons for the sales in question. To date, however, we have usually been able to persuade senior CRA representatives that the length of the holding period in itself is not determinative. *Strassburger* is the first reported case of which we are aware in which the CRA went to court on the basis of a 365-day test. Time will tell whether *Strassburger* is the harbinger of a new administrative test in this area.

Thomas E. McDonnell
Thorsteinssons, Toronto

Payments in Lieu of Rent: "Taxable Intentions"?

In *Transocean Offshore Limited* (2004 TCC 454), the Tax Court considered whether a settlement payment made by a Canadian resident to a non-resident for voluntary termination of a bareboat charter agreement was subject to withholding tax under paragraph 212(1)(d) of the Income Tax Act. In 1997, Petro-Canada and its co-venturers entered into a bareboat charter agreement with a US corporation, Transocean Offshore Inc. (TOI), to charter an offshore drilling rig owned by the taxpayer, Transocean Offshore Ltd., an affiliate of TOI. The co-venturers also secured related services for a two-year period with an American affiliate of TOI, Transocean Ventures Inc. (TOVI). The taxpayer, TOI, and TOVI were non-residents of Canada engaged in the business of chartering offshore drilling apparatus and providing related ancillary services. Under the charter agreement, the co-venturers agreed to pay TOI a fixed rate for each day that the offshore drilling rig was in actual use and to pay for various upgrades to the offshore drilling rig. In 1998, the co-venturers terminated both the charter agreement with TOI and the drilling services agreement with TOVI. (The drilling services agreement was terminated in accordance with its terms because the charter agreement had been terminated.) Under the termination agreements, the co-venturers were required to pay the taxpayer—not TOI or TOVI—US $40 million as full consideration for the voluntary termination of the agreement. No evidence was adduced as to how the amount was calculated. It was pointed out that the total amount that would have been paid under the agreement was US$43.8 million. At no time did the co-venturers take possession of the offshore drilling rig, and the rig did not enter the territorial sea of Canada. The co-venturers withheld and remitted to the CRA 25 percent of the settlement payment on a timely basis. The taxpayer subsequently applied to the CRA for a refund of the tax withheld, but the CRA denied the request on the basis that the payment was subject to paragraph 212(1)(d).

On the basis of the surrogatum principle, the CRA argued that the settlement payment had been paid as, on account or in lieu of payment of, or in satisfaction of rent or a similar payment for the use of, or the right to use in Canada, the offshore drilling rig, such that the amount paid was subject to withholding tax under paragraph 212(1)(d). In a nutshell, the surrogatum principle holds that a payment of damages should be treated for income tax purposes in the same way as the substituted payment (in this case, rental payments to a non-resident) would have otherwise been treated. The taxpayer argued that the charter agreement never became operative, that the offshore drilling rig was never used in Canada, and that no payments under the charter agreement were ever made or became due. Thus, damages were not in lieu of a rental or similar payment. The CRA responded that obligations were created when the contract was signed, and that these obligations were at the root of the existence of the settlement payment; the settlement payment was made for rents that would have been due in the future, and therefore the amount was taxable.

The taxpayer also referred the court to subparagraph 212(1)(d)(ix), which exempts from Canadian tax a rental payment for the use of, or the right to use, any corporeal property outside Canada. The taxpayer argued that the jurisprudence has consistently held that damages paid for breach of contract do not take on the specific character of the object they replace. For example, damages for termination of an employment contract are not remuneration or a benefit from employment, and a payment in respect of future interest on early repayment of a loan is not interest. Thus, damages in respect of the termination of a lease are not rent. The CRA responded that jurisprudence regarding damages in respect of employment contracts does not apply to general business contracts: damages relating to employment contracts are an exception to the general rule that damages are taxable.

The TCC agreed with the CRA that court decisions regarding damages for breach of an employment contract and unearned interest do not apply to trade agreements, and it confirmed that the surrogatum principle takes precedence when trade agreements are involved. The taxpayer did not introduce any evidence to contradict the CRA's assumption that the settlement payment was made for loss of rental revenue arising from the breach of the charter agreement. The TCC concluded that the US $40 million was paid as, on account or in lieu of payment of, or in satisfaction of rent or a similar payment for the use of, or for the right to use in Canada, a property, and therefore the amount was subject to withholding under paragraph 212(1)(d).

What would otherwise be a simple application of the surrogatum principle in a domestic context may lead to anomalous results if a non-resident is involved.

Consider a situation in which a corporation resident in Canada becomes a lessee under a 25-year lease agreement concluded with a non-resident manufacturer in year 1 in respect of customized equipment to be delivered in year 5. At the time the lease agreement is entered into, it is unclear whether the corporation will use the equipment in its US or Canadian business; that decision will depend on its needs when it takes delivery of the equipment in year 5. In year 3, the corporation negotiates a termination agreement under which it has to pay a significant settlement amount. According to the reasoning of the TCC in *Transocean Offshore Limited*, such a payment will likely be subject to withholding tax under paragraph 212(1)(d). The corporation may not be able to benefit from the exemption provided in subparagraph 212(1)(d)(ix).

Assume that, in the circumstances described above, the corporation initially intends to use the equipment in Canada. The corporation changes its intention in year 2 and decides to use the equipment exclusively in its US business. In year 3, before using any of the equipment, the corporation terminates the lease agreement and makes a settlement payment. Will the payment be subject to withholding tax? Is the tax treatment of the non-resident to be based on its customer's intentions rather than the actual use or non-use of property, as the case may be? From a policy perspective, if the property is never used in Canada, a strong argument can be made that the settlement payment is not caught by paragraph 212(1)(d).

The taxpayer in *Transocean Offshore Limited* has filed an appeal to the Court of Appeal.

Benoît Lacoste Bienvenue
KPMG LLP, Montreal

Finalizing Tax Accounts: Limits on Reassessments

Maximizing the use of various tax accounts is an important part of tax planning for private corporations and their shareholders. The capital dividend account (CDA), the refundable dividend tax on hand (RDTOH) account, non-capital losses, the undepreciated capital cost balances for depreciable assets, and unabsorbed investment tax credit pools are some of the more significant examples. Can the minister readjust the balances in those accounts outside the normal reassessment period?

The CRA may reassess at any time within the "normal reassessment period," which is defined in subsection 152(3.1) of the Income Tax Act as three years after the earlier of the mailing date of a notice of original assessment and the mailing date of an original notification that no tax is payable. In the case of a mutual fund trust or a corporation other than a Canadian-controlled private corporation, this period is extended to four years. The general limitation periods may be extended to take into account the carryback of losses, gifts, and tax credits; transactions with non-arm's-length non-residents; and other special circumstances. Paragraph 152(4)(a) removes all limitation periods when a tax filing contains any misrepresentation that is attributable to neglect, carelessness, or wilful default or that represents a fraud, and when a waiver is filed.

There are hidden surprises. For example, subsection 143.2(15) effectively extends the reassessment period indefinitely to give effect to the "tax shelter" (as defined) rules.

A common misconception is that a reassessment starts the three- or four-year period running again. This is incorrect; the reassessment period always runs from the mailing date of the *original* assessment or notification that no tax is payable.

In *New St. James* (66 DTC 5241 (Ex. Ct.)), the taxpayer offset income earned in a particular year by a loss carried forward from an earlier year. The taxpayer assumed that the amount of the loss carried forward was cast in stone because the loss year was statute-barred. The court, however, allowed the minister to reduce that loss by disallowing certain expenses incurred in the loss year. *New St. James* has been quoted with approval in subsequent cases.

The principle enunciated in *New St. James* appears to allow the CRA to recompute tax accounts in any year in the carryforward-carryback period in which those items are taken into account in computing tax, notwithstanding that the year in which the transactions that gave rise to the tax accounts occurred cannot be reassessed because it is statute-barred.

For example, a taxpayer might incur an overall loss in a particular taxation year in which a gain on a particular disposition was reported as a capital gain. If that loss is being offset by the taxpayer, say, six years later against income in that sixth year, it appears to be open to the CRA to recharacterize the capital gain realized in the loss year as an ordinary income gain. The loss carried forward would then be reduced or even eliminated entirely by what was previously thought to have been the tax-free portion of a capital gain. Even though the particular year is statute-barred for reassessment, the CRA takes the position that the recharacterization is for the purpose of determining the tax payable in the sixth year, which is open for reassessment. The taxpayer would have to object to the CRA's assessment or reassessment of that sixth year in order to challenge the recharacterization of the gain.

One can remove the uncertainty about the amount of a loss by requesting a determination of the amount pursuant to subsection 152(1.1). However, it appears that the amount of other tax accounts can remain unresolved for some time.

The *New St. James* principle casts doubt on the conventional wisdom that a corporation can safely pay a capital dividend after the date upon which the year in which the capital dividend increment was created becomes statute-barred. *New St. James* appears to stand for the proposition that, in effect, the quantum of the CDA is not entirely statute-barred until the statute-barring date has passed for the year in which the last capital dividend is paid.

The *New St. James* principle may not be entirely negative. Query, for example, whether a gain that was filed as an ordinary income gain in a statute-barred year might be recharacterized in a current year as a capital gain so as to create a CDA. There may yet be interesting court decisions on this type of fact situation.

Perry Truster
Truster Zweig LLP
Richmond Hill, Ontario

Nullifying Catastrophic Trustee Decisions

In *Juliar* (2000 DTC 6589 (Ont. CA)), the parties to an estate freeze mistakenly took back promissory notes instead of shares from Freezeco, so that section 84.1 applied to deem a dividend to have been received by the transferring parties. The Ontario Court of Appeal upheld an order in the lower court allowing the parties to rectify the transaction by substituting shares for the notes. In *Snow White Productions Inc.* (2000 BCSC 604), the British Columbia Supreme Court granted an order rectifying a film production services agreement to permit the taxpayer to claim investment tax credits.

In both cases, the courts were satisfied that the parties had made an honest mistake in the documents evidencing their transactions; the parties were allowed to rectify the documents to reflect their original intention, notwithstanding that their intention was to avoid tax. Would a court allow the parties to a transaction to nullify it altogether, rather than correct it, if the transaction can be shown to have catastrophic tax consequences if allowed to stand? Specifically, would the court do so in the context of an exercise of discretion on the part of the trustee of a trust?

Occasionally, the court will be asked to *vary* the terms of a trust when it appears that the variation will allow the trust to avoid a serious tax consequence: see *Russ v. British Columbia (Public Trustee)* ((1994), 3 ETR (2d) 170 (BCCA)). Does it follow that a court would respond positively if it was asked to *nullify* some action taken by the trustees because that action would have unanticipated and catastrophic tax consequences?

A line of authority in the United Kingdom suggests that the courts there will exercise an equitable jurisdiction to relieve the trust (and the trustees) in an appropriate case. The leading decision is *Hastings-Bass* ([1975] 1 Ch. 25). The trustees in that case asked the court to nullify their exercise of a power of appointment under the trust because it would result in unexpected and adverse estate tax consequences. On the facts of the case, the court refused to do so. But the court said that, as a general principle, it did have the power to declare the exercise of discretion by a trustee to be of no effect when it was clear that the trustee would not have acted had the proper considerations (including tax considerations) been taken into account.

Several other UK cases have applied this principle. In *Green v. Cobham* ([2000] WTLR 1101 (Ch. D.)), a deed of appointment creating an accumulation and maintenance trust for a minor was declared to be void ab initio because the trustees failed to consider that the new trust would be a resident of the United Kingdom and subject to tax on a large capital gain.

In *Abacus Trust Company (Isle of Man) Limited* ([2001] STC 1344 (Ch. D.)), a trustee was instructed to make a nominal distribution to a charity one day after the trust's tax year-end. The trustee made the distribution two days before the year-end, with the result that the settlor of the trust became assessable for a substantial capital gains tax liability. The court declared the appointment in favour of the charity void ab initio. It is noteworthy that the Inland Revenue Commissioners refused to agree that the appointment to the charity was null and void, refused to be joined as a party to the application to the court, and refused to be bound by the decision of the court. However, it is not clear how the commissioners could place themselves above the law and refuse to be bound by the court's decision.

It appears that the *Hastings-Bass* decision has not yet been applied by a Canadian court. However, as noted above, Canadian courts have applied a somewhat analogous principle in the rectification context. The CRA can be expected to oppose an application for a nullification order, especially if it appears that the trustees are attempting to avoid the consequences of aggressive tax planning gone wrong. At the Canadian Tax Foundation's 2001 annual tax conference, a CRA official said, "We feel strongly that obtaining a rectification order should not become a convenient method of 'fixing' aggressive tax plans that are uncovered on audit." However, if the trustees exercised their discretion in ignorance of the adverse tax consequences, and if it can be shown that the trustees would not have exercised their discretion if they had known of the consequences, a court may be sympathetic to a request for nullification.

David G. Thompson
Thorsteinssons, Vancouver

Business Losses: General Partner Deemed a Limited Partner

Subsection 96(2.1) of the Income Tax Act generally restricts the amount of losses that a limited partner can claim to the limited partner's at-risk amount. The subsection applies to members of partnerships who are limited partners under the general law of partnerships. However, subsection 96(2.4) sets out a number of situations in which members of partnerships who are not otherwise limited partners under the general law will nonetheless be deemed limited partners for tax purposes.

Subsection 96(2.4) provides that a taxpayer who is a member of a partnership at a particular time is a limited partner if at that time, or within three years after that time, (a) the partner's liability is limited by the operation of any law governing the partnership arrangement (an exclusion applies in favour of professional limited liability partnerships); (b) the partner is entitled to receive, either absolutely or contingently, a benefit defined in paragraph 96(2.2)(d) of the Act; or (c) one of the reasons for the existence of the partner is to limit the liability of any person with respect to the partnership interest and is not to permit any person who has an interest in the partner to carry on that person's business (other than an investment business) in the most effective manner.

An additional rule relating to the effect of certain buy-sell arrangements is set out in paragraph 96(2.4)(a), but is not discussed here.

These deeming rules are broad and may have unintended consequences, as shown in the following examples.

■ *Paragraph 96(2.4)(a):* Assume that a general partnership is formed on January 1, 2001 ("the particular time") with a fiscal period ending on December 31. On December 31, 2004, the partnership is converted to a limited partnership. Does paragraph 96(2.4)(a) operate to deem the partners limited partners in 2001? The answer turns on the scope of the phrase "within 3 years after that time." Does "3 years" mean three calendar years (the wider meaning), or does it mean the three consecutive periods of 365 days ending after the particular time (the restricted meaning)?

Under the Interpretation Act (RSC 1985, c. I-21), it may be argued that in the absence of a definition of "year" for the purposes of the subsection, it should be taken to mean the period of 365 days from the particular time (Interpretation Act section 37(1); compare section 28). If the partnership incurred losses in 2001, the interpretation of "year" could directly influence the amount of loss deductible by the partners in respect of that year. If the restricted meaning is the correct interpretation, the partners would be entitled to deduct the 2001 losses without regard to the at-risk rules. If the wider meaning applies, the conversion to a general partnership in 2004 could limit the deductibility of the losses in 2001 because the at-risk rules would become retroactively applicable.

■ *Paragraph 96(2.4)(b):* In *Docherty* (2003 TCC 754), the court ruled that two general partners were deemed limited partners for prior taxation years, and it restricted the amount of business losses they could deduct to their respective at-risk amounts. By the terms of the partnership agreement, the two partners did not have to suffer any operational losses from the project for a period of 15 years. The project was not completed, and that partnership clause was never invoked. Nonetheless, the court ruled that the general partners were caught by the broad wording of paragraph 96(2.4)(b), which applies even if the benefit in question is a contingent one.

■ *Paragraph 96(2.4)(c):* Assume that Profitco incorporates a wholly owned Subco. The two corporations form a limited partnership in which Subco is the general partner and Profitco is the limited partner. The limited partnership incurs losses, and after a period of time Subco is wound up into Profitco so that Profitco may utilize the losses. Provided that the reason Subco was formed by Profitco was to help Profitco carry on its business in an effective manner—say, to mitigate the impact of potential lawsuits on its operations—paragraph 96(2.4)(c) should not apply to deem Subco a limited partner and restrict the deductibility of the losses to its at-risk amount.

Manu Kakkar
Kakkar and Associates
London, Ontario

Safe Income Not Prorated on Partial Rollover

729658 Alberta Ltd. (2004 TCC 474) makes an important point regarding the calculation of safe income when an Opco's shares are transferred to a Holdco on a partial rollover basis prior to a sale to a third party. Contrary to an established CRA administrative position, the decision suggests that Holdco may inherit all of the safe income attributable to the Opco shares even though a portion of the accrued capital gain on those shares is realized on the transfer to Holdco.

This point is easiest to illustrate with a simple example, loosely based on the facts in *729658*. Assume that A owns all the common shares of Opco. The shares have an FMV of $12 million, an ACB of $1, PUC of $1, and a safe income entitlement of $2 million. An unrelated third party is prepared to purchase the shares at their FMV. Prior to the sale, A transfers the shares to a new Holdco in consideration of a promissory note for $10 million and common shares having a nominal PUC. The parties make a section 85 election in which the agreed amount for the shares is $10 million. Immediately thereafter, Opco pays a stock dividend of $2 million to Holdco in shares having a nominal PUC and a $2 million redemption amount. Holdco sells the Opco common shares to the third party for $10 million, and Opco redeems the stock dividend shares for $2 million.

A intends that the transactions will have the following tax consequences:

1) On the sale of the Opco common shares to Holdco, A will realize a taxable dividend of $10 million because the amount of the Holdco note exceeds the PUC/ACB of the shares by this amount (section 84.1).
2) Holdco will acquire an ACB of $10 million for the shares by reason of the section 85 election.
3) Holdco will realize a taxable dividend of $2 million on the redemption of the stock dividend shares, but this will be a tax-free intercorporate dividend. The dividend will not be recharacterized as a capital gain because the amount of the dividend does not exceed the $2 million of Opco's safe income (subsection 55(2)).
4) Holdco will not recognize any gain on the sale of the common shares for $10 million because this amount is equal to its ACB of the shares.

Implicit in the third point is the conclusion that all of Opco's safe income of $2 million was transferred to Holdco on the sale to it of the Opco common shares, notwithstanding that A and Opco elected a transfer amount ($10 million) that resulted in A recognizing five-sixths of the accrued capital gain on the shares. This raises the question whether, on a proper reading of subsection 55(2), Holdco inherited all of the safe income ($2 million), or only a lesser amount equal to one-sixth of it ($333,333).

In *729658*, the CRA assessed Holdco on the basis that the $2 million taxable dividend was a capital gain because the safe income of Opco was only $333,333. Since the dividend exceeded this amount, the full amount of it was to be regarded as a capital gain. The Tax Court (Woods J) rejected this argument and allowed the appeal.

The case is significant for the manner in which the judge reached her conclusion. Subsection 55(2) is an anti-avoidance provision, designed to prevent the tax-free distribution of unrealized gains in the guise of an intercorporate dividend. In this case, there was no avoidance of tax on the transactions taken together, because A structured the sale of the Opco shares to Holdco to fall under section 84.1 so as to realize a taxable dividend rather than a capital gain. In effect, A chose to be taxed on the net value of Opco at dividend rates rather than capital gains rates. Presumably A did so because the inclusion rate for capital gains in the year of the transaction was 75 percent, with the result that the tax on a capital gain in that year was higher than the tax on a dividend of a corresponding amount. (Effective with the 2000 taxation year, the inclusion rate for capital gains was reduced to 50 percent, with the consequence that capital gains then became taxable at a lower rate than taxable dividends.)

The judge expressly rejected the CRA's argument that on a section 85 transfer the safe income of Opco is "recognized" by the transferor to the extent of any capital gain realized at that time. This is the significant point of the case. It suggests that planners have a degree of flexibility in structuring transactions involving safe income, as long as there is no outright avoidance of tax on the underlying accrued gains. What is not directly dealt with in this case is the question whether a shareholder in Opco is free to exchange his Opco shares for two or more classes of Holdco shares and to allocate the safe income between those classes of shares. The reasoning in the case suggests that notwithstanding the CRA's views on the matter, there now may be some flexibility in this regard. As well, the decision may support an argument that a vendor can do a partial rollover to crystallize the capital gains exemption without eroding safe income.

Thomas E. McDonnell
Thorsteinssons, Toronto

Readers are invited to submit ideas or written material to *Tax for the Owner-Manager*. Please write to Thomas E. McDonnell in care of the Canadian Tax Foundation.

Published quarterly

Canadian Tax Foundation
595 Bay Street, Suite 1200
Toronto, Ontario M5G 2N5
Telephone: 416-599-0283
Facsimile: 416-599-9283
Internet: http://www.ctf.ca
E-mail: t.mcdonnell@sympatico.ca

ISSN 1496-0427