TAX FOR THE Owner-Manager

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Acceptable Loss Trading

On May 3, 2004, Hemosol Corporation announced that as a result of a series of transactions with MDS Inc., an arm's-length party, it had received $16 million for a "significant portion of its unused tax losses and other tax assets." The announcement was remarkable. After the implementation of the GAAR, and especially since the Federal Court of Appeal's decision in *OSFC Holdings Ltd.* (2001 FCA 260), loss trading was presumed to be a dead art. More remarkable still is that the Hemosol transactions were blessed by the CRA in an advance income tax ruling. (See ruling 2003-0031823, as amended by supplemental rulings 2004-0056501 and 2004-0069151R3.)

Hemosol Inc., a taxable Canadian public company involved in a blood products business, was in serious financial difficulty and in need of an infusion of capital. At the time of the subject transactions, it had $300 million available to it in unused tax attributes consisting of non-capital losses, a carryforward balance in its SR & ED pool, and unused ITC carryforwards. MDS, also a Canadian public company, carried on a profitable laboratory business. It owned 11.7 percent of Hemosol's outstanding shares and was its most significant shareholder.

Hemosol and MDS embarked on a complex series of transactions designed to give MDS access to Hemosol's tax attributes at a cost of $16 million. The objective was to channel the profits of MDS's laboratory business through Hemosol and back to MDS—cleansed by Hemosol's tax losses—while insulating MDS's profitable laboratory business from Hemosol's struggling blood products business. It is impossible to set out in a short article the complex series of transactions undertaken by MDS and Hemosol; interested readers should refer to the rulings for the details. What follows is an abbreviated summary of the essential facts.

MDS dropped the assets of its profitable laboratory business into a limited partnership ("Labs LP") in which MDS was the limited partner (99.99 percent) and its wholly owned subsidiary Subco was the general partner (0.01 percent). Hemosol (hereinafter referred to as "Old Hemosol") incorporated a new corporation ("New Hemosol") and dropped the assets of its blood products business into a limited partnership ("Products LP") in which Old Hemosol was the limited partner and New Hemosol was the general partner. When the transactions were completed, Old Hemosol held a 7.1 percent interest in Products LP and New Hemosol held a 92.9 percent interest. The shareholders of Old Hemosol were issued shares of New Hemosol that mirrored their shareholdings in Old Hemosol prior to the series of transactions. The shares of Old Hemosol were reorganized, and MDS rolled its units in Labs LP into Old Hemosol. MDS acquired shares of Old Hemosol representing 47.5 percent of the votes and 99.5 percent of the equity. The public, other than MDS, wound up with shares representing 52.5 percent of the votes and 0.5 percent of the equity. The Old Hemosol assets consisted of 99.9 percent of the units in Labs LP and 7.1 percent of the units in Products LP. MDS contributed $16 million, which found its way to Products LP through a series of transactions. Finally, Old Hemosol was renamed and delisted, and New Hemosol was listed as Hemosol Corp.

From an income tax perspective, MDS did not technically acquire control of Old Hemosol as a result of the series of transactions. The profits of MDS's successful laboratory business were allocated to Old Hemosol and were sheltered by Old Hemosol's existing non-capital losses, SR & ED pool, and ITC carryforwards. The profits were ultimately flowed out to MDS in the form of tax-free dividends on its shares in Old Hemosol. By using two separate limited partnerships, MDS's laboratory business was insulated from Hemosol's riskier blood products business.

MDS continued to manage the day-to-day business of the laboratory business under a management agreement with Labs LP. The former shareholders of Old Hemosol continued to own (through New Hemosol)

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the blood products business. The blood products business likely avoided bankruptcy through the injection of the $16 million. Old Hemosol gave up only its non-capital losses, SR & ED pool, and ITC carryforwards, which it was not likely to be able to use in the near future, or perhaps ever.

The series of transactions was certainly aggressive. It was carefully crafted to manoeuvre through the various highly technical provisions of the Act. The same can be said, of course, for the series of transactions examined in *OSFC* and *Kaulius* (2003 DTC 5644 (FCA)), which will soon be reviewed by the Supreme Court of Canada.

The FCA applied the GAAR to deny the loss trading involved in *OSFC* and *Kaulius.* It was able to discern in the Act read as a whole an unwritten (but nonetheless clear and unambiguous) rule prohibiting loss trading between arm's-length taxpayers. It is therefore surprising that the CRA was prepared to sanction in a ruling the MDS-Hemosol transactions. There appears to be no marked difference between the series of transactions undertaken by MDS and Hemosol and those described in *OSFC* and *Kaulius.*

It is true that Hemosol may well have been saved from bankruptcy by virtue of receiving the $16 million, and one might argue that there was therefore an overriding business purpose to the transaction. However, in *OSFC*, the trustees of Standard Life were also solely motivated by a business purpose in selling the mortgage portfolio in question—that is, they wanted to monetize the portfolio. The court in *OSFC* looked only to the motivation of OSFC, not to that of the trustees. Not surprisingly, it concluded that OSFC's primary purpose was to acquire tax losses. If one looks at the MDS-Hemosol transaction from MDS's perspective, it is difficult to conclude that accessing $300 million in losses for an expenditure of only $16 million was not, at the very least, its primary motivation.

The only real distinction between the *OSFC* facts and the MDS-Hemosol facts is that in *OSFC* there was an actual transfer of losses from Standard Life to OSFC and the other partners, whereas in MDS-Hemosol the losses remained with Old Hemosol and MDS accessed them by channelling the profits of its laboratory business through Old Hemosol. Some would say that this is a distinction without a difference. In ruling favourably on the MDS-Hemosol series of transactions, the CRA has indicated that not all arm's-length loss trading is unacceptable. To this extent, the implied policy in the Act against arm's-length loss trading is not as clear as it was believed to be. Taxpayers are left to wonder when, and in what circumstances, such trading is now acceptable.

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Anti-Avoidance: Will the SCC Be Influenced by the UK Approach?

On February 11, 2004, the Supreme Court of Canada granted leave to appeal in *Canada Trustco Mortgage Co.* (2004 CarswellNat 1925), the first GAAR case to be heard by that court. The appeal will be heard in March 2005. In the interim, the Appellate Committee of the House of Lords has recently rendered judgment in *Barclays Mercantile Business Finance Limited* (2004 UKHL 51), a case involving facts very similar to those in *Canada Trustco.* The committee dismissed the Inland Revenue's appeal from the judgment of the UK Court of Appeal on the basis that the series of transactions in question, though designed to reduce tax, did not involve an improper level of tax avoidance.

Both cases involved a circular sale and leaseback scenario in which the taxpayer purchased capital assets in anticipation of a lease to a third party, thereby acquiring significant tax shelter through an increase in capital cost allowance (CCA). Both transactions required the taxpayer to make a substantial borrowing to finance the purchase of the assets; however, related transactions ensured that the taxpayer was never economically at risk with respect to the repayment of the borrowing. In the Canadian courts, the issue is whether the deduction of CCA in these circumstances is a misuse or abuse so as to engage the general anti-avoidance rule (GAAR). In the United Kingdom, the question was the scope of the *Ramsay* principle, under which certain tax-motivated transactions may be disregarded in determining the fiscal consequences of an interconnected series of transactions.

In *Canada Trustco*, the minister argued, inter alia, that there was no real cost against which Canada Trustco's claim for CCA could rest. Accordingly, it was an abuse of the relevant provisions of the Act to allow the taxpayer to claim CCA. In the Tax Court, Miller J rejected this argument. To accept it, he said, would require him to recharacterize the legal form of the transaction for the purposes of determining whether there had been an abuse. He was not prepared to do so. Instead, the transaction was to be viewed first in terms of the legal consequences; only if it was found abusive at this level might it then be recharacterized under the GAAR to what was reasonable in the circumstances. In effect, the minister may not ignore valid legal arrangements and recharacterize on the basis of the alleged economic substance. The minister's appeal was dismissed (2004 FCA 67).

In the appeal to the Supreme Court of Canada, the minister asked the court, inter alia, to consider whether, in determining if a transaction results in a misuse of the provisions of the Act or an abuse of the Act read as a whole, the court is required to look beyond the legal form of the transaction to consider also the economic and commercial realities thereof. In this respect, the minister's approach is similar to that taken by the Inland Revenue in *Barclays Mercantile*, and it is because of this that the case is of interest to us in Canada.

In reaching its conclusion in *Barclays Mercantile*, the committee made specific reference to the principle in *Ramsay* (1981 STC 1747). That principle seeks to determine the nature and character of an interdependent series of transactions by reference to the results sought and achieved. If one or more of the transactions in such a series has been inserted solely for fiscal reasons, then, in certain circumstances, those intermediary transactions may be ignored in determining the tax consequences. The difficulty with the *Ramsay* decision lies in deciding when and in what circumstances its principle is to be applied. The *Barclays Mercantile* case does not entirely resolve this difficulty, but it is a step in that direction.

As explained by the committee, until the development of the *Ramsay* principle, UK revenue statutes were "remarkably resistant to the new non-formalist methods of interpretation," and "a good deal of intellectual effort is devoted to structuring transactions in a form which will have the same or nearly the same economic effect as a taxable transaction but which it is hoped will fall outside the terms of the taxing statute" (paragraphs 35 and 33 of the judgment). *Ramsay* purported to change this by emphasizing the purposive approach to statutory interpretation: words in the tax act were to be construed so as to give effect to the intention of Parliament in enacting them. (Note the distinct parallel here to the object-and-spirit approach followed by Canadian courts.) As one court put it in a case subsequent to *Ramsay*: "The ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically" (*Collector of Stamp Revenue v. Arrowtown Assets Ltd.* (2003 HKCFA 46), cited by the committee in *Barclays Mercantile* at paragraph 36).

The committee concluded that what was called for in the circumstances was a close analysis of what, on a purposive construction, the statute actually requires. In so doing, the committee explained that the object of granting CCA is to provide a tax equivalent to the normal accounting deduction from profits for the depreciation of machinery and plant used for the purposes of a trade. When a finance lease is involved, the focus is on what the lessor does, not the lessee. It is immaterial, for example, to ask what the lessee does with the purchase price, how it funds the payment of rent, and how it uses the leased assets.

In respect of the assertion that the transaction had "no commercial reality," the committee stated that such an assertion depended entirely upon an examination of what happened to the purchase price *after* it had been paid. This was not permissible. The only question was whether the taxpayer had in fact incurred an expenditure on capital equipment. The committee found that it had, and that it was therefore unnecessary to look at the arrangements entered into to ensure that the taxpayer was in funds to repay the money borrowed to make the expenditure in the first place.

This seems to be a narrowing of the circumstances in which the English courts will apply the *Ramsay* principle. The decision can be seen as backing away from a willingness to strike down an anti-avoidance scheme on the basis of judicial (as opposed to legislative) authority. In this context, the *Canada Trustco* case raises a similar conceptual issue. Under the GAAR, the question of abuse arises only after it has been decided that the transactions involved do not offend the object and spirit of the relevant provisions. In assessing whether there is an abuse, the courts to date have decided that they are bound by the legal effect, not the economic substance, of the transactions under review. If the Supreme Court rejects this approach in favour of an economic substance analysis as the first step, it will significantly extend the scope of the GAAR and, it is suggested, in a way that was rejected by the English court in *Barclays.*

Whether the Supreme Court of Canada ultimately adopts or departs from the committee's narrow manner of delineating the transaction in applying its anti-abuse doctrine remains to be seen; however, the analysis undertaken by the House of Lords certainly provides food for thought in anticipation of the Supreme Court hearing.

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Safe Income Planning

Editor's note: The recent Tax Court decision in 729658 Alberta Limited *(2004 TCC 474) was noted in "Safe Income Not Prorated on Partial Rollover,"* Tax for the Owner-Manager*, October 2004. The conclusion in that case may be relevant in a number of fairly standard owner-manager situations. One of them, the use of the capital gains exemption on the sale of shares to a third party, is discussed in this article.*

"Safe income" is the amount of undistributed income that may be distributed to a corporate shareholder without attracting the deemed capital gain rule in subsection 55(2) of the Income Tax Act. Generally, when one corporation (Holdco) receives a dividend from another (Targetco) in order to reduce the value of the shares of Targetco prior to the sale of such shares, subsection 55(2) will convert the dividend to a capital gain to the extent that the gain can reasonably be considered to be attributable to anything other than the "safe income" of Targetco vis-à-vis Holdco. *729658 Alberta Ltd.* raises the question of when safe income is to be prorated if the Targetco shares are transferred to Holdco on a partial rollover basis prior to the sale to a third party. Of particular interest is the question whether the safe income calculation is affected by the decision to claim the capital gains exemption. Consider the following four scenarios.

Scenario 1. Assume that Holdco owns all of the shares of Targetco and that the following values apply:

FMV of Targetco shares	$1,200,000
ACB of Targetco shares	nil
Safe income of Targetco vis-à-vis Holdco	$200,000

If, in contemplation of the sale of the Targetco shares, Targetco pays a $200,000 dividend to Holdco, following which Holdco sells the shares to an arm's-length party for $1,000,000, the capital gain taxed to Holdco is $1,000,000.

Scenario 2. Scenario 2 is identical to scenario 1, except that individuals X and Y, each of whom owns 50 percent of the shares of Targetco, first roll their shares of Targetco into Holdco under subsection 85(1) and elect proceeds of nil, thereby deferring 100 percent of the accrued gain on the transfer. Again, the gain taxed to Holdco is $1,000,000.

This result is not spelled out in the Act. However, it is a reasonable interpretation based on the wording of subsection 55(2), and it accords with the CRA's administrative practice.

Scenario 3. Scenario 3 is identical to scenario 2 except that individuals X and Y each elect proceeds of $500,000 pursuant to subsection 85(1) and are taxed on capital gains of $500,000. As a consequence, Holdco acquires an ACB of $1,000,000 and realizes no gain on the resale to the third party. The capital gain of $1,000,000 is fully taxed in the hands of X and Y.

In essence, this was the situation examined in *729658 Alberta Ltd*. (In that case, X and Y were subject to section 84.1 on the transfer of their shares to Holdco and were taxed on deemed dividends rather than on capital gains.) The issue was whether the $200,000 dividend from Targetco to Holdco was in excess of the safe income entitlement of Holdco. The CRA said that because Holdco had inherited only one-sixth of the gain inherent in the shares of Targetco, it acquired only one-sixth of its safe income, $33,333. The court did not agree: it held that because the $1,000,000 gain that would have been taxed to Holdco in scenario 1 had been taxed to X and Y, no mischief had been perpetrated. Therefore, the safe income of Targetco vis-à-vis Holdco was the full $200,000.

Although this result is reasonable, is it technically correct? The answer is no, if the appropriate comparison is to circumstances in which a Holdco acquired shares of a Targetco from an arm's-length party for $1,000,000 at a time when Targetco had safe income on hand of $166,667. If one assumes that a subsequent unrealized appreciation occurred in the Targetco assets of $200,000, and that Targetco had after-tax income of $33,333 on hand at the time Holdco proposed to sell the shares to another purchaser, it would be inappropriate to regard Targetco as having safe income on hand of the full $200,000 as well as an ACB of $1,000,000. This example is essentially the foundation stone of the CRA's administrative practice, which is designed to prevent the double counting of safe income and ACB.

The court chose not to examine subsection 55(2) in this light, saying that this was not the set of circumstances presented by the *729658 Alberta* facts. Rather, as indicated above, it asked whether or not the gain in excess of safe income had been fully taxed to X, Y, and Holdco as a group. Because the transfer to Holdco had been structured to trigger the operation of section 84.1, the accrued gain had been fully taxed, albeit at dividend rates rather than at capital gain rates. (The Crown apparently conceded that this difference was immaterial.) This raises an interesting planning issue, as described in the next example.

Scenario 4. The facts in scenario 4 are the same as those in scenario 3, with one major difference; X and Y each claim the capital gains exemption in respect of the gain realized on the transfer to Holdco by electing proceeds of $500,000. Does this additional fact change the safe income calculation? Arguably, it should not. As in scenario 3, the entire gain is taken into account *in computing income*, but it is not taxed because of a specific provision—the capital gains exemption. A purposive approach suggests that subsection 55(2) ought not to be applied so as to prevent the operation of a specific rule such as that in section 110.6. If, however, the *729658 Alberta* decision is read to mean that it applies only when the accrued gain has been *fully taxed*, then the CRA's position will likely prevail. Although there does not appear to be a compelling reason to read the subsection this way, careful practitioners will want to consider the risks involved in structuring a sale to extract the safe income and utilize the capital gains exemption.

The lesson to be learned from the court's analysis is that when a generally worded anti-avoidance provision such as subsection 55(2) has been enacted to prevent a particular abuse, the courts may look at the result of a series of transactions to determine whether or not a taxpayer has realized the advantage sought to be denied by Parliament. If it appears that no advantage has been obtained, the general language should not be interpreted technically as if there had been an abuse. This is in contrast to provisions with respect to which there is no ambiguity, in which case the words in the Act must be interpreted literally. (For example, see *Antosko*, 94 DTC 6314 (SCC).)

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No Power To Correct Errors Made in Statute-Barred Years

The decision of the Tax Court in *Trom Electric* (2004 TCC 727) raises a narrow but important point: the minister may not reassess an open year if the basis for doing so is contrary to law, even when the taxpayer is likely to escape taxation on an amount that is admittedly income.

The *Trom* case involves the appropriate method of accounting for income from construction contracts under generally accepted accounting principles (GAAP) and the legal principle of estoppel. The taxpayer carried on a construction business. Under GAAP, it could report its income on either a percentage-of-completion basis or a completed-contract basis. It chose (and followed consistently) the percentage-of-completion method in preparing its financial statements. However, it reported its income on the completed-contract basis, as it was permitted to do under the administrative practice outlined in *Interpretation Bulletin* IT-92R2, "Income of Contractors," December 29, 1983.

In its 1992 year, the taxpayer made certain adjustments to its financial statement income in determining income for tax purposes: holdbacks outstanding at year-end were deducted, and holdbacks that had been deducted at the end of the 1991 year were added back. Expert evidence at trial established that this was not the proper way of accounting for the holdbacks under GAAP. Under the completed-contract method, no deduction is allowed in respect of holdbacks. Accordingly, unless some provision in the Act or the general law of income tax permitted the deduction and addback, the taxpayer had followed an improper method of reporting its income for 1992. The 1992 year was open for reassessment, and the minister added back the holdbacks taken in respect of the 1992 contracts. He also left in the 1992 income the holdback claimed (improperly) in 1991 and added back to 1992 income by the taxpayer under its (improper) method of determining income in that year. The 1991 year was statute-barred for reassessment. The issue in the case was whether the minister was entitled to include the 1991 amount in the taxpayer's 1992 income.

The Tax Court rejected the CRA's argument that omitting the 1991 holdbacks from income in 1992 would permit the taxpayer to escape taxation because the correct approach—reassessing the 1991 year—was statute-barred. Counsel argued that the taxpayer should be estopped from arguing that the 1991 amount should not be included in income in 1992 because it had chosen to do so itself; the minister had accepted that position, and the taxpayer would now be prejudiced because the 1991 year was statute-barred.

The court did not accept this argument. It said that the only issue was the correctness of the 1992 assessment and it was irrelevant that the taxpayer might escape taxation on the 1991 amount. Further, the principle of estoppel had no operation in this case. Citing earlier authorities, the court pointed out that estoppel is a principle that prevents a party from asserting a state of facts different from those asserted to another person at an earlier time, where the other has relied on that assertion to his detriment. It does not extend to representations of law. The correct determination of income is a question of law, not of fact. In filing its 1992 return on the basis that the 1991 amount was income in 1992, the taxpayer proceeded on an incorrect conclusion of law but did not thereby make a representation of fact. Therefore, the minister was not entitled to say that the taxpayer was estopped from taking the position that the 1991 amount was to be taxed in 1991, not in 1992.

In other circumstances, the tax consequences of transactions or events occurring in a statute-barred year may be recharacterized in the current year. For example, it has been held that the minister is entitled to redetermine the amount of a non-capital loss incurred in a statute-barred year when the taxpayer seeks to deduct that loss in the current year: see *New St. James* (66 DTC 5241 (Ex. Ct.). See also Perry Truster, "Finalizing Tax Accounts: Limits on Reassessments," *Tax for the Owner-Manager*, October 2004.

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Partners, Partnerships, Third Parties, and Arm's Length

The Act has little to say about the relationship between a partnership and another person. Paragraph 251.1(1)(e) provides that a majority-interest partner and a partnership are affiliated persons; however, there is no similar rule to determine when a partnership and another person are deemed not to deal at arm's length. In transactions involving the partnership and another person, if the parties are not at arm's length, section 69 can impose a one-sided adjustment, resulting in double taxation. This issue may be complicated further if the other person is also a member of the partnership. (See *Interpretation Bulletin* IT-419R2, "Meaning of Arm's Length," June 8, 2004, paragraph 27, for the CRA's views on when a partner is regarded as non-arm's-length with the partnership.)

Paragraph 251(5)(a) provides that related persons are deemed not to deal with each other at arm's length. The definition of "related persons" does not expressly include partnerships, although in certain circumstances a partnership is treated as if it were a separate person (section 96). The general rule in paragraph 251(1)(c)—in cases not otherwise provided for, it is a question of fact whether persons deal with each other at arm's length—probably applies to determine the relationship between a partnership and a third party, including a member of the partnership.

This leads to the question whether, in the case of dealings between a partnership and a third party who is not a member of the partnership, the relationship between that third party and the partnership is to be determined at the partnership level or the partner level. The recent decisions in *Brown* (2003 DTC 5298 (FCA)) and *Deptuck* (2003 DTC 5272 (FCA)) address this issue, among others. (Those other issues are important for anyone dealing with tax shelter issues, but are not considered in this article.)

In both cases, a partnership claimed capital cost allowance (CCA) on depreciable assets (software) acquired from a person that was not a member of the partnership, resulting in a loss that was allocated to the members of the partnership. The CRA determined that the partnership and the vendor were not dealing at arm's length as a matter of fact because the directing mind of both the partnership and the vendor were the same. (For decisions on the determination of a non-arm's-length relationship, see *Sheldon's Engineering* (55 DTC 1110 (SCC)), *Merritt* (69 DTC 5159 (Ex. Ct.)), *McNichol* (97 DTC 111 (TCC)), and *RMM* (97 DTC 420 (TCC)).) The CRA applied section 69 to reduce the partnership's cost of the depreciable property and each partner's pro rata share of the partnership's loss.

In both cases, the individual taxpayers argued that paragraph 69(1)(a) should not apply because they, as partners, individually dealt at arm's length with the vendor. They said that their decision to join the partnership was not influenced by the vendor or the partnership. In essence, they argued that the question of arm's length should be determined at the partner, not the partnership, level.

The FCA disagreed and held that subsection 96(1) directs that the income or loss of the partners is to be determined as if the partnership were a separate person. Therefore, any matter relevant to the computation of partnership loss, including the effect of any acquisition or disposition of property, must be addressed as if the partnership were a separate person. Where the acquisition of property is relevant to this computation, the question is whether the vendor and the partnership (not each partner) are dealing at arm's length.

In *Deptuck*, the court added that subsection 96(1) envisions a single computation of income at the partnership level. This in turn requires that there be a uniform acquisition cost of the partnership's capital assets on which CCA is calculated. Therefore, one must look at the partnership level to determine whether one person is at arm's length with another. If one were to determine the question of arm's length at the partner level, then paragraph 69(1)(a) could require a different measurement of the acquisition cost for different partners. This would be contrary to the scheme of subsection 96(1) and would produce results not intended by the Act.

The implications of the *Brown* and *Deptuck* decisions must be addressed when one analyzes the tax implications of transactions between a partnership and third persons. All of the provisions in the Act that deal with transactions between non-arm's-length parties must be considered at the level of the partnership and not the partner. This has practical (and difficult) implications for persons who become members of a limited partnership, particularly those involved in tax shelter arrangements. The individual limited partner may deal with all parties at arm's length, but the critical question of arm's length is to be answered at the partnership level, where he has little knowledge or influence. This places an onerous burden of due diligence on the professional adviser who seeks to determine the tax consequences of a client's investment in the limited partnership.

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Converting Foreign-Denominated Amounts into Canadian Dollars

In two recent cases, *Imperial Oil Limited* (2004 TCC 207; 2004 FCA 361) and *Inco Limited* (2004 TCC 468), the courts revisited the issue of the conversion of amounts denominated in a foreign currency into Canadian dollars for the purposes of the Income Tax Act. The leading case is *Gaynor* (91 DTC 5288 (FCA)), in which it was held that Canadian currency was the only monetary standard of value known to Canadian law. To determine the taxpayer's capital gain that arose on the sale of US-dollar-denominated securities, the court held that the cost and the sale proceeds must be converted into Canadian dollars at the exchange rate in effect at the time of purchase and the time of sale, respectively.

Imperial Oil and *Inco* dealt with, among other things, paragraph 20(1)(f) of the Act. Under that provision, a taxpayer that has issued debt at a discount from its principal amount may be entitled to a deduction for all or part of the excess of the original-issue proceeds over the lesser of the principal amount and the amount paid in satisfaction thereof.

In both cases, the taxpayers had issued US-dollar-denominated debentures at a discount. Several years later, some of the discounted debentures were redeemed. Over the years, the Canadian dollar had depreciated significantly in value: the face amount of the debt in Canadian dollars calculated at the exchange rate in effect at the time of redemption was significantly higher than the face amount calculated at the exchange rate in effect at issue.

Miller J, in *Imperial Oil* (TCC), held that the principle in *Gaynor* was limited to computing capital gains. The case was distinguished on the basis that a capital gain required the acquisition and disposition of an asset, whereas an expense on income account required a snapshot at the time of payment. Miller J held that each amount in paragraph 20(1)(f) did not have to be converted into Canadian dollars; only the result—that is, the deductible amount—had to be converted at the exchange rate in effect at the time of redemption. Alternatively, Miller J would have converted each US-dollar-denominated amount in the formula into Canadian dollars at the exchange rate in effect at the time of redemption. Miller J found that Parliament's intent was that foreign exchange losses were deductible not under paragraph 20(1)(f) but under subsection 39(2). As a result, the taxpayer was entitled to a small deduction under paragraph 20(1)(f) and to a large capital loss under subsection 39(2).

In *Inco*, Bonner J agreed with Miller J that paragraph 20(1)(f) did not permit the deduction of foreign exchange losses. In Bonner J's view, the face amount of an obligation is fixed at issue, and the conversion to Canadian dollars is to be made at the exchange rate in effect when the obligation is issued. Because the taxpayer repaid exactly what it borrowed, no gain or loss arose. The object of paragraph 20(1)(f) is to allow a deduction within limits only of discounts that are closely related to interest but do not fall within paragraph 20(1)(c). Consequently, no deduction was allowed.

The Federal Court of Appeal in *Imperial Oil* overturned the Tax Court's decision and held that the principle in *Gaynor* was not limited to the computation of capital gains and losses, but was applicable to paragraph 20(1)(f). Sharlow JA stated that *Gaynor* stood for the proposition that if a foreign-currency transaction is an element of any computation required by a statutory formula, the amount of the foreign currency must be converted to Canadian dollars at the conversion rate prevailing at the time of the transaction.

Therefore, the principal amount of the debt and the issue proceeds were, respectively, the Canadian-dollar equivalent calculated at (1) the exchange rate in effect at redemption and (2) the rate in effect at issue. As a result, the taxpayer was entitled to a deduction of three-quarters of its loss on redemption under subparagraph 20(1)(f)(ii). However, the taxpayer was denied a capital loss under subsection 39(2) for the balance of the loss on the basis that subsection 248(28) prohibited the double counting of the transaction in subsection 39(2). In the court's view, the deduction in subparagraph 20(1)(f)(ii) was intended to be equivalent to the tax relief for a capital loss; therefore, to allow an additional deduction under subsection 39(2) would be contrary to parliamentary intent.

As a result of the FCA's decision in *Imperial Oil*, the *Gaynor* principle applies to all foreign-denominated amounts for the purposes of the Act; amounts denominated in a foreign currency must be converted into Canadian dollars at the exchange rate in effect at the time of the relevant transaction.

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Audits Versus Investigations: Know Which Is Which

The distinction between an audit and a "special investigation" has been the focus of a fair amount of jurisprudence over the last couple of years; perhaps the watershed case is the Supreme Court of Canada's decision in *Jarvis* ([2002] 3 SCR 757). The case involved a tax evasion prosecution. One issue was the admissibility in evidence of documents and statements compelled by the CRA pursuant to subsections 231.1(1) and 231.2(1) of the Income Tax Act and obtained from the taxpayer during an audit.

The Supreme Court held that a distinction must be drawn between the CRA's audit powers and its investigation powers. Taxpayers are statutorily bound to co-operate with CRA auditors for tax assessment purposes: subsections 231.1(1) and 231.2(1) of the Income Tax Act and sections 288 and 289 of the Excise Tax Act require taxpayers to answer questions and provide documents. An adversarial relationship crystallizes between the state and the individual when the "predominant purpose" of an official's inquiry is the determination of penal liability. In that event, all Charter protections that are relevant in the criminal context apply to the CRA's investigation. Notwithstanding the legislative requirements to provide information and documents, a taxpayer is permitted to remain silent and is afforded a host of other rights, including the right to counsel and the right to be informed of that right before being questioned. If the CRA wants to see specified information, it must first obtain a judicially authorized search warrant in order to compel production by the taxpayer.

The determination of the "predominant purpose" of an inquiry is essentially a question of mixed fact and law. According to *Jarvis*, the following factors are relevant:

1) Did the authorities have reasonable grounds to lay charges? Does it appear that a decision to proceed with a criminal investigation could have been made?
2) Was the general conduct of the authorities such that it was consistent with the pursuit of a criminal investigation?
3) Did the auditor transfer files and materials to the investigators?
4) Was the auditor's conduct effectively that of an agent for the investigators?
5) Does it appear that the investigators were intending to use the auditor as a tool for gathering evidence?
6) Is the evidence sought relevant to the taxpayer's civil tax liability generally? Or is it relevant only to the taxpayer's mens rea and penal liability?

The Supreme Court held that the "predominant purpose" test did not prohibit the CRA from conducting a criminal investigation and an administrative audit in parallel. Further, the court held that since the threat of prosecution underlies every tax return if a false statement is knowingly made, there is nothing to prevent auditors from passing to investigators their files containing validly obtained audit materials. Accordingly, if an investigation into penal liability is commenced subsequent to an audit, the investigators may avail themselves of the information obtained during the audit prior to the commencement of the criminal investigation, but not the information obtained pursuant to the audit but after the commencement of an investigation into penal liability.

More recent case law has suggested that a taxpayer is not required to simply answer questions in the face of what appears to be a special investigation aimed at criminal wrongdoing. The taxpayer is entitled to challenge the appropriateness and constitutionality of the inquiry at an early stage: *Les Plastiques Algar (Canada) Ltée* (2004 FCA 152). Accordingly, practitioners are well advised to assess whether the predominant purpose of any audit is a probable prosecution. If there is doubt, it is probably a good first step to ask the CRA, in writing, for some indication of the purpose of the audit or investigation, or of the progress and objective of the audit. In one recent file, we asked each of the following questions:

1) Is there an ongoing or underlying audit?
2) What is the purpose or nature of the audit?
3) Who is the auditor? Has the auditor transferred any files or materials to Special Investigations?
4) Who are the individuals at the CRA who are involved in this matter?
5) Has the auditor or the CRA arrived at a preliminary or final conclusion?
6) Does the auditor or the CRA suspect that a criminal offence may have been committed?
7) Is the auditor requesting this information solely for the purposes of his or her audit, for some other purpose, or on behalf of someone else?
8) Has the matter been referred to Special Investigations?
9) Is there a parallel special investigation, or any other investigation, concerning any of the subject matter to which the requirement for information is aimed, or concerning the taxpayer, his past employer, or any other related party?

The list is not exhaustive, and other questions may have to be asked, depending on the circumstances of the particular case. If the practitioner does not have the benefit of solicitor-client privilege, the client should be advised to consider the desirability of retaining legal counsel.

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Practice Notes

Two recent Tax Court decisions are worth mentioning as reminders of some practical aspects of the real world of tax practice.

Dickson (2004-73 (IT)I); 2004-72 (IT)I)) involved a claim for the child tax benefit (CTB) under section 122.6

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of the Income Tax Act. Generally, a taxpayer's entitlement to the CTB is limited by the combined incomes of the taxpayer and a cohabiting spouse or common-law partner. In this case, it appears that the taxpayer claimed the CTB on the basis of her own income, not the combined incomes of herself and her partner. Legally, the taxpayer was clearly in the wrong, and she admitted as much through her agent at trial. Nonetheless, she argued that she was entitled to the CTB as calculated because many other taxpayers in the same circumstances had filed on a similar basis and not been reassessed. This being so, she said, it was unfair to deny her the benefit of the CTB as claimed.

This is not an uncommon argument; many tax advisers have heard it and wondered how far they might go in advising their clients to file on the basis that "other people are getting away with it." The answer, of course, is that the fact that others may be filing improperly and not being reassessed is no justification for doing the same in the hope of getting away with it, too. The court in this case said so in very explicit terms (at paragraphs 5 and 15): "The problem is it's totally wrong in the law. . . . It would not matter if you proved that every taxpayer in the country, other than your clients, got away with it. . . . I just can't allow the appeals. You know, I believe your word that there's other people that you know in your circumstances that have been doing it. It's wrong."

The court had some harsh things to say (at paragraphs 16 and 18) about tax return preparers who knowingly prepare returns on an improper basis: "[T]here's thousands of those tax preparers across this country that think their job is to cheat on behalf of their clients. . . . While I'm not pointing the finger at you, it's time the tax preparers got out of the business or educated themselves so that when the client says, well, is there anything we can do about this assessment, it's not good enough to say, 'well, I know there's hundreds of people doing it.'"

These comments apply equally to tax advisers. Although clients often do not appreciate being told that it is irrelevant that other taxpayers are "getting away with something" while they cannot, that is nevertheless the message that must be sent. *Dickson* is a very clear statement to that effect.

A different situation was before the court in *Lust* (2001-3755 (IT)G)). The taxpayer—an engineer, not a lawyer—prepared agreements between himself and his controlled company, E Co, and between E Co and P Co, an unrelated party. The latter agreement provided for P Co to loan money to E Co to finance the development of certain technology acquired by E Co from the taxpayer. The taxpayer caused the money to be paid directly to himself, not to E Co as contemplated by the agreement.

The minister took the position that under the written agreements, E Co was the only party entitled to be reimbursed for expenses. By causing P Co to make payments to himself, the taxpayer had diverted funds due to E Co. He was therefore indebted to E Co for these amounts. Because this notional loan was not repaid within the time limit in subsection 15(2), the amount was properly included in the taxpayer's income.

The court made the point that the taxpayer, not being legally trained, had failed to appreciate that, in law, E Co was a separate legal person from himself. Had the taxpayer appreciated the implications of the separate corporate personality of E Co, he would have had another agreement between himself and E Co under which E Co would have reimbursed him for the expenses. In that event, the amounts would not have been received as advances, and subsection 15(2) would have no application.

The court sympathized with the taxpayer, but it did not feel that anything could be done in view of the way the contracts were worded. The judge observed (at paragraphs 16 and 18), "I have sympathy for a layman that wandered into the lion's den when he started to draw multi-million dollar contracts and would not wander into a competent lawyer's office that would give him legal advice. . . . And if you had spent the few dollars, you probably would not have been here today. It is a complicated world out there."

In a complicated tax system, expert advice is often required even in relatively straightforward situations if adverse tax consequences are to be avoided. Competent tax advice is usually expensive, and clients may balk at the cost of obtaining it. General practitioners should be sensitive to this fact, and they should advise their clients to remember that paying for good advice at the outset is often cheaper than accepting a large tax bill later on.

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