TAX FOR THE Owner-Manager

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The De Facto Director

A director of a corporation may become personally liable for the unmet tax obligations of the corporation, subject to certain defences. For example, subsection 227.1(3) of the Income Tax Act provides a due diligence defence, and subsection 227.1(4) provides that no action may be brought more than two years after the director ceased to be a director. Similar provisions apply for GST and provincial sales tax purposes. Given the uncertainty of the due diligence defence, one strategy adopted by directors who face potential liability under these provisions has been to resign as early in the process as possible in order to start the ticking of the two-year clock.

Recently, we have seen the CRA attempt to undermine the two-year defence by asserting that notwithstanding the legal resignation as a director, if that same person has continued to perform the actions of a director "in fact," he or she remains liable under the relevant directors' liability provisions as a de facto director. The decision in *Parisien* (2004 TCC 276) indicates a number of things *not* to do if one wants to avoid being characterized as a de facto director.

Parisien was assessed under subsection 323(1) of the Excise Tax Act for an amount of net tax that should have been paid by the corporation of which he had been a "legal" (de jure) director since November 21, 1999. Although Parisien spent only minimal time at the corporation, he regularly remitted provincial and federal taxes (albeit incorrectly), completed source deductions, and was an authorized co-signer for the company. Parisien submitted his resignation as a director in writing on March 31, 2000, but continued to keep the payroll records, fill out deposit stubs, and remit source deductions. He also submitted a late GST return. Despite the written resignation, Parisien was not removed from the corporate registry until approximately one year later. As a result, the CRA would not recognize Parisien's resignation and took the additional position that Parisien continued to act as a director and was therefore liable for the corporation's tax debt.

Two issues were considered by the court: (1) Was the written resignation of March 31, 2000 sufficient to establish that Parisien stopped being a de jure director on that date? (2) If so, did Parisien's actions thereafter cause him to be a de facto director?

Lamarre J easily concluded that the resignation letter of March 31, 2000 was sufficient in corporate law to establish that Parisien had ceased to be a de jure director. However, the court concluded that Parisien's subsequent actions indicated that he acted "ostensibly as a director," and was therefore a de facto director of the corporation. The judge noted that although Parisien resigned from his position on March 31, 2000, no changes were reported or indicated to any third parties. He was still a co-signer for the corporation, and he continued to sign some cheques, take care of the payroll, and send the cheque stubs for payment of source deductions to the government. He even sent in the corporation's GST return form on May 15, 2000. On the basis of these facts, he was held to be a de facto director, and he was forced to defend himself from the assessment.

Despite the finding that he was a de facto director, the court accepted Parisien's due diligence defence, finding that he had exercised the degree of care and diligence that a reasonably prudent person would have exercised in comparable circumstances. Focusing on the late GST return, the court attributed the document's inaccuracies and unprofessional execution to Parisien's inexperience as a director. The court found that Parisien did what he could to get the cheque signed and the return sent in on time, stating that it was evident that Parisien had no control over the company's business practices. In this sense, the court highlighted the fact that Parisien was not the principal contractor and, although he was designated as a shareholder, he did not invest any money in the company; rather, he agreed to donate his time in exchange for an eventual share in the profit from the business. On this basis, the court

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stated that Parisien was wise to resign when he did and acknowledged his continuing efforts to do what he could do to help, all the while knowing that he had no control over the situation.

Ultimately, as a result of Parisien's inexperience, good intentions, and persistence, combined with the president's almost total mismanagement of the company and the fact that he took control after Parisien resigned, the court accepted Parisien's due diligence defence.

Other taxpayers in similar situations may not be as lucky as Parisien. The cases on directors' liability make it clear that due diligence defences are often very difficult to make out. The *Parisien* decision is a reminder that there is more to effecting a resignation than simply writing it down on a piece of paper.

Directors who wish to resign must be diligent and ensure that the corporate registry properly reflects the actual resignation date. If they do not cease their association with the company, they ought to specify the basis on which they continue to act (as a mere employee, as an officer, etc.). In these cases, careful planning and professional advice will usually be required to avoid liability. A director who formally resigns but remains involved in the business in an unplanned and undocumented manner runs a real risk of remaining liable as a de facto director.

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Disability Payments: Lump Sum Partly Taxable

In *Tsiaprailis* (2005 SCC 8), an employee who had been seriously injured in a car accident received periodic long-term disability benefits for about eight years under an insurance policy paid for by her employer. These payments were taxable as employment income under paragraph 6(1)(f) of the Income Tax Act. In May 1993, the insurer terminated the benefits on the basis that the appellant was no longer totally disabled. The appellant sued. A $105,000 settlement was reached: the settlement amount represented payment for the appellant's past entitlement to periodic insurance payments plus interest; 75 percent of her entitlement to future benefits under the policy; and $6,455 for costs, GST, and disbursements. The appellant was reassessed by the CRA to include the settlement amount in her income.

The employee's appeal to the Tax Court of Canada (2002 TCC 1563) was allowed. The issue was whether the settlement amount was taxable under paragraph 6(1)(a) of the Act as a benefit received or enjoyed in the year in respect of, in the course of, or by virtue of employment or under paragraph 6(1)(f) as an amount received that was payable to the appellant on a periodic basis in respect of the loss of all or any part of her income from employment pursuant to a disability insurance plan.

In the Tax Court, Bowman ACJ, as he then was, held that the lump-sum settlement was not taxable under paragraph 6(1)(f) because the settlement, which was arrived at after a lawsuit was commenced and which was negotiated as a compromise, could not on any basis of statutory interpretation be described as an "amount . . . payable to the taxpayer on a periodic basis." Bowman ACJ also held, following his decision in *Landry* (98 DTC 1416), that paragraph 6(1)(a) did not apply to tax an amount that was not taxable under the more specific provision, paragraph 6(1)(f).

The Federal Court of Appeal (2003 FCA 136), in a 2-1 decision, allowed the Crown's appeal in part. The majority disentangled the elements of the lump-sum settlement and held that the portion in respect of past unpaid benefits was taxable under paragraph 6(1)(f) as representing amounts payable on a periodic basis.

In a 4-3 decision, the Supreme Court of Canada dismissed the appeal and upheld the decision of the FCA. Both the majority and the minority judgments relied on the decision in *MNR v. Armstrong* ([1956] SCR 446). In that case, the SCC held that a lump sum paid by a former husband to his ex-wife in settlement of future obligations under a divorce decree was not deductible from the ex-husband's income because it was not paid pursuant to that decree as required by the applicable statutory provision.

Charron J, speaking for the majority, decided that the surrogatum principle applied. Consequently, the tax treatment of the lump-sum settlement depended on what the amount was intended to replace. Charron J was of the opinion that part of the settlement was to replace past unpaid benefits and part of it presumably was for future benefits and costs. In her view, the *Armstrong* case was applicable only to the portion of the settlement award in respect of future payments. Therefore, that portion of the settlement was not taxable. The portion of the settlement allocated to past benefits, being a replacement for those benefits, was taxable under paragraph 6(1)(f) because those past benefits would have been taxable under that provision.

Abella J, speaking for the minority, held that *Armstrong* could be applied to the entire award. In applying the surrogatum principle, she concluded that the nature of the payment was to release the insurer from a liability claim and to extinguish the appellant's entitlement under the policy. In her view, the settlement was negotiated on the basis of liability under the policy for costs, accumulated arrears, and future benefits; however, it was not composed of the last two amounts. The settlement was an amount paid to extinguish any liability for claims that might be asserted because of the policy; it was not a payment made pursuant to the policy. Therefore, the entire award was not taxable under paragraph 6(1)(f).

It is interesting to note that Charron and Abella JJ relied on the same case to support their differing conclusions. Now that the SCC has ruled on this issue, advisers should ensure that settlement documents specify the liability to which each portion of a lump sum relates, so that the portions thereof that are not referable to past unpaid periodic amounts are not taxable.

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Corporate Guarantee Payment Not a Subsection 56(2) Benefit

Owner-managers of private companies (and their advisers) sometimes neglect to accurately document transactions between themselves and their corporations. Every year there are a number of reported decisions in which the matter is before the Tax Court because of a misunderstanding of the facts and legal effect of one or more transactions. Usually, this comes about because of a failure to properly record transactions on a timely basis. *Williams* (2004 TCC 838) is a recent example.

The situation in *Williams* is a familiar one. The taxpayer owned several operating companies under an umbrella holding company. In fact, it is likely that there were two holding companies, one on top of the other, in what is sometimes referred to as a "tower structure"; the details of the structure are not clear from the decision. Although that lack of clarity was not crucial to the court's decision, it probably was one of the factors that led the CRA to make the reassessment that gave rise to the appeal.

The taxpayer purported to implement a crystallization transaction in 1994, under which he transferred shares of his holding company (Holdco A) to a new holding company (Holdco B), thereby creating the tower structure. He asserted that he owned the shares of Holdco B, which in turn held the shares of Holdco A. However, the minute books seem to indicate that Holdco A had redeemed the shares held by Holdco B, which leads one to think that the taxpayer himself was the owner of both holdcos. On a date subsequent to the crystallization transaction, the taxpayer received new shares of Holdco A in the course of a recapitalization of that company. Whether or not he or Holdco B owned Holdco A is not made clear in the reasons for judgment, and (as noted below) this point was not critical to the decision reached by the court.

The problem started when the assets of a new business were purchased by one of the taxpayer's operating companies (Opco A), apparently with the intention of transferring those assets to a new operating company. Opco B was formed for this purpose and purported to acquire the assets from Opco A. However, no shares of Opco B were issued at this time; the shareholdings were to be attended to later, after the accountants determined who should be the owner. Presumably, the shares of Opco B should have been issued to either Holdco A or Holdco B to maintain the overall holding company structure. As it turned out, Opco B ceased business before any shares were issued.

Before Opco B was formed, the Williams companies banked with the CIBC under an arrangement that required each of the companies in the group to guarantee the lines of credit extended to the others. When Opco B was formed, it became a party to this guarantee arrangement. Williams was not asked for, and did not volunteer, a personal guarantee. Funds were advanced to Opco B by the bank. Within two years Opco B was insolvent and unable to repay the advances. Holdco B was called on under the guarantee and made payments to the bank to settle the debt. Thereafter, accounting entries were made to reflect loans to Opco B from Holdco B. Even though it was clear that Opco B would never be able to repay these advances, they were reflected in the financial statements of both companies as intercorporate loans.

As the CRA viewed these transactions, Holdco B had made payments on behalf of Opco B that should be included in Williams's income under subsection 56(2). The assessment crystallized the disagreement about the true owner of Holdco A. Was it Holdco B (in which case it is hard to believe that the assessment would have been issued), or was it Williams? The CRA said that Williams was the owner, and asserted that a benefit was conferred on Williams by Holdco B.

The court did not make a finding as to the true share ownership of Holdco A. It went directly to the issue of whether subsection 56(2) should apply in these circumstances. The judge reviewed the four conditions that must be met if the minister is to succeed with a subsection 56(2) assessment. The first of these is that there must have been a transfer of property to a person other than the taxpayer. Here, payments were made by Holdco B to the bank under the guarantee agreement. The court held that repayment of a bona fide commercial loan was not a transfer of property. Crucial to this holding was the finding that the guarantee arrangements with the bank were entered into in the normal course of the business operations of the group.

The second condition is that the transfer must be made at the direction of, or with the concurrence of, the taxpayer. That condition was not met. The payments were required by the bank, and the taxpayer had no control over the actions of the bank in enforcing the guarantee. It was not sufficient that the taxpayer was the sole shareholder and director of Holdco B. Legally, he could not prevent the bank from enforcing payment.

Third, the payment or transfer must have been made for the benefit of the taxpayer. Here, the taxpayer was not personally liable to the bank on the guarantee, and it could not be said that he benefited from the payment by Holdco B.

Fourth, the payment or transfer must have been an amount that would have been income to the taxpayer if it had been made to him. Technically, any payment to a shareholder by a corporation that is in the nature of a distribution will be taxable as a dividend. However, the judge said that the payment here was not the sort of payment that was intended to be caught by the fourth branch of the subsection 56(2) test.

There are two lessons to be learned from this case. The first is the importance of full documentation of all transactions involving a corporation and its shareholders. One senses from the arguments for the Crown reported in the judgment that the CRA was uncomfortable with what it thought might be going on. It is possible that the case would have been resolved short of court had the evidence of the share ownership been clearer.

The more important lesson is to be found in the judge's analysis of the conditions for the application of subsection 56(2). For the subsection to apply, there must be a payment or transfer of property for the benefit of the taxpayer. A payment made pursuant to a bona fide legal obligation (such as the guarantee here) is not the sort of payment that normally will give rise to a subsection 56(2) benefit. However, in this case the taxpayer had not joined in the guarantee to the bank. Had he done so, a payment by his company in discharge of his personal liability would have given rise to an assessable benefit. A more difficult case is the one in which both the individual shareholder and other group companies are jointly liable on a guarantee. If one or more of the companies settles the debt due on the guarantee and no payments are made by the shareholder, is there an assessable benefit? The answer will depend on the particular facts, but a shareholder would properly be concerned about the possibility in such a case.

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Acquisition of Control and Amalgamation on the Same Day: Multiple Year-Ends?

The Income Tax Act is silent regarding the time at which an amalgamation occurs for tax purposes. The CRA's position concerning the effective date of an amalgamation is that it is the earliest moment on the day of the amalgamation in the absence of a particular time specified in the certificate of amalgamation: see *Interpretation Bulletin* IT-474R ("Amalgamations of Canadian Corporations," March 14, 1986), paragraph 9.

At a recent CRA round table (discussed in document no. 2004-0086741C6, dated October 8, 2004), the CRA was presented with the following situation. Two corporations were amalgamated on March 1; one of the amalgamating corporations carried out transactions (rollovers, stock redemptions, and repayment of paid-up capital) on the day of the amalgamation. Although no time was specified in the certificate of amalgamation, the order of occurrence of the transactions was set out in the supporting legal documents. The issue was whether the amalgamating (predecessor) corporation or the amalgamated (continuing) corporation should report those transactions. The CRA responded that the position stated in IT-474R normally applies when corporations amalgamate. However, when corporations amalgamate as part of an arrangement whereby a series of transactions is carried out on the same day as the amalgamation, and no time is specified on the certificate of amalgamation, "the time of the amalgamation is the one specified in the arrangement insofar as the series of transactions occurs logically." This departure ("the round table response") from the CRA's general position apparently was intended to relieve the amalgamated corporation from reporting transactions that were intended to be carried out by, and reported by, a predecessor corporation.

However, the CRA's round table response could have unintended negative consequences. For example, in *Technical Interpretation* 2004-0105481E5, dated January 27, 2005, a corporation acquired the shares of a target corporation, transferred those shares to a wholly owned subsidiary, and caused the target and subsidiary corporations to be amalgamated, all on the same day. No election was filed under subsection 256(9); therefore, by virtue of that provision, control was deemed to be acquired at the commencement of the day. Consistent with its position in a number of similar circumstances, the CRA stated that if no particular time was specified on the certificate of amalgamation, the target corporation would have only one deemed taxation year-end. That is, both the deemed taxation year-end that arose as a result of the acquisition of control and the deemed taxation year-end that arose as a result of the amalgamation were considered to occur at the same moment in time (immediately before the commencement of the day). Implicit in this conclusion is that the time of the amalgamation was considered to be the first moment of the day.

If the CRA's methodology in the round table response is applied, the "logical" time of the amalgamation of the target corporation and the acquisition corporation could not be at the first moment of the day, but rather at some time *after* the target corporation was acquired. Two deemed taxation year-ends could result—the first immediately before commencement of the acquisition day because of the acquisition of control, and the second during the acquisition day immediately prior to the time of the amalgamation specified (or logically inferred from the series of transactions) in the arrangement. The problem of multiple year-ends probably would not be resolved by specifying a particular time in the certificate of amalgamation (which only certain jurisdictions permit in any event). Further, electing pursuant to subsection 256(9) would not resolve the dual year-ends because the acquisition of control necessarily precedes the amalgamation.

An additional taxation year has numerous potential negative consequences in addition to the extra compliance costs. For example, the aging of non-capital losses as well as certain other beneficial "tax accounts," such as investment tax credits and foreign tax credits, will be accelerated. If a capital gains reserve is being claimed, the short taxation year could result in faster gains recognition. Subsection 78(1) also might apply sooner than it otherwise would.

Owing to the statutory deeming rule in subsection 256(9), certainty is possible with respect to the timing of an acquisition of control and thus the related deemed taxation year-end. However, there is no such statutory deeming rule with respect to the time of an amalgamation for the purposes of the Act. Accordingly, the CRA's policy is important in providing certainty in this area. Before the CRA's round table response, an amalgamation was considered to occur at the first moment of the date specified in the certificate of amalgamation (in the absence of a specific time on the certificate of amalgamation). It is hoped that the CRA will clarify that its round table response will not be applied in a manner that will result in multiple year-ends in the typical takeover and amalgamation circumstances described above.

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Time Limits for Reassessing a Partnership and Its Partners

A recent technical interpretation (TI 2005-0111961I7, February 2, 2005 [issued in French]) confirms the CRA's view that the minister may reassess a partner directly in respect of its share of income from a partnership pursuant to subsection 152(4) without making a determination in respect of the partnership pursuant to subsection 152(1.4). Briefly, subsection 152(1.4) allows the minister to determine the income or loss of the partnership. Paragraph 152(1.7)(a) then makes the determination binding on all of the partners, subject to their rights of objection and appeal. (See "Partnerships: Compliance Issues," *Tax for the Owner-Manager*, October 2003, for a related article on the implications of subsections 152(1.4) and 152(1.7).)

The facts given in the TI are as follows:

1) X Co, a corporation, is a member of a general partnership, BCOM.
2) The last day on which the minister may make a determination of the income of BCOM pursuant to subsection 152(1.4) is February 28, 2005.
3) The last day of the normal reassessment period (subsection 152(3.1)) by which the minister may assess X Co in respect of its share of income of BCOM is April 25, 2005.

The question posed was whether the minister may make an assessment in respect of X Co's liability to pay tax for a particular taxation year pursuant to subsection 152(4) when the minister is otherwise precluded from determining the income of BCOM because of the time limit in subsection 152(1.4). To put the question another way, can the minister assess X Co pursuant to subsection 152(4) on, say, March 10, 2005 when the last date for determining the income of BCOM and its partners pursuant to subsections 152(1.4) and 152(1.7) is February 28, 2005?

The CRA confirmed in the TI that the minister can make an assessment against X Co pursuant to subsection 152(4) *without* making a determination of the income of BCOM and its partners pursuant to subsections 152(1.4) and 152(1.7). As a result, the minister can make a new assessment against X Co by virtue of subsection 152(4) even if the time limit described by subsection 152(1.4) has expired.

The CRA's position is supported by the tax policy underlying subsection 152(1.4) and its related provisions. These provisions were enacted primarily to facilitate the minister's assessment of a partnership and its partners. Prior to the introduction of these provisions in 1998, the minister had to assess each partner individually pursuant to subsection 152(4) because a partnership is generally not considered a taxpayer for the purposes of the Act. The new provisions permit the minister to determine the income of the partnership and have that determination binding on all of the partners. However, subsection 152(1.4) and its related provisions do not preclude the minister from assessing a *particular partner* within the time limits prescribed by subsection 152(4). In the example given in the TI, an assessment made on March 10, 2005 by the minister on X Co pursuant to subsection 152(4) would not be binding on the other partners of BCOM. Another corollary from the TI is that the minister can assess X Co outside the normal reassessment period if the conditions of either paragraph 152(4)(a) or paragraph 152(4)(b) are met.

It is important for taxpayers and their advisers to note that subsection 152(4) and subsection 152(1.4) are mutually exclusive in their respective calculation of the last day that the minister may assess a partner. Therefore, the date on which a taxation year of a partner becomes statute-barred for reassessment is the *later* of the cutoff dates provided for in the two provisions.

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Change in Use of Real Estate: Interpretation Bulletin IT-218R

If the owner of real estate changes the way in which it is used, the change may have income tax implications, depending on the tax character of the property before and after the change. The rules in section 45 of the Income Tax Act cover many, but not all, of the possible permutations and combinations. In addition to the specific statutory rules, *Interpretation Bulletin* IT-218R ("Profit, Capital Gains and Losses from the Sale of Real Estate, Including Farmland and Inherited Land and Conversion of Real Estate from Capital Property to Inventory and Vice Versa," September 16, 1986) sets out a number of administrative positions that should be considered in any change-of-use situation. One of these positions is considered below.

Although the Act is silent on what constitutes a change in use that triggers the rules in section 45, there is a body of jurisprudence on the point. The leading case on the conversion of property from inventory to capital property is *Edmund Peachey Ltd. v. The Queen* (79 DTC 5064 (FCA)). There, the court said that a clear and unequivocal positive act implementing a change of intention is necessary to change the character of property (in this case, land) from a trading asset to a capital asset. An intention to change the character of the property is insufficient in itself to effect a change of use. (Interested readers are referred to the cases citing *Peachey* for examples of how the courts have applied this "positive and unequivocal" concept.)

Interpretation Bulletin IT-218R deals, inter alia, with a conversion of property from depreciable capital property to inventory. (Such a conversion would occur, for example, when an apartment building held for the purpose of generating rental income is converted into condominium units for resale.) Technically, the change in use would trigger a deemed disposition, with the attendant recapture and capital gain consequences. However, the CRA's administrative position (IT-218R, paragraph 11) is that no recapture is to be recognized on the conversion. Instead, the recapture is recognized as the units are sold. Although this position is obviously beneficial to the taxpayer, there is some question about its technical correctness; taxpayers should be aware that a strict reading of the applicable rules might seem to dictate the opposite conclusion.

The definition of the undepreciated capital cost (UCC) of depreciable property of a prescribed class in paragraph 13(21)(f) requires that the computation always start with the cost on the date the property was acquired rather than with the previous year's closing UCC. The balance in the class is increased by the capital cost of depreciable property added to the class and reduced by the amount of capital cost allowance (CCA) claimed to the date of the computation. Because of an amendment to subsection 13(1) effective after May 25, 1976, there need not be an actual disposition of a property in the class in order to trigger a recapture. It is sufficient if the asset is no longer in the class and some amount of CCA was claimed in respect of it while it was in the class.

To illustrate the technical concern, assume that a rental property of a separate class is acquired for $100,000 and depreciated down to $80,000. Assume that the property is converted to inventory (say, condominiums for resale). Under the CRA's administrative position, there is no disposition at the date of conversion. On a strict reading of the Act, however, there is still a recapture of $20,000. This is so because regulation 1102(1)(b) stipulates that depreciable property of a prescribed class does not include property described in inventory. Therefore, in computing the UCC of the class at the end of the year of conversion, the capital cost added to the class is nil and the CCA previously taken ($20,000) is deducted. The resulting negative amount of $20,000 is recaptured by subsection 13(1).

Notwithstanding this technical concern, the CRA apparently does not take the position that the recapture has to be recognized in the year in which the conversion is made. Taxpayers who face a conversion in such circumstances may want to consider seeking confirmation of the administrative position if the potential recapture is material.

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Practice Notes

Two recent tax court decisions are worth noting. One deals with home office expenses, the other with a section 160 assessment.

Jenkins v. The Queen

Paragraph 18(12)(a) of the Income Tax Act describes the conditions that must be met by a self-employed individual seeking to deduct the costs of maintaining a home office. There are two requirements, and the taxpayer may qualify under either branch. Either the office is the individual's principal place of business, or it is used on a regular and continuous basis for meeting clients. *Jenkins* (2005 TCC 167) illustrates the difficulties that a taxpayer may encounter in trying to meet these requirements.

Jenkins and his wife were partners in a fishing business. They operated several fishing boats on a seasonal, not a continuous, basis. They maintained a home office in which they kept their business records, made up payrolls, answered correspondence, and generally attended to the business aspects of their fishing operations. Effectively, all the fish that were caught were sold off the boats at the dock, and clients' visits to the office were negligible.

The CRA denied the taxpayer the right to deduct any expenses of the home office. It was accepted that the taxpayer could not meet the "regular and continuous" branch of the test, because he met and dealt with his clients at the docks, not in his home office. The main argument was whether the home office was the taxpayer's "principal place of business," a phrase that is not defined in the Act. The minister argued that one determined the "principal place" by reference to the place where the core activity of a business is carried on. Here, the core activity was fishing, so the principal place ought to be regarded as being on one or more of the three boats.

The taxpayer pointed out the incongruity of such a proposition by citing the situation of Imperial Oil. Imperial Oil's core activity is finding and extracting natural resources from many sites; but, he argued, no one would say that its principal place of business was anywhere but at its head office in Calgary. The court agreed. A taxpayer's "principal place of business" is the place where the business of the core activity is conducted, not the location of that activity per se. In Jenkins's case, that was the home office, and the appeal was allowed.

Merchant v. The Queen

Section 160 of the Act allows the minister to assess the transferee of property when the property is transferred to a spouse, child, or other person not at arm's length and the transferor was liable for taxes at the time of the transfer. *Merchant* (2005 TCC 161) illustrates two important points regarding section 160.

The taxpayer assisted his children with their college expenses by loaning them money from time to time. The taxpayer owed substantial arrears of tax in one of the years in which loans were made to one of his sons. The minister assessed the son under section 160 on the basis that the amount loaned was a transfer of property made by the taxpayer with the intention of avoiding payment of his tax arrears. The evidence documenting the loans was skimpy; it consisted of handwritten notes on the back of a family document. There were no ledgers or banking records evidencing the payments. In these circumstances, the minister said that the payments were not bona fide loans but outright transfers subject to section 160.

The Tax Court allowed the appeal. In doing so, it made two points that are important for taxpayers who are involved in family transactions.

First, section 160 applies to a "transfer" of property. A loan is not a transfer in this context. If the payments to the son were bona fide loans, there was no transfer and thus no basis for the assessment. The minister had argued that the lack of appropriate documentation was evidence that there was no real intention to make loans; the fact that the advances were made at a time when the father knew that he owed back taxes indicated that the real purpose of the payments was the avoidance of those liabilities. The court disagreed. It affirmed the principle that a true loan is not a transfer for section 160 purposes. On the evidence, the court said that it was persuaded by the testimony of the father and the son that they intended the payments to be loans. Second, the judge expressly rejected the argument that the lack of formal documentation was a justification for the minister's position. Indeed, he said that in matters involving the family—for example, where parents assist their children in attending university—

he did not expect to see formal ledgers of account. The notes that the father made of the payments were "the very type of record one might expect in a family arrangement" (paragraph 22 of the judgment).

It is helpful to have the court recognize the realities of family arrangements, especially the fact that formal documentation will not be required if other credible evidence is presented. Of course, careful advisers will continue to counsel the wisdom of properly documenting family transactions to avoid the necessity of a court appearance if the CRA challenges the true nature of the arrangements.

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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.

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