TAX FOR THE Owner-Manager

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Scientific Research Incentives for CCPCs

The Income Tax Act offers Canadian-controlled private corporations (CCPCs) very generous tax incentives in connection with expenditures that qualify as "scientific research and experimental development" (SR & ED) carried on in Canada. Traps for the unwary are buried in the rules, however; this article highlights two of them.

Aside from virtually unlimited flexibility in determining when SR & ED can be deducted, the most important aspect of the SR & ED system is the availability of investment tax credits (ITCs) that can be offset against taxes otherwise payable and a refund mechanism that is triggered when the ITCs exceed such taxes.

The normal ITC rate is 20 percent. However, subsection 127(10.1) provides CCPCs with an additional 15 percent if (1) the corporation is a CCPC throughout the particular taxation year, and (2) the SR & ED falls within the "expenditure limit," which is $2,000,000 per annum (prorated for short years). The normal 20 percent rate applies to any excess.

The expenditure limit is reduced by $10 for every $1 by which the previous year's taxable income exceeds the "business limit" for that year. For larger CCPCs, the expenditure limit is also reduced by $4 for every $10 of taxable capital (computed for the purposes of the large corporations tax) in excess of $10,000,000 because subsection 125(5.1) reduces the business limit in such circumstances.

The expenditure limit and the business limit must generally be allocated among members of an associated group of corporations. There is an exception for certain widely held associated groups (proposed subsection 127(10.22)).

The 35 percent ITC first reduces federal tax. If the available ITC exceeds the federal tax otherwise payable, the excess is refundable. If the excess was earned in connection with current expenditures, 100 percent is refundable. If the excess was earned in connection with capital expenditures, 40 percent is refundable. If the CCPC earned only a 20 percent ITC, the refund rate is 40 percent for both current and capital expenditures. Alternatively, the excess can be carried back 3 years and forward 10 years.

The "prescribed proxy amount" (clause 37(8)(a)(ii)(B)) is available to taxpayers who do not wish to debate the CRA about which components of overhead constitute SR & ED and which do not. This election allows the taxpayer to treat as SR & ED an amount not exceeding actual overhead, equal to 65 percent of the portion of salary or wages of employees directly engaged in SR & ED carried on in Canada. The prescribed proxy amount qualifies for ITC purposes but is not otherwise treated as SR & ED. Therefore, the writeoff cannot be deferred and carried forward in the SR & ED expenditure pool as "real" SR & ED can.

Two significant traps are hidden in these complicated rules. First, a partnership cannot flow the extra 15 percent ITC to its corporate partners even if they are CCPCs. This was highlighted in *Canadian Solifuels Inc.* (2001 FCA 280). Accordingly, it is inefficient for CCPCs to incur SR & ED expenditures through a partnership.

Second, in order for the CCPC to maintain the expenditure limit at $2,000,000, the previous year's taxable income cannot exceed the business limit. With today's relatively low federal corporate income tax rates, it is relatively common for a CCPC not to bonus its income down to the business limit. In such a case, the expenditure limit will be eroded, and this will have negative consequences if substantial SR & ED expenditures are incurred in the following year. One might have considered accruing a bonus to create or increase a loss, which could have been carried back to reduce the previous year's taxable income to the business limit. Unfortunately, this technique is no longer available: subsection 127(10.2) was amended (effective for taxation years that commence after 1995) to provide that the taxable income of the previous taxation year must be computed "before taking into consideration the specified future tax consequences for that last taxation year." One such "specified future tax consequence" (defined

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in section 248) is a loss carried back. Planners will therefore need to decide on the appropriate level of income before the return of income is filed for the year.

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Bonuses to Family Members Under Increased Scrutiny

The CRA's longstanding position has been that it will not challenge the reasonableness of salaries and bonuses paid by a Canadian-controlled private corporation (CCPC) to an individual who is a shareholder of the corporation, provided that the individual is active in the business operations and is resident in Canada. This policy was most recently confirmed at the Canadian Tax Foundation's 2003 annual conference. The stated purpose of the policy is to provide flexibility to a CCPC and its active shareholder-managers to take advantage of lower marginal tax rates by reducing the corporation's taxable income to, or below, the small business deduction limit.

On the other hand, the CRA has made it clear that bonuses paid to individuals other than principal shareholder-managers will be subject to the normal test of reasonableness. *Ambulances B.G.R. Inc.* (2004 TCC 168) is one of the most recent cases to address the reasonableness of such bonuses. At issue was whether the bonuses paid by the taxpayer to its sole shareholder's two children could be deducted in calculating its income for its 1995, 1996, and 1997 taxation years. The Tax Court of Canada found in favour of the taxpayer.

The facts are rather interesting. Neither of the children was a shareholder of the taxpayer. The sole shareholder's daughter was the taxpayer's controller and worked 50 to 70 hours a week. Her bonus was challenged by the CRA as unreasonable because it was in excess of the bonus paid to the taxpayer's sole shareholder.

The sole shareholder's son was the taxpayer's equipment manager. The CRA appears to have challenged his bonus because he spent only 50 percent of his efforts on the taxpayer's business. The minister also argued that the bonuses were paid to reduce the taxpayer's income only to take maximum advantage of the small business deduction; that the children were not shareholders of the taxpayer; that the taxpayer paid no bonuses to any of its other employees, apart from the members of the sole shareholder's family; and that the bonuses were not paid to earn income and were not of a reasonable amount.

The minister's approach was rejected by the Tax Court. The court said that the taxpayer received genuine services from the children in return for the bonuses paid to them. The children played a material role in the taxpayer's financial success. The remuneration that they received during the years under appeal did not take into account their exceptional contribution to the taxpayer. Their bonuses represented well-deserved remuneration that had been expected but not paid during prior years, and the court found that they were reasonable and therefore deductible.

The CRA announced at the 2003 annual conference that it would consider ruling on the reasonableness of shareholder-manager remuneration. Since that announcement, the CRA has issued a number of rulings and technical interpretations that are of interest. These include the following:

- In ruling 2004-0072741R3, the CRA allowed the deduction of a bonus, the payment of which resulted in a non-capital loss.
- In TI 2004-0106951I7(E), amounts paid to shareholders were considered not to be bonus amounts but benefits conferred on them in their capacity as shareholders on the discontinuance of a business. The amounts paid to these shareholders were deemed to be dividends pursuant to subsection 84(2).
- In *Income Tax Technical News* no. 22, the CRA stated that it will not challenge the reasonableness of salaries and bonuses paid out of "non-active business income" as long as the recipient is an individual who is a shareholder of the corporation, active in the business operations, and resident in Canada.
- Rulings 2004-0060191R3 and 2003-0039873 dealt with the payment of bonuses out of income triggered from a sale of business assets. In both rulings, the bonuses were considered reasonable in the circumstances.

It appears from recent cases and rulings that bonuses to individuals other than principal shareholder-managers are facing increased scrutiny from the CRA. Accordingly, practitioners should review the most recent CRA pronouncements before advising clients on these matters.

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Outsourcing Expenses Deductible

In *Pantorama Industries Inc.* (2004 TCC 256; 2005 FCA 135), the appellant operated a number of clothing stores out of leased premises in Canada. In the years under appeal (1995-1998), the appellant opened 46 new stores and closed about 80 stores. Between 25 and

30 leases were renewed each year. The majority of the new leases were for terms of five to seven years; the lease renewals were for one to seven years.

Since 1979, Snowcap Investments Ltd., a retail leasing consultant, had been retained by the appellant to find new locations for stores and to negotiate leases and renewals of leases. Snowcap was paid a monthly fee; it also received variable fees for each new lease or renewal it secured and for arranging to convert stores within the same premises. Snowcap, in effect, acted as a real estate department for its clients, including the appellant.

The CRA disallowed the appellant's deduction of the variable fees paid to Snowcap as being on account of capital and therefore not deductible by virtue of paragraph 18(1)(b) of the Income Tax Act.

In the Tax Court, Paris J cited the usual income-versus-capital principles in dismissing the appeal, placing particular reliance on the decision in *Rona* (2003 DTC 979 (TCC)). In that case, professional fees paid for services relating to studies on the acquisition of competitors' shares, interests in joint ventures, and assets were found to be in respect of the expansion of the business structure; they were therefore on account of capital and were not deductible as a current expense.

In applying the income-versus-capital principles, Paris J concluded that the appellant had paid the variable fees to Snowcap for arranging new leases or lease renewals, or for similar services. The fixed monthly payments covered the general advice and planning assistance provided. Paris J found that the leases were part of the structure of the appellant's business, and that the leases and renewals amounted to an expansion of the appellant's business structure that would allow for new or continued sales. Therefore, the variable fees pertained to the appellant's business structure. In Paris J's opinion, each variable payment was a one-time payment relating to a particular lease or renewal for which an enduring benefit was received, the duration of which was equal to the length of the lease or renewal. The recurrent nature of the payments did not make them on account of income. Paris J concluded that the variable fees were on account of capital and were not currently deductible.

In a unanimous decision, the Federal Court of Appeal (FCA) took an entirely different view of the variable fees. The court stated that although it was possible that expenses that recurred every year over the life of a long-established business were on capital account, "this would tend to be rather exceptional." The court concluded that in the context of the appellant's business, the variable fees were not paid to secure an actual asset but to enable the appellant to continue to carry on its business. The FCA also held that the Tax Court judge had no evidentiary foundation for his finding that the appellant was engaged in a business expansion similar to that in *Rona*.

The FCA relied on the decision in *Canada Starch Co.* (68 DTC 5320), which stated that once a commercial structure is in place, monies paid each year to ensure that it can continue to be exploited profitably are on income account.

The court in *Pantorama* held that the payments of variable fees, having been made for many years, were necessary to ensure the ongoing operation of the appellant's business. The appellant's purpose in paying the variable fees every year was to achieve continued profitability by responding to evolving consumer needs and preferences in the location of its stores.

The FCA based its decision in part on its view that the CRA would not have raised the assessments in issue if Snowcap's services had been provided in-house and paid for in the form of salaries, travel expenses, etc. The court concluded that if expenses for the same in-house services would have been deductible, then the outsourcing of the services should not have a bearing on the tax treatment of the expenditures. The FCA held that the variable fees paid to Snowcap were not on account of capital and allowed the taxpayer's appeal.

Pantorama illustrates the continuing difficulties that the courts (and professional advisers) face in characterizing certain types of payments as being on income or capital account. The FCA's decision in *Pantorama* is in line with the business realities of the situation under review, and it should allow taxpayers to deduct expenses incurred for outsourced services if the expenses of providing such services in-house would otherwise be deductible.

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Section 112 Stop-Loss Rules Prevail

The rules in subsection 112(3) et seq. operate to deny the recognition of a capital loss on the disposition of shares in a range of circumstances. Often, the rules are discussed in the context of post mortem tax planning. However, they can have unanticipated consequences in other situations, as the following examples demonstrate.

■ **Example 1:** Assume that Holdco owns all of the issued common and preferred shares of Opco; as a result, Holdco and Opco are affiliated. The preferred shares have an FMV and an ACB of $1 million and a nominal PUC. Opco redeems the Holdco preferred shares for $1 million. Is Holdco permitted to add the

$1 million loss on the preferred shares to the ACB of its common shares under subsection 40(3.6)?

Comment: Subsection 40(3.6) does not apply to add the $1 million loss to Holdco's common shares. Paragraph 40(3.6)(b) provides that the loss determined without reference to paragraph 40(2)(g) and subsection 40(3.6) is to be added to the ACB of Holdco's common shares. By inference, all other provisions of the Act are to be considered in computing the amount of the loss *before* any subsection 40(3.6) adjustment. Paragraph 112(3)(b) grinds Holdco's loss by, inter alia, the amount of all taxable dividends received by Holdco on its preferred shares. In the example, Holdco received a deemed dividend on the preferred shares of $1 million. Subsection 112(3) will therefore grind Holdco's $1 million loss to nil before it can be added to the ACB of its common shares. The key point is that subsection 40(3.6) does *not explicitly prevent* subsection 112(3) from grinding the loss otherwise determined on Holdco's preferred shares. The CRA agrees with this interpretation (TI 2003-0035135).

■ **Example 2:** Assume that X Trust is an alter ego trust, and Mr. X is its sole beneficiary. The trust owns common shares of X Co with a nominal FMV and an ACB of $1 million. The common shares have paid well over $1 million in capital dividends to X Trust. The trust sells its common shares of X Co to Mrs. X, the spouse of Mr. X, for a $1 million loss. The trust is deemed to be affiliated with Mrs. X pursuant to proposed subparagraph 251.1(1)(g)(ii) because the trust's major interest beneficiary, Mr. X, is affiliated with his spouse, Mrs. X. Do subsections 40(3.3) and 40(3.4) operate to suspend the capital loss in the hands of the trust so as to preserve it until such time as Mrs. X disposes of the shares to a non-affiliated person?

Comment: Subsections 40(3.3) and 40(3.4) will not suspend X Trust's $1 million capital loss on its common shares. Subsection 40(3.4), like subsection 40(3.6), has to be read as requiring that subsection 112(3) be considered in determining the amount of the loss that will be suspended. Paragraph 112(3)(a) grinds the trust's loss by the amount of the capital dividends it received on the common shares. The net loss after the grind is nil, so the amount that may be suspended under subsection 40(3.4) is also nil.

■ **Example 3:** Assume that Mr. Q sells a portfolio investment in the open market for a $10,000 loss and reacquires the identical property ("substituted property") in the open market within 30 days from the initial sale. Mr. Q received over $10,000 in taxable dividends from his original portfolio investment before the sale. Mr. Q is considered to be affiliated with himself. Does paragraph 53(1)(f) apply to add the $10,000 superficial loss on Mr. Q's original investment to the ACB of his substituted property?

Comment: Paragraph 53(1)(f) applies to add the $10,000 superficial loss to Mr. Q's substituted property. The paragraph provides that the amount of the superficial loss to be added to the ACB of the substituted property is to be reduced by any subsection 112(3) grind. However, under subparagraph 112(3)(a)(ii), the amount of the reduction is nil because the amount of taxable dividends received by Mr. Q is greater than the $10,000 superficial loss. Accordingly, paragraph 53(1)(f) applies to add the $10,000 superficial loss to the ACB of Mr. Q's substituted property. The CRA supports this interpretation in *Interpretation Bulletin* IT-456R, "Capital Property—Some Adjustments to Cost Base," July 9, 1990, at paragraph 11.

In summary, the section 112 stop-loss rules must be examined whenever a loss-recognition issue arises, because section 112 overrides the other provisions of the Act. In policy terms, it appears that the section 112 rules are intended to treat the amount of any capital dividend as a recovery of the original cost of the shares. In example 3, the section 112 rules do not apply because the taxpayer received ordinary dividends subject to tax. Subsection 112(3) would have applied in that example to grind the loss had Mr. Q received a large amount of capital (as opposed to taxable) dividends on his investment prior to the initial sale. If the recipient of the taxable dividend is a corporation entitled to deduct the amount of the dividend in computing taxable income, the amount of the dividend reduces any capital loss otherwise realized on the disposition of the share. Presumably, this is because the taxable dividend is not subject to tax when it is received by the corporate shareholder.

The foregoing examples show that the section 112 stop-loss rules are not applicable solely in the post mortem planning context. The tax adviser must be cognizant of the dividend payment history of the shares on which the loss is being triggered in order to properly assess the impact of the section 112 rules on a particular transaction.

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Fairness: A Changing Standard of Review

The courts, often relying on *Sharma* (2001 FCT 584) and *Cheng* (2001 FCT 1114), have consistently held that the appropriate standard to be applied in the judicial review of discretionary decisions by the minister of national revenue under the fairness provisions in the Income Tax Act is that of "patent unreasonableness." On May 2, 2005, the Federal Court of Appeal (FCA) challenged that view.

In *Lanno* (2005 FCA 153), the taxpayer had asked the minister to exercise his discretion to grant the taxpayer's request for a reassessment. The Federal Court dismissed the taxpayer's application for judicial review. On appeal, the FCA questioned whether the Federal Court judge had chosen the correct standard of review by applying the standard of patent unreasonableness.

The FCA said that the determination of the appropriate standard of review requires a "pragmatic and functional analysis," taking into account the purpose of the statutory scheme, the scope of any applicable privative clause, the relative expertise of the tribunal and the reviewing court, and the nature of the question in dispute.

In undertaking its analysis in the context of discretionary decisions made under the fairness package, the FCA set out the factors that must be considered:

> 1) The fairness package was enacted because Parliament recognized the need for relief from certain provisions of the *Income Tax Act* that can result in undue hardship because of the complexity of the tax laws and the procedural issues entailed in challenging tax assessments. The granting of relief is discretionary, and cannot be claimed as of right. This factor would point to a standard of review that is more deferential than correctness.
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> 2) The decision under review cannot be appealed, but it is subject to judicial review by the Federal Court, and it is not protected by a privative clause. That would point to a reasonableness standard.
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> 3) The decision under review combines fact finding with a consideration of the policy of tax administration, and sometimes questions of law. The expertise of the decision maker is undoubtedly higher than that of the courts in relation to matters of the policy of tax administration. However, the expertise of the decision maker is not higher than that of the courts in relation to questions of law or findings of fact. That would point to a reasonableness standard.

In its analysis, the FCA could find no relevant factor that pointed to a standard of review that would be more deferential to the minister's discretion than the standard of "reasonableness." As a result, the FCA concluded that the appropriate standard of review was not patent unreasonableness but reasonableness.

In support of its decision, the FCA referred to *Hillier* (2001 DTC 5399), a case in which the FCA concluded that the minister's failure to take into account the delay in making its decision was "unreasonable." The FCA's reference to this case is curious. Nowhere in the reasons in *Hillier* is there any analysis of the appropriate standard of review, and no suggestion is made that the word "unreasonable," by itself, was used to signal such a marked shift in that standard. It is not surprising, therefore, that in subsequent decisions the courts continued to apply the test of "patent unreasonableness" without any mention of *Hillier*.

Whatever the FCA's intention may have been in *Hillier*, its intention in *Lanno* is clear. The standard of review in respect of the minister's exercise of his discretion under the fairness provisions is no longer "patent unreasonableness" but "reasonableness." This change was confirmed by the FCA three days after its decision in *Lanno* when, in *Vitellaro* (2005 FCA 166), the FCA affirmed that this is the standard.

The result for taxpayers is a lower threshold of review in respect of decisions made by the minister under the fairness provisions. The FCA's willingness to closely scrutinize these decisions rather than simply defer to the discretion of the minister is good news for taxpayers and their counsel alike.

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Charitable Organizations Investing into the United States

It is not uncommon for an owner-manager to set up a private or public foundation, either to foster a specific cause or simply to serve as a conduit for corporate donations. Any such foundation may have assets that are invested in the United States; therefore, compliance with US tax rules should not be overlooked.

Article XXI of the Canada-US tax treaty generally provides for the deduction of cross-border charitable donations and the reciprocal recognition of exemption for religious, scientific, literary, educational, or charitable organizations. Article XXI(1) specifically exempts from US tax any US-source income earned by a Canadian-resident charitable organization to the extent that the same income is exempted from tax in Canada. Article XXI(4) also exempts such a Canadian-resident charitable organization from US excise taxes imposed with respect to private foundations if it has received substantially all of its support from persons other than citizens or residents of the United States.

Pursuant to article XXVI, the US and Canadian competent authorities have entered into a mutual agreement that implements article XXI: Notice 99-47, "Guidance Relating to Article XXI of the United States-Canada Income Tax Convention." The procedure described in Notice 99-47 eliminates the requirement for certain Canadian religious, scientific, literary, educational, or charitable organizations to complete and file form 1023, "Application for Recognition of Exemption," in order to be recognized as charitable organizations under section 501(c)(3) of the Internal Revenue Code (IRC).

Under the terms of the mutual agreement, recognized charitable organizations that are organized under the laws of either Canada or the United States automatically receive recognition of exemption without application in the other contracting state. US organizations must be recognized as "exempt" under section 501(c)(3) of the IRC in order to qualify; Canadian organizations must be recognized as Canadian "registered charities" (as defined in subsection 248(1) of the Income Tax Act) by the CRA.

In the absence of receiving certain financial information, the Internal Revenue Service will presume that all Canadian registered charities are private foundations. Such a conclusion does not affect the exemption provided for under the treaty. Nevertheless, it is generally considered advantageous to be classified as a public charity rather than a private foundation. Private foundations in the United States are subject to numerous restrictions on their operations and investments that are not applicable to public charities. Grants and contributions to public charities from individuals, corporations, government entities, and private foundations are subject to fewer limitations and restrictions than grants and contributions to private foundations. More important in the present context, private foundations are required to file form 990-PF (Return of Private Foundation), which generally requires more detailed information concerning an organization's finances and operations than form 990 (Return of Organization Exempt Under Section 501(c)(3)), the form filed by public charities. On the other hand, in order to continue to qualify as such, many public charities must complete schedule A, part IV-A and meet a "public support" test each year, which private foundations are not required to do. There may be other ancillary benefits to obtaining IRS recognition of exemption and public charity classification. Advisers should conduct a review of those benefits on a case-by-case basis.

Although a Canadian registered charity automatically receives recognition of exemption under the treaty without application in the United States, it is required to file annually form 990 or form 990-PF unless it receives less than $25,000 of US-source income. The penalty for failure to file form 990 or form 990-PF is US$20 per day per return, subject to a maximum equal to the lesser of US$10,000 and 5 percent of the gross receipts of the organization. If the organization has gross receipts in excess of US$1 million for the year, the penalty increases to US$100 per day, subject to a maximum of US$50,000 per return. Gross receipts arguably include not only US-source income but worldwide income of the organization for the relevant year. These penalties are not treaty-protected; they apply unless it can be shown that the failure to file was due to a "reasonable cause." Generally, "reasonable cause" is construed as "ordinary business care and prudence." Whether a taxpayer has exercised ordinary care and prudence is to be determined on the basis of all the facts and circumstances. A failure to file form 990 or form 990-PF cannot be statute-barred; thus, penalties can continue to build up.

Finally, section 6114(a) of the IRC also requires that taxpayers taking the position that the treaty overrules a general US tax principle or law must disclose that position on a tax return, or, if no return is required, as the IRS may prescribe. Accordingly, taxpayers that claim an exemption as described above may use and attach form 8833 or a separate statement indicating that they are claiming exemption pursuant to article XXI of the treaty.

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Alberta Unlimited Liability Corporations

Alberta recently enacted important amendments to its Business Corporations Act (ABCA), including the introduction of Alberta unlimited liability corporations (AULCs). AULCs (like Nova Scotia unlimited liability companies, or NSULCs) should be eligible to be treated as partnerships or disregarded entities for US federal tax purposes while retaining their status as corporations for Canadian tax purposes. The hybrid nature of a ULC makes it a very useful vehicle for US individuals or corporations investing into Canada. It is understood that the government of Alberta will levy the same nominal fees on AULCs that are imposed on other corporations governed by the ABCA. The fees for establishing and maintaining an NSULC, by contrast, are $4,000 and $2,000 respectively.

Both NSULCs and AULCs expose their members to unlimited liability, although the nature, extent, and timing of the liability differ between the two jurisdictions.

In particular, liability of a member of an NSULC generally is considered not to attach until the NSULC has been wound up. On the other hand, there is a risk that a shareholder of an AULC could be held liable for obligations of the AULC at any time, although one might reasonably argue that such liability does not attach until the AULC has been dissolved. In any event, it is possible to limit liability exposure by interposing an entity, such as a US C or S corporation (depending on the circumstances), between the ULC and the investors. In general, taxpayers should exercise great caution when deciding whether to hold an interest in any ULC directly.

AULCs generally are subject to the same rules as all corporations governed by the ABCA—including, for example, the provisions permitting vertical and horizontal short-form amalgamations. An NSULC, by contrast, generally may not amalgamate without a court order (in addition to the approval of three-quarters of its members). Certain other actions that are relatively straightforward under the ABCA (for example, the reduction of stated capital) are significantly more complicated for NSULCs.

The ABCA amendments specifically permit extraprovincial corporations (both NSULCs and conventional limited liability corporations) to be continued as AULCs. The amendments also permit limited liability corporations governed by the ABCA to be converted into AULCs and vice versa. For an NSULC to be continued as an AULC, the continuance must be authorized by a special resolution of the NSULC's members, and it must be established to the satisfaction of the registrar under the Nova Scotia Companies Act that the proposed continuance will not adversely affect creditors or shareholders of the company. By way of contrast, there are no specific provisions that permit an extraprovincial limited liability corporation to continue as an NSULC, although there are techniques for indirectly accomplishing this (some of which could give rise to material adverse US or Canadian tax consequences).

The directors of an NSULC may be resident anywhere in the world, whereas the ABCA requires at least one-quarter of the directors of a corporation governed by that statute to be, in general terms, ordinarily resident in Canada and either Canadian citizens or permanent residents. The ABCA, like most modern corporations acts, sets out detailed rules concerning the duties of directors and officers.

The ABCA now provides a broad 30-day safe harbour from the prohibition against incestuous shareholdings. In particular, the amendments permit a corporation to hold any number of shares of itself or of its parent corporation for a maximum of 30 days. If the shares are still held at the expiry of the 30-day period, the shares must be cancelled, the consideration received for them returned, and the entry that records the consideration in the stated capital account of the corporation cancelled. This is an amendment of general application that will likely prove very useful for planning that involves not only AULCs but also limited liability corporations that are governed by the ABCA.

In Alberta, the ULC concept has been grafted on to a modern corporations act, which is broadly similar to other modern corporations acts throughout Canada. Most practitioners are likely to feel more comfortable with AULCs than with NSULCs for this reason alone. Although there may be situations in which the particular rules (or ambiguities) associated with NSULCs would be desirable, in general there appears to be little reason to select an NSULC over an AULC in the future. The advantages of AULCs likely will continue to grow as the ABCA evolves to meet the needs of the business community and as jurisprudence clarifying the ABCA and parallel provisions of other corporations acts in Canada develops at a much faster pace than the Nova Scotia Companies Act.

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Practice Notes

Interest Expense

Paragraph 20(1)(c) of the Income Tax Act permits the deduction of interest paid on money borrowed to earn income from a business or from property. Suppose that a loan is made for a use that meets the purpose test, and the taxpayer then takes out a second loan in order to pay the interest due on the first loan. Is the interest on the second loan deductible?

The technical question is whether the use of the borrowed funds meets the "for the purpose of earning income" test in paragraph 20(1)(c). Strictly speaking, the second loan is for the purpose of paying interest, not for the purpose of earning income. Absent a specific provision allowing the deduction, a payment of interest is regarded as being on capital account: *Gifford* (2004 SCC 15). Subsection 20(3) provides that when money is borrowed to repay an earlier loan, "for greater certainty" the principal of the second loan is deemed to have been borrowed for the same purpose as that underlying the first loan. There is no comparable provision deeming the interest on the second loan to have been paid for the same purpose.

From a practical perspective, the second loan would not have been made but for the first one, and it would be reasonable to say that the interest on the second loan should be deductible as long as the first loan meets the purpose test. Technically, one might argue that because subsection 20(3) deems the second loan to meet the purpose test, the interest on the second loan is therefore deductible. In fact, this is the CRA's longstanding administrative practice, which was recently confirmed in document no. 2005-0116661C6, "Interest Deductibility on Second Loan—Gifford." However, subsection 20(3) deals with the refinancing of the *principal* of the first loan and, strictly speaking, says nothing about a second loan to pay interest. It is comforting (and appropriate) that the CRA recognizes the business realities in such a situation and does not challenge the deductibility of the interest paid on the second loan.

Commissioned Employee Expenses: Paragraph 8(1)(f)

Under defined conditions, paragraph 8(1)(f) allows an employee who is remunerated by commission to deduct amounts expended "for the purpose of earning the income from the employment." This deduction is the most generous of the several provided for in section 8. The recent Tax Court decision in *Ross* (2005 TCC 286) is an example of how far-reaching the paragraph may be.

Ross, who was in the securities business, earned commissions by promoting investments and underwritings. It was agreed that he met the conditions for a deduction under paragraph 8(1)(f) if the expenses in issue were incurred "for the purpose" of earning income from his employment.

The expenses were incurred in connection with a thoroughbred horse-breeding and racing activity. Ross testified that he had started the activity in order to develop a client base among entrepreneurially minded persons. The CRA agreed that the activity was carried on as a business, but it applied section 31 to restrict the losses otherwise deductible under that section. Ross argued that the disallowed portion was deductible under paragraph 8(1)(f) as an expense of earning commission income.

The Tax Court held that on the "modern approach to the deduction principle" (paragraph 15), the appeal should be allowed. The judge accepted the taxpayer's evidence that Ross would not have undertaken the horse-breeding and racing activity to the degree that he did if it were not for his desire to attract new clients. As well, there was evidence showing a direct link between the horse-breeding and racing activity and the earning of commission income.

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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This case is perhaps an extreme example of how far a court may go in allowing deductions when it is satisfied that the expenses were incurred with a valid income-earning purpose. It would have been open to the court to dismiss the appeal on the basis that the horse-breeding and racing business was an activity separate from Ross's employment and that the deductions associated with it were not therefore deductible in computing his employment income. (In this regard, see subsection 4(1).) Alternatively, the court might have applied the decision of the Supreme Court of Canada in *Symes* ([1993] 4 SCR 695). In that case, the court held that the cost of child care could not be deducted as a business expense because of the specific limitations on child-care expenses in section 63.

It is noteworthy that the court did not choose to decide the case on either of these grounds; instead, it adopted a liberal approach to what constitutes an expense incurred to earn commission income. This aspect of the case will be of interest to other taxpayers who incur substantial non-traditional promotion expenses in order to earn commission income.

One note of caution: the Crown has appealed the Tax Court's decision to the Federal Court of Appeal. The usefulness of this case as a precedent will depend on how the higher court deals with the decision.

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