T A X FOR THE O w n e r - M a n a g e r

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## The Windup Bump

Paragraphs 88(1)(c) and (d) of the Act provide a step-up in the tax value of non-depreciable capital property owned by a corporation where the property is owned by a 90 percent or greater subsidiary that is wound up into its parent, or where the property is owned by a wholly owned subsidiary that is amalgamated with its parent. Each of these transactions is referred to herein as a "combination."

Commentators usually concentrate on the technical impediments that deny this bump when the property in question is ineligible property. This article deals with the more mundane issue of when the bump can inadvertently be lost in connection with property whose tax value is eligible to be bumped.

In broad terms, the bump is available if the parent corporation's adjusted cost base (ACB) of the shares of the subsidiary (determined immediately before the combination) exceeds the tax value of the subsidiary's underlying assets (determined immediately before the combination), net of liabilities. On the combination, the parent or the amalgamated corporation, as the case may be, inherits the subsidiary's tax value. However, if the property is non-depreciable capital property to the subsidiary, the inherited tax value can be stepped up in accordance with the formula provided in paragraph 88(1)(d).

The bump is intended to be equal to the excess of the ACB of the parent's shares of the subsidiary over the net tax values of the assets of the subsidiary. However, the tax value of the property cannot be increased above its fair market value determined at the time that the parent acquired control of the subsidiary. As illustrated below, the actual formula can yield an unpleasant (and probably unintended) surprise in at least one situation.

Assume that

- a parent acquires the shares of a corporation ("the target") for $100,000 from an arm's-length vendor;
- the only asset on the books of the target at that time is a rental property that is capital property to it;
- the tax value of the rental property is $30,000;
- the target has no liabilities;
- the parent intends to demolish the building so that it can develop the land for sale; and
- prior to demolition, the rental property generates $50,000 of after-tax rental income, all of which is expended on costs that must be capitalized for income tax purposes.

If the target is combined with the parent immediately after the acquisition, the tax value of the land will be bumped to $100,000, computed as follows:

| | |
|---|---|
| ACB of shares to parent | $100,000 |
| Less net tax value of the target's real estate immediately before the combination | (30,000) |
| Potential bump | 70,000 |
| Tax value of the real estate to the subsidiary | 30,000 |
| Tax value to the parent (cannot exceed the fair market value of the real estate when control was acquired) | $100,000 |

The $50,000 of subsequent development costs will result in the real estate having a tax value of $150,000.

However, if development costs were expended by the target before it was combined with the parent, the development costs would, in effect, not increase the tax value of the property. This point is illustrated as follows:

| | |
|---|---|
| ACB of shares to parent | $100,000 |
| Less net tax value of the target's assets immediately before the combination | (80,000) |
| Potential bump | 20,000 |
| Tax value of real estate to the subsidiary | 80,000 |
| Tax value to the parent (cannot exceed the fair market value of the real estate when control was acquired) | $100,000 |

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The tax value of $100,000 is $50,000 less than the $150,000 tax value in the first scenario. The difference arises because the development costs were incurred by the target rather than by the parent.

*Perry Truster*
Truster Zweig LLP
Richmond Hill, Ontario

## Associated Corporations: Deemed Active Business Income

Planners often seek to avoid association between corporations in order to preserve each corporation's ability to utilize its own business limit for the small business deduction. In the right circumstances, however, deemed association between two corporations by virtue of each being associated with the same third corporation can be a valuable planning tool to multiply access to the small business deduction: what would otherwise be income from property received from the third corporation is converted to active business income of the associated corporations.

Association between corporations is relevant for a number of reasons under the Act, including the following:

1) Eligibility for certain refundable and enhanced investment tax credits is determined according to the taxable incomes of all associated corporations (sections 127 and 127.1).
2) The annual part VI.1 dividend allowance must be shared by all associated corporations (subsection 191.1(3)).
3) Income that would otherwise be income from a personal services business (and therefore not income from an active business) is deemed to be income from an active business if it is received from an associated corporation on account of services provided to that corporation (subsection 125(7)).
4) Associated CCPCs are required to share the $50 million capital deduction for large corporations tax for CCPCs (subsection 181.5(7)).
5) Corporations that are associated at any time during a taxation year are required to share a single $300,000 business limit (subsections 125(2) and (3)).
6) Canadian property income received from an associated corporation is deemed to be active business income if it is deducted in computing the active business income of the payer corporation (subsection 129(6)).

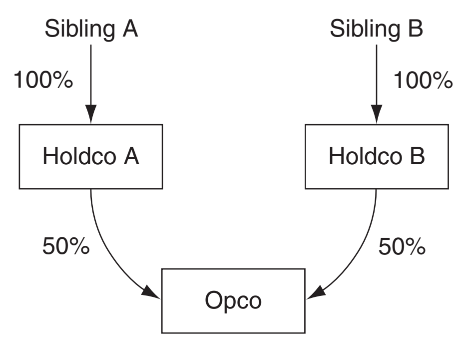
The examples above illustrate that the association rules should be borne in mind in many diverse situations and, in some instances, should be considered at all times during a taxation year, not merely at the corporate year-end. The balance of this article, however, will focus on points 5 and 6 above.

Subsection 256(1) describes five situations in which two or more corporations will be regarded as associated with each other. In addition, two corporations will be deemed to be associated with one another pursuant to subsection 256(2) where the two corporations

1) would not be associated with one another but for subsection 256(2), and
2) are associated or deemed by subsection 256(2) to be associated with the same third corporation that is a CCPC.

In other words, two corporations that would otherwise not be associated with each other in a year will be deemed to be associated if they are both associated with a third corporation at the same time during the year, provided that the third corporation is a CCPC. This deemed association may be avoided strictly for the purposes of section 125 where the third corporation elects not to be associated with either of the two other corporations in the year (form T2, schedule 28). If this is done, however, the third corporation's business limit for the year will be nil.

Consider the example shown in the accompanying figure.




Holdco A and Holdco B are both associated with Opco because of the lookthrough rules in section 256. They would not, however, be associated with one another if it were not for subsection 256(2), since there is no cross-shareholding between the corporations or their respective shareholders. Without more, Holdco A, Holdco B, and Opco will therefore be required to share a single business limit in accordance with subsections 125(2) and (3) if any small business deduction is to be taken advantage of.

However, if Opco elects not to be associated with either Holdco A or Holdco B in a taxation year, Holdco A and Holdco B will avoid being associated with one another through Opco for the purposes of section 125. If this election is made, Holdco A and Holdco B will each be entitled to its own business limit for the year; however, Opco's business limit will be deemed to be nil. On this basis, it is possible to multiply the associated group's access to the small business deduction through the interaction of subsection 256(2) and section 125.

It may be difficult to fully utilize two business limits: Opco's business limit will be ground to nil under subsection 256(2) when it elects not to be associated with the holdcos. Subsection 129(6) can assist in this regard by deeming any income from property that is paid by Opco to the holdcos to be active business income of the holdcos to the extent that such income is deducted by Opco in computing its active business income for the year. (The CRA accepts that an election under subsection 256(2) disassociates corporations only for the purposes of section 125 and not for the purposes of subsection 129(6): TI (external) 2003-0030905, October 15, 2003 (French) and TI (external) 2003-0037075, October 30, 2003 (French).) Thus, if each of the holdcos owns a portion of the real property used in Opco's active business and leases that portion of the real property to Opco, the lease payments will be deemed to be active business income of the holdcos pursuant to subsection 129(6), provided that Opco deducts these lease payments in computing its active business income. Similarly, if significant shareholders' loans can be created between Opco and the holdcos, any interest paid by Opco to the holdcos may be treated as active business income of the holdcos to the extent that the payment of such interest was deductible to Opco in computing its active business income. Of course, the interest deductibility rules should be carefully considered before one implements any structure that relies on interest payments being deductible to the payer.

*Tim Kirby*
Felesky Flynn LLP, Edmonton

## Privilege: Legal Advice Disclosed to Accountants

A recent case from the realm of securities regulation addressed the question of whether a taxpayer that discloses otherwise privileged information to its accountant loses the benefit of the legal privilege in a subsequent proceeding. In *Philip Services* (2005 CanLII 30328 (Ont. SCJ)), the Ontario Superior Court of Justice ruled that privileged documents provided to one's accountants for the purposes of audit activities maintained the privilege and could not be subpoenaed afterwards by government authorities. The corollary of the ruling is that information and advice obtained from an accountant that does not relate to the accountant's audit activity is unprivileged and therefore subject to disclosure, unless a lawyer is involved in the process and the accountant's work is structured as agency work.

The case involved an action by the Ontario Securities Commission against Philip and its senior officers for failure to make adequate disclosure at the time of a public offering of securities. Key to the OSC's case was a legal opinion and related legal memoranda prepared by Philip's lawyers, which had been provided to an accounting firm to assist it in preparing an audit report on the company's financial statements. The OSC alleged that Philip had waived the legal privilege otherwise attached to the documents by disclosing them to a third party, the accounting firm. The OSC's position was that although the documents may have initially been privileged, Philip had effectively and completely waived the privilege by providing them to the accounting firm.

Shortly after the public offering of its securities, Philip made a series of announcements that substantially altered the financial picture presented at the time of the public offering. The price of Philip's shares dropped dramatically, Philip was delisted and sought bankruptcy protection, and the OSC commenced an investigation. In response to a summons from the OSC to produce documents, Philip and its accounting firm disclosed a number of documents, including the legal opinion and several letters and legal memoranda.

The main issue in the Ontario court was whether the disclosure of the legal opinion and the other law-firm-related documents to Philip's auditor resulted in the loss or waiver of privilege by Philip. The court began its analysis by noting that, generally, information and advice passing between a client and its accountant is not privileged. However, the court also noted that the documents may be privileged if the accountant receives the information or advice in its capacity as agent of the client in obtaining legal advice for the client (*Susan Hosiery Ltd.* ([1969] CTC 353 (Ex. Ct.)).

With that background in mind, the court then accepted the OSC's finding that the legal opinion was given to the accounting firm in its capacity as auditor and not for the purpose of seeking, receiving, or implementing legal advice regarding Philip's affairs. However, the court disagreed with the OSC's argument that the provision of the documents to the auditors constituted a complete waiver of the privilege. Citing recent decisions of the Supreme Court of Canada on similar issues, the court concluded that it was clear that "restrictions on solicitor-client privilege to attain other important societal objectives are to be closely scrutinized and restricted to what is absolutely necessary for the competing objective so as to achieve the minimal necessary impairment of solicitor-client privilege" (paragraph 51).

This observation ultimately led the court to conclude that the information (including the legal opinion) provided to the accounting firm maintained its privilege, so long as the information was provided for audit purposes only. This finding is an important safeguard for taxpayers dealing with their auditors. It confirms that when auditors request full disclosure of tax positions, the underlying documentation can retain its solicitor-client privilege. There are, however, at least two very important caveats.

First, the documents must be "privileged" in the first place. This suggests that if legal advice is to be kept truly confidential from the taxing authorities, it must be obtained from lawyers and not from accountants. Only legal advice—which may include advice obtained from an accountant acting as the lawyer's agent—is subject to solicitor-client privilege.

Second, privileged legal information provided to accountants for purposes other than their audit function will not retain that privilege. This suggests that there may be doubt about the privilege if the legal advice is disclosed to the accountants for the purpose of, for example, helping them to formulate a tax strategy unrelated to an audit engagement.

The federal courts in Canada have not seen fit to extend privilege to tax advice provided by accountants, even though the advice is often given in circumstances very similar to those in which a lawyer provides advice on the same tax issue. *Philip Services* is a reminder that until the courts take a different view, taxpayers (and their advisers) should carefully consider how tax advice is to be sought in any sensitive matter.

*Robert G. Kreklewetz and Simon Thang*
Millar Kreklewetz LLP, Toronto

## Multiple Trusts, Subsection 104(2), and the CRA

Subsection 104(2) of the Income Tax Act deems a trust to be an individual in respect of the trust property. Where there is more than one trust and (1) substantially all of the property of the various trusts has been received from one person and (2) the various trusts are conditioned so that the income thereof accrues or will ultimately accrue to the same beneficiary or group or class of beneficiaries, the CRA may deem the multiple trusts to be a single individual under the Act.

In a technical interpretation dated December 13, 2005 (document no. 2004-0090941E5), the CRA again comments on the application of this discretionary deeming rule to a particular fact situation (see also document no. 9306245, dated May 20, 1993; document no. 9304865, dated May 20, 1993; and document no. 9714835, dated June 30, 1997 for the CRA's earlier comments).

In the scenario described in the TI, a taxpayer creates three separate trusts by will for the benefit of each of the taxpayer's three adult children. Each trust receives $1 million of the taxpayer's funds on the taxpayer's death. Separate bank and brokerage accounts and bookkeeping are used for the trusts.

The CRA sets out its general approach to the application of the deeming rule and makes a number of additional comments, including the following. The CRA restates its position (as set out in CRA document no. 9M19190, October 8, 1999) that because the term "class of beneficiaries" is not defined in the Act, the CRA will use its common meaning and will take into account definitions in the applicable legislation governing trusts. Further, in the CRA's view, "members of the same family" could be one class of beneficiaries. The CRA also states that for the deeming rule to be applied, it is not necessary that each trust have the same beneficiaries; it is sufficient that the beneficiaries of each trust be of the same group or class of beneficiaries.

Notwithstanding the foregoing, the CRA states that subsection 104(2) will not be applied when a testator or a settlor creates a separate trust for each of his or her children. These comments are consistent with the CRA's views as set out in document no. 9304865, where the CRA stated that subsection 104(2) is not applicable in the following circumstances:

1) a parent settles two trusts;
2) each of the trusts has one of the settlor's children as the beneficiary;
3) each trust holds different property; and
4) neither trust is revocable, and after the settlement of the trusts the settlor has no powers over any aspect of the trusts or the property held by the trusts.

The CRA's favourable comment in the latest TI regarding the application of the deeming rule in subsection 104(2) to separate trusts established for each child of a testator may seem surprising, given some of the CRA's other comments. Perhaps the favourable comments arise from the decision in *Mitchell v. MNR*

(56 DTC 521 (TAB)). In that case, the taxpayer created a separate trust for each of his four children. The elements of each trust (including the trustee) were identical, except for the names of the beneficiaries. Each trust agreement provided that the taxpayer would pay $150 to the trustee, who would then incorporate a company and invest the funds in shares of the company. The Tax Appeal Board concluded that the facts of the case did not bring it within subsection 63(2) of the Income Tax Act, RSC 1952 (the predecessor of subsection 104(2)), even though it could be held that substantially all of the property of the four trusts had been received from the same person. The board held that these trusts were not conditioned so that the income thereof accrued, or would ultimately accrue, to the same beneficiary or group or class of beneficiaries, since each trust provided for a different beneficiary.

The *Mitchell* case supports the proposition that subsection 104(2) does not apply to separate trusts created by an individual inter vivos or by will for each of his or her children. What remains unclear is in what circumstances the deeming rule can be applied to multiple trusts created by a taxpayer for groups or classes of beneficiaries. For example, is a group or class consisting of the taxpayer's child and that child's children the same group or class that consists of another of the taxpayer's children and that child's children?

*Philip Friedlan*
Friedlan Law
Toronto and Markham, Ontario

## Meals and Entertainment Expenses Still Only 50 Percent Deductible

The Federal Court of Appeal's recent decision in *Stapley* (2006 FCA 36, reversing the informal procedure TCC decision, 2005 DTC 1095) reaffirms that meals and entertainment expenses are in most cases only 50 percent deductible. The FCA's decision in itself is not surprising; the novelty of the case is found in the argument of the taxpayer, which was supported by the lower court.

The taxpayer was a self-employed real estate agent who gave his clients gift certificates for food and beverages and tickets to sporting events and concerts. When computing his income for the 2000, 2001, and 2002 taxation years, he deducted 100 percent of the cost of the food vouchers and tickets. The CRA disallowed 50 percent of the deductions on the basis of subsection 67.1(1) of the Act. The TCC found that the taxpayer's deductions were not caught by this provision because the taxpayer himself never consumed the meals or attended the entertainment events. He merely provided vouchers to his clients in the hope of generating more business, and he had no control over whether the vouchers would ever be used. The Tax Court of Canada found that the expenses in question were deductible as general business expenses pursuant to section 9 of the Act and were not caught by section 67.1.

The FCA examined subsection 67.1(1) and stated that there is nothing in the legislation that specifies that the particular taxpayer must consume or enjoy the goods in issue for the provision to apply. The court then went on to say that section 67.1 is a complete code covering the deductibility of expenses because it contains 11 specific exceptions to the general 50 percent limitation on the deductibility of meals and entertainment expenses.

If the taxpayer's argument regarding personal consumption or enjoyment of the meals or entertainment was correct, then 2 of the 11 exceptions would be irrelevant. Of particular note, the exception in paragraph 67.1(2)(a) (which permits a restaurant to fully deduct the cost of the meals it serves its customers as a cost of goods sold) would not be needed, evidently because the restaurant owners would never have personally consumed the meals they sold to customers.

The FCA concluded that notwithstanding that meals and entertainment vouchers are business expenses deductible under section 9 of the Act, they are still caught by the more specific provision of section 67.1. This conclusion follows the general principle of statutory interpretation, *expressio unius exclusio alterius est*.

In obiter, the FCA was sympathetic to the taxpayer's assertion that tax legislation should not influence a taxpayer in choosing how to spend its marketing budget. Stapley would have received a 100 percent business deduction if he had purchased flowers for his clients or if he had provided a rebate of a portion of his real estate commissions by spending an amount equal to the amount of the promotional gift. Section 67.1 provides an obvious disincentive for a taxpayer to purchase gifts of food and entertainment for the purpose of building and maintaining his client relationships. The court alluded to the possibility of Parliament legislating a 12th exception to the limitation in subsection 67.1, which would enable the taxpayer to file evidence to rebut the presumption of personal enjoyment. The practical difficulty of administering such a tax provision is probably the reason that this exception has never been introduced into the legislation.

In the result, taxpayers who want to promote their businesses by giving gifts to clients will have to choose methods other than that adopted by Stapley if they hope to deduct 100 percent of the gifts. The result in *Stapley* is arguably the correct one on a strictly textual approach to section 67.1. One wonders, though, whether it adequately reflects the purposive approach most recently emphasized by the Supreme Court in the *Canada Trustco* decision (2005 SCC 54).

*Manu Kakkar*
Kakkar and Associates Limited
London, Ontario

## Shop Floor SR & ED: Are You Missing Out?

In an effort to support the advancement of science and technology in Canada, the federal government provides tax incentives under the scientific research & experimental development (SR & ED) tax credit program to taxpayers that carry on eligible activities in Canada. The benefits available under the SR & ED program can offer a tremendous strategic advantage for Canadian corporations.

The program provides two types of benefits to claimants: full deductibility of current and capital SR & ED expenditures and the ability to receive investment tax credits (ITCs) on qualifying expenditures. Federal ITC rates and their refundability vary across taxpayers. For corporations, ITCs can range from 20 to 35 percent of qualified SR & ED expenditures, and their refundability can range from 0 to 100 percent. For example, a qualifying CCPC could be entitled to a $700,000 refund on its first $2 million of SR & ED expenditures incurred in a year. In addition, most provinces and territories provide R & D tax incentives to Canadian corporations with a permanent establishment in the province, and in many instances those incentives are refundable. For example, New Brunswick, Nova Scotia, and Newfoundland offer a 15 percent fully refundable R & D ITC; Quebec provides a refundable ITC of 17.5 to 37.5 percent on wages and on 50 percent of amounts paid to an unrelated subcontractor for R & D performed by its employees in Quebec.

SR & ED is often thought of as work done in the lab by scientists, but in fact the majority of SR & ED tax credit claims involve experimental development in the shop floor environment. Shop floor SR & ED projects are common in manufacturing companies, but many companies do not capitalize on the potential benefits of these claims. The CRA's *Cross-Sector Shop Floor Guidance Document* explains what constitutes shop floor SR & ED. Shop floor SR & ED involves creating new or improving existing materials, devices, products, or processes in a commercial setting or production environment. Attempting to improve processes or output with existing equipment or through modifications of existing equipment is often a good indicator of shop floor SR & ED. When a technological issue arises, whether expectedly or unexpectedly, the efforts required to resolve the issues may constitute SR & ED, and the related expenditures may qualify as SR & ED expenditures.

To claim benefits under the SR & ED program, the claimant must file form T661, "Claim for Scientific Research and Experimental Development Expenditures Carried On in Canada," and form T2 SCH 31, "Investment Tax Credit—Corporations (Form T2038IND for Individuals)." Form T661 and its related schedules must be filed no later than 12 months after the filing due date of the taxpayer's tax return. For example, a corporation must file its SR & ED claim no later than 18 months after year-end. In completing form T661, a claimant must file technical project descriptions for the top 20 SR & ED projects undertaken during the taxation year and a summary of expenditures for all projects claimed. Eligible expenditures can include labour, materials, subcontractors, capital assets, and overheads; these expenditures must be provided on a project-by-project basis.

One of the challenges in claiming shop floor SR & ED is finding sufficient evidence to support the labour expenditures claimed for a particular project. In July 2004, the CRA released its *Allocation of Labour Expenditures for SR & ED Guidance Document*. This document is of particular interest to those small and medium-sized businesses that carry on shop floor SR & ED but do not have a formal SR & ED tracking system. In this document, the CRA provides guidance to claimants in using labour allocation methodologies in the compilation of their SR & ED expenditures. The CRA recognizes that the R & D environment influences the way information is gathered and summarized and that different allocation methods can be used in different R & D environments. The CRA also recognizes the various types of supporting documentation that can be used by claimants to support an allocation of labour expenditures, which may or may not include timesheets. Timesheets can be a good source of supporting information, but it is recognized that they are not the only source of information to support the allocation method used by a claimant.

Eligibility rules as they apply to shop floor SR & ED can be complex. However, the rules may be worth investigating, because there can be significant financial benefits in claiming shop floor SR & ED—benefits that may provide a competitive edge to the company.

*Krista Robinson*
Ernst & Young LLP, Montreal

## More on GAAR: The Overs Decision

In my article on the *Evans* decision (2005 TCC 684) (see "The Evans Case: GAAR in a Post-Canada-Trustco World," *Tax for the Owner-Manager*, January 2006), I suggested that the forthcoming GAAR decisions of the Tax Court of Canada would bear watching to see how the TCC would apply the tests set out by the Supreme Court in *Canada Trustco* (2005 SCC 54) and *Mathew* (2005 SCC 55). *Evans* was the first such case; *Overs* (2006 TCC 26) is another.

The planning in *Overs*, like that in *Evans*, involved a closely held private corporation. The taxpayer owned all the shares initially, but sold some of them to his wife as part of an arrangement to refinance a substantial debt that he owed to the company. The debt of some $2.26 million would, but for the refinancing, have been included in his income under subsection 15(2) as a loan to a shareholder unpaid at the end of the year. Just before the year-end, the taxpayer sold shares in the company worth about $2.3 million to his wife, who had borrowed the purchase price from a chartered bank; the taxpayer then used the proceeds to repay his loan to the company. The company guaranteed the bank loan to the wife and placed $2.3 million on deposit with the bank in support of the guarantee. The wife paid interest on the bank loan at commercial rates and a modest fee to the company for its services in providing the guarantee.

Under section 73, the sale to the wife was deemed to take place at the husband's cost of the shares, unless the parties elected out of the section. They chose not to do so. Under section 74.1 of the Income Tax Act, any income or loss on the shares purchased by the wife was attributable to the husband. No dividends were paid on the shares in the two years under appeal. The wife paid interest on the bank loan and the guarantee fee in those years, and she reported a loss for tax purposes. This loss was attributed to the husband under section 74.1, and he claimed it in computing his income. The minister argued that the deduction of the loss was abusive in these circumstances and assessed, relying on GAAR.

The Tax Court allowed the appeal, primarily on the basis that none of the steps involved in the series of transactions was an avoidance transaction. The court said that each of the sections of the Act relied on in the planning was used for the very purpose for which it was included in the Act. The court seemed to say that there cannot be an avoidance transaction unless there is a misuse or abuse of a section, whatever the result might be of the series taken as a whole.

In my view, this is an inappropriately narrow reading of the definition of "avoidance transaction." In particular, paragraph 245(3)(b) refers to a transaction that is "part of a series of transactions, *which series*, but for this section, would result, directly or indirectly, in a tax benefit" (emphasis added). This suggests that in determining whether or not there is an avoidance transaction one looks to the result of the series, not just to the operation of the particular section(s) involved. With the result of the series in mind, one then asks whether the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit.

In *Overs*, there are at least three results of the series:

1) The wife became the owner of common shares in the company.
2) The husband repaid his shareholder loan, thereby avoiding an income inclusion.
3) The husband became entitled, in effect, to deduct the interest on the bank loan and the amount of the guarantee fee.

Either result 2 or result 3 would produce a tax benefit; thus, the series is an avoidance transaction if achieving the tax benefit was its primary purpose. The court did not discuss the question of primary purpose at all; instead, it focused on what it believed was the "proper" use of each section involved. As a consequence, its finding that there was no avoidance transaction is analytically weak.

On the facts, I believe that it would have been open to the court to find that the primary purpose of the transaction was the wife's acquisition of shares worth $2.3 million. There is no suggestion in the reasons that the purchase was a sham, or that she acquired the shares beneficially for her husband. Neither is there a suggestion that the arrangement with the bank was anything other than a bona fide loan. All this being so, the arrangement involved a substantial commercial transaction that had ancillary tax benefits for the husband.

One suspects that the minister's complaint was that the strict application of sections 73 and 74.1 resulted in the husband avoiding a subsection 15(2) income inclusion and winding up with a deductible interest expense on what previously had been his personal loan from the company for non-income-earning purposes. However, if one changes the facts somewhat—such that instead of buying shares from the husband, the wife borrowed money from him to purchase shares of a publicly traded company—section 74.1 would apply in the same way to attribute the loss to the husband. The real complaint was probably the fact that the arrangement allowed the husband to dodge the subsection 15(2) inclusion. But to make a GAAR case out of this set of facts, the minister had to show that there was something abusive in the wife's purchasing shares from the husband rather than on the open market. This he failed to do.

In the end, the result in the case seems correct to me, although the reasoning leaves something to be desired. I understand that another case on somewhat similar facts has been argued in the Tax Court since *Overs*; we will wait and see how another court reacts to this sort of husband-wife planning.

*Thomas E. McDonnell*
Thorsteinssons LLP, Toronto

## Still More on GAAR: The Desmarais Decision

Following on the Tax Court's refusal to apply GAAR in *Evans* and *Overs*, and its comments that it would not have done so in two other cases, *Univar* (2005 TCC 723) and *XCO Investments* (2005 TCC 655), the decision in *Desmarais* (2006 CCI 44 (Fr.); 2006 TCC 44) comes as quite a shock to tax professionals. Not only did the court apply GAAR to deny a tax benefit, but it did so in terms that hearken back to the "overarching policy of the Act" approach rejected by the Supreme Court in *Canada Trustco*. If nothing else, the case demonstrates that the common law is alive and well in the tax field.

The planning involved here will strike many advisers as not very aggressive. In a greatly simplified form, it may be summarized as follows.

The taxpayer owned a minority interest in C Ltd, a private company. The other shares were held by a group of six unrelated individuals. C Ltd was a qualified small business corporation; a sale of its shares by the taxpayer qualified for the capital gains exemption. The company had substantial assets, but it was not in a position to pay dividends because of debt undertaken in the course of its business activities.

The taxpayer and his brother each owned 50 percent of the shares of a second company, G Ltd, which had substantial surpluses. The two brothers were at odds over their personal investment objectives and agreed to divide their ownership in G Ltd. In the taxpayer's case, this involved forming a holding company to which he transferred his shares of G Ltd. The brother did the same with a holdco of his own. G Ltd paid dividends to the two holdcos, which they received free of tax. The taxpayer sold a portion of his shares in C Ltd to his holdco for preferred shares having a redemption value and paid-up capital equal to the full value of the C Ltd shares. He recognized a capital gain on this transfer, but it was fully sheltered by his capital gains exemption. The number of shares was chosen so that after the transfer to the holdco, that company owned just less than 10 percent of the shares of C Ltd. One consequence of this was that the holdco and C Ltd were not "connected corporations" for the purposes of section 84.1. Consequently, there was no grind in the paid-up capital of the holdco preferred shares the taxpayer received on the transfer. The holdco used some of the cash dividends received on its shares in G Ltd to redeem the shares issued to the taxpayer in exchange for his C Ltd shares. Because the shares redeemed had full paid-up capital and cost base, no dividend or capital gain was recognized on the redemption.

The minister applied GAAR and deemed the redemption proceeds to be taxable dividends. He did so on the basis that the taxpayer had abused the Act by gaining access to the surplus of G Ltd on a tax-free basis. In the minister's view, the scheme of the Act required that any distribution of the surplus of a company (here, G Ltd) be taxed in the hands of its shareholders (paragraph 28 of the decision).

The Tax Court (per Archambault J) agreed and dismissed the appeal. He said that the scheme of the Act relevant to these transactions was contained in section 84.1. Parliament, he said, intended to prevent stripping of the surpluses of an operating company when the mechanism used was similar to that under review in this case (paragraph 32 of the decision). He noted that the taxpayer had carefully structured the transfer of his C Ltd shares to stay below the 10 percent ownership threshold, which otherwise triggers section 84.1. He inferred that Parliament was content to allow such transfers only where the risk of a surplus strip was low, because the taxpayer, as a less than 10 percent shareholder, would be unlikely to influence decisions regarding the payment of dividends to the holdco. (This inference is breathtakingly broad, and one wonders on what basis the court arrived at it.) Here, on the other hand, the taxpayer and his brother controlled G Ltd, the company whose funds were distributed to fund the redemption of the holdco shares issued on the transfer of the C Ltd shares. In the result, the taxpayer achieved a strip of G Ltd earnings through the mechanism of the transfer of the C Ltd shares for full paid-up capital and cost base shares of the holdco.

The decision stands in stark contrast to two earlier judgments of the Tax Court. In *XCO Investments*, Bowman CJ made the point that where an anti-avoidance rule otherwise applies to a situation, it is not open to the minister to apply GAAR just because he believes

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Canadian Tax Foundation
595 Bay Street, Suite 1200
Toronto, Ontario M5G 2N5
Telephone: 416-599-0283
Facsimile: 416-599-9283
Internet: http://www.ctf.ca
E-mail: 1tmcdonnell2@rogers.com

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that the remedy afforded by the specific rule is insufficient (2005 TCC 655, at paragraph 40). This supports the proposition that where a taxpayer takes full cognizance of the anti-avoidance rule and structures a transaction so as to meet its specific requirements, it follows that any resulting tax benefit is not abusive. In *Evans*, the chief justice considered a planning transaction in which the taxpayer sold shares to a partnership, not a corporation, so as to avoid falling within section 84.1. He saw nothing improper or abusive in the taxpayer doing so and refused to apply GAAR. Archambault J was clearly aware of the *Evans* decision (he refers to it in passing in footnote 22 to the text at paragraph 16 of his reasons), but he did not discuss in any way why he disagreed with the approach taken in that case.

The course of the common law can, depending on one's vantage point, appear inscrutable. This is particularly the case with respect to emerging trends in the jurisprudence. Often, it is only with the benefit of several years' hindsight that one can identify the real significance of a particular judgment. At this point in the evolution of the common law of GAAR, it is next to impossible to say whether the decision in *Evans* or that in *Desmarais* will turn out to reflect the correct analysis of the applicable law. In the meantime, professional advisers will need to re-evaluate the sorts of private company planning that will escape GAAR pending a clarifying judgment (or two) from the Court of Appeal.

*Thomas E. McDonnell*
Thorsteinssons LLP, Toronto