TAX FOR THE Owner-Manager

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## GAAR and Lipson: Evolution or Revolution?

Bowman CJ's decision in *Lipson* (2006 TCC 148) has thrown the tax community into a tizzy. How are we to reconcile two opposing decisions—*Lipson* and *Overs* (2006 TCC 26)—involving the same statutory provisions (the spousal rollover and attribution rules)?

In both cases, the husband sought to use the spousal rollover rules to create "reverse attribution" of expenses attributable to borrowings by his spouse. In *Overs*, the husband sought to repay a shareholder debt to his holding company to avoid an income inclusion under section 15. Little J concluded that the taxpayers used the various rules, including section 73 and the attribution rules, exactly as they were intended to be used, so that there was no avoidance transaction and GAAR did not apply. A critical fact may turn out to be that the husband's loan in *Overs* existed at the time the series of transactions giving rise to the assessment was implemented.

In *Lipson*, the spouses wanted to purchase a new home, and they sought to make a portion of the interest on their mortgage deductible. To accomplish this, Mrs. Lipson borrowed money to purchase shares of Mr. Lipson's holding company. The sale used the same statutory provisions as *Overs*, with the expectation that the same reverse attribution results would arise. When her loan was refinanced by a mortgage on the new house, the interest expense on the new mortgage was also expected to flow back to, and be deductible by, Mr. Lipson.

One might have thought that the tax consequences of this type of arrangement had been settled by the Supreme Court decision in *Singleton* ([1999] 4 FC 484; [2001] 2 SCR 1046). In fact, the CRA's assessment in *Lipson* was initially based on Bowman CJ's trial decision in *Singleton* (96 DTC 1850), but was amended to rely on GAAR when that decision was overturned by the FCA and the SCC. Bowman CJ intimates in *Lipson* that such reliance might not have been necessary given a number of questions he posed which suggest he might have been convinced to reach the same result using a traditional "ineffective or incomplete transaction" analysis. However, the minister "put all of his eggs in the GAAR basket," and Bowman CJ proceeded on that basis.

Bowman CJ recently analyzed the application of GAAR in a complex and sophisticated series of transactions in *Evans* (2006 TCC 684). In that case, he concluded that no abusive tax avoidance resulted from the combined effect of a number of independent provisions of the Act. Further, he concluded that each of those various provisions had been used in a manner that accomplished exactly what the provisions intended. In *Lipson*, he dismisses his decision in *Evans* in three sentences.

Bowman CJ has expressed concern about the use and misuse of the interest deduction in other cases, and thus his decision in *Lipson* is hardly surprising. His decisions in *Mark Resources* (93 DTC 1004 (TCC)), where he reviewed the "carefully planned and meticulously executed arrangement" to transfer US losses to Canada, in *Singleton*, and in *Gifford* (2001 DTC 168 (TCC); 2002 FCA 301; [2004] 1 SCR 411)), where he found a creative solution for a self-represented employee, show that he is not afraid to confront the conventional wisdom of planning that uses interest deductions. In *Lipson*, with passing reference and deference to the Supreme Court, he once again challenges contrived interest deductions, and this time he finds the attempts abusive.

Citing *Ludco* ([2001] 2 SCR 1082), *Novopharm* (2003 FCA 112), and *Tennant* ([1996] 1 SCR 254), he concludes that the object of paragraph 20(1)(c) is to permit the deduction of interest when borrowed money is used for a commercial purpose. The corollary is that interest on money borrowed for personal uses (such as buying a residence) is not deductible. Subsection 20(3) allows a deduction for interest on money borrowed to repay

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money previously borrowed for commercial purposes. Both these provisions were misused in the transactions undertaken by the Lipsons, since "[t]he overall purpose as well as the use to which each individual provision was put was to make interest on money used to buy a personal residence deductible." Further, these provisions were abused: the interest deduction provisions and attribution rules were used "to achieve a purpose for which they were never intended."

In determining whether a transaction or series of transactions constitutes abusive tax avoidance, many factors must be considered, including "the statutory provisions relied on, the overall result that the use of the combination of provisions seeks to achieve and the genuineness or artificiality inherent in the transaction." The "contrived transaction" undertaken by the Lipsons was the very sort of transaction that GAAR was designed to prevent.

Where does this leave conventional planning strategies? Can you still sell an investment portfolio, use the proceeds to pay down the mortgage, and then borrow to acquire another portfolio? Is such a series of transactions any more contrived than the ones the Overses and Lipsons undertook? Is there a difference if you buy the house first and then sell the portfolio to pay down the mortgage, rather than selling the portfolio to raise the down payment for the house? Was the real problem in *Lipson* the unanswered questions about who really incurred the interest expense? Or was the real reason for the decision the fact that for Bowman CJ the planning involved failed his personal "smell test"?

The decision in *Lipson* has been appealed. It remains to be seen whether the Court of Appeal will answer any of these questions. In the meantime, the only certain advice is to pay attention to details and be meticulous in implementation.

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## Quebec Targets the "Quebec Truffle"

On May 9, 2006, the Quebec government introduced legislation (which became law on June 13, 2006; SQ 2006, c. 13) to eliminate the "Quebec truffle." This term describes a transaction designed to eliminate provincial tax on various sources of income. A typical transaction works in the following way.

A corporation resident in a province other than Quebec earns investment income. It pays tax, including refundable tax, under part I of the Income Tax Act on that investment income, together with tax under part IV of the Act, if applicable. A trust resident in Quebec holds shares of the corporation. A large dividend is paid by the corporation to the Quebec trust. Payment of the dividend generates a refund of refundable dividend tax on hand (RDTOH) to the corporation. The RDTOH refund is used, in part, to satisfy the dividend payable to the Quebec trust.

In a variation on the transaction, a spouse who holds appreciated capital property transfers it to a spousal trust resident in Quebec. The trust then disposes of the property and realizes the gain in such a way that the attribution rules do not apply to attribute the gain to the transferor spouse.

The Quebec trust includes in its income the amount of the dividend or capital gain. Federal tax is payable at 29 percent (assuming that the trust was an inter vivos trust), less the "Quebec abatement" of 3 percent of income earned in Quebec pursuant to subsection 120(2) of the Act. The dividend is also subject to the dividend tax credit. Either under the terms of the trust or by a trustee resolution, the income or gain is made payable to a beneficiary not resident in Quebec. Normally, when a trust pays or makes an amount of its income payable to a beneficiary, the amount is deducted from the trust's income for the purposes of the Act and included in the income of the beneficiary. In this case, however, the trustees elect under subsection 104(13.1) or (13.2) of the Act, the effect of which is to deem the amount of the dividend or gain not to have been paid or made payable to the beneficiary. As a consequence, the income is taxable in the trust.

Until amendments to the Taxation Act (Quebec) (QTA) on May 9, the federal election was not effective for the purposes of the QTA. This meant that the income was not included in the trust's income for the purposes of the QTA. Under the income tax legislation of the other provinces (subject to various anti-avoidance rules), the amount of the trust's income was determined by reference to the trust's taxable income for the purposes of the Act. Therefore, no provincial tax was payable either in Quebec (because it did not recognize that any income was retained in the trust) or in the province of receipt (because it viewed the income as remaining in the trust rather than received by the beneficiary). The result was the elimination of provincial tax.

To counter this type of planning, the QTA was amended to deem a trust that has made the federal subsection 104(13.1) or (13.2) election to have, in effect, made an equivalent election for the purposes of the QTA. The result is to impose Quebec tax on the trust's income. Notably, Quebec provincial tax rates are among the highest in the country. Even more notably, the legislation was imposed on a retrospective basis.

Normally, tax legislation is changed with effect from the time of announcement or the time of passage (depending on the legislation in question). The retrospective effect of the Quebec legislation is striking. It applies to all taxation years of all trusts that are not statute-barred as of May 9, 2006.

The Quebec government claims that the law is not retrospective, and that it simply clarifies what was always the intention of the law. This claim is questionable. Although changes were made to the QTA in the late 1990s (with respect to trusts resident in Quebec with preferred beneficiaries) and in 2002 (with respect to trusts in other provinces with Quebec beneficiaries), the Quebec minister of finance publicly stated that the 2002 changes did not apply to trusts resident in Quebec.

The imposition of retroactive tax on trusts will raise many hundreds of millions of dollars of revenue in Quebec. Despite an intense lobbying effort, the Quebec government introduced and passed the amendments to the QTA within five weeks. It remains to be seen how the affected taxpayers will challenge assessments levied by Quebec under the new law.

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## Interest Deduction for Corporations: Cash or Accrual Basis?

There seems to be no end to interest deductibility litigation. The recent *Crown Forest* decision (2006 TCC 47) revisited an issue that appeared to have been settled more than 30 years ago in *Mid-West Abrasive* (73 DTC 5429) and came to a different conclusion.

Paragraph 20(1)(c) provides that a deduction is available in respect of interest "paid in the year or payable in respect of the year (depending on the method regularly followed by the taxpayer in computing the taxpayer's income)." Crown Forest deducted interest on the cash basis for income tax purposes, notwithstanding that it prepared its financial statements on the accrual basis in accordance with generally accepted accounting principles (GAAP). Consistent with recent jurisprudence (such as *Canderel* ([1998] 1 SCR 147)), the court had no difficulty allowing the corporation to use an approach for income tax purposes that differed from its accounting approach. The more interesting issue in *Crown Forest* for the purposes of this article was the meaning to be given to the phrase "depending on the method regularly followed" in paragraph 20(1)(c). In particular, is the "method" referred to the method followed for accounting for profits generally, or is it the method followed for accounting for interest?

*Mid-West Abrasive* had held, in essence, that because corporations must generally compute income on the accrual basis for income tax purposes, interest must also be deducted on the accrual basis because this is the "method regularly followed." The FCTD said specifically that except in rare circumstances, a corporation could not deduct interest on the cash basis while otherwise using the accrual basis to compute income for income tax purposes.

The TCC held that Crown Forest was entitled to take the interest deduction on the cash basis for income tax purposes because it was clear, so far as interest was concerned, that the cash basis was the method that it had followed consistently for income tax purposes. Interestingly, the court did not address the *Mid-West Abrasive* case in arriving at its decision. The court said that in view of the decisions in cases such as *Canderel*, it could no longer be said that GAAP is a complete methodology for calculating income for tax purposes. That being so, it could not be said that GAAP is the methodology referred to in paragraph 20(1)(c). The only requirement to be taken from the words actually used in that paragraph is "that interest be accounted for on a consistent basis."

The reasoning behind the TCC's decision may have been that the corporation that claimed the interest deductions was a pure holding company that had incurred the interest in question in financing the acquisition of the shares of Crown Forest. (The two corporations were later combined.) Therefore, in contrast to the situation in *Mid-West Abrasive*, there were no other business activities for which the accrual basis would have been mandatory. The reasons for judgment, however, are silent on this point.

The *Crown Forest* case does not appear to have been appealed. Whether a higher court will approve the TCC's approach to the interpretation of "method" in paragraph 20(1)(c) will have to wait either for another case or until more comprehensive interest deduction rules are legislated. Advisers should not depend on a prompt legislative response, given the Department of Finance's apparent difficulty in introducing legislation in response to a number of interest deduction cases of significance, such as *Ludco* ([2001] 2 SCR 1082) and others. Until legislation is introduced, I remain skeptical regarding the correctness of the *Crown Forest* decision.

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## Subsection 256(9): Deemed Change in Control

The Federal Court of Appeal's recent decision in *La Survivance* (2006 DTC 6288) reaffirms that a statutory deeming provision may import into a term a meaning that is entirely different from its regular meaning. (The written decision is in French; the Federal Court of Appeal has not yet provided an official English translation.) In this case, the deeming provision in question was subsection 256(9) of the Income Tax Act. In general terms, the provision states that where control of a corporation is acquired at a particular time on a day, the acquiring person is, for the purposes of the Act, deemed to have acquired control at the commencement of the day and not at the particular time, unless the corporation elects otherwise.

The taxpayer was a public corporation that controlled an insurance company, Les Clairvoyants. On July 5, 1994, the taxpayer sold its shares of Les Clairvoyants to Société Nationale, a Canadian-resident private corporation. The sale resulted in a loss of $2,654,323 for the taxpayer. The taxpayer claimed that at the time it sold the shares, Les Clairvoyants was a small business corporation and that therefore the loss was an allowable business investment loss (ABIL).

For Les Clairvoyants to qualify as a small business corporation, it was necessary that it have been a Canadian-controlled private corporation (CCPC) at the time of the sale. The taxpayer argued that pursuant to subsection 256(9) of the Act, Société Nationale was deemed to have acquired control of Les Clairvoyants at the commencement of July 5, 1994 and, at the same moment, the taxpayer had relinquished control of Les Clairvoyants. According to the taxpayer, when it actually sold the shares later that same day, Les Clairvoyants was, for the purposes of the Act, controlled by Société Nationale and was therefore a CCPC.

The minister of national revenue disallowed the taxpayer's claim for the ABIL deduction. In the minister's view, Les Clairvoyants was not a CCPC at the time of the share sale because at that time a majority of its shares were owned by the taxpayer, a public corporation.

In dismissing the taxpayer's appeal, the Tax Court of Canada (2005 DTC 689) concluded that although subsection 256(9) deemed Société Nationale to have acquired control of Les Clairvoyants at the commencement of July 5, 1994, the provision did not deem the taxpayer to have relinquished control at that time. The Tax Court judge concluded that from the commencement of July 5, 1994 until later that day when the share sale occurred, Société Nationale had deemed control of Les Clairvoyants pursuant to subsection 256(9) of the Act, but that the taxpayer nevertheless retained legal control. In his view, since Les Clairvoyants was not controlled exclusively by Société Nationale, it was not a CCPC and the taxpayer was not entitled to the ABIL deduction claimed. The taxpayer appealed to the Federal Court of Appeal.

The taxpayer's appeal was allowed. The Federal Court of Appeal determined that Parliament intended subsection 256(9) to apply to both the corporation acquiring control and the corporation relinquishing control. The court concluded that at the first moment of July 5, 1994, the taxpayer was deemed to have relinquished control, and Société Nationale was deemed to have acquired control, of Les Clairvoyants. Accordingly, when the taxpayer sold its shares later that day, Les Clairvoyants was, for the purposes of the Act, deemed to have been controlled by Société Nationale and was therefore a CCPC for which the taxpayer was entitled to claim the ABIL deduction on a disposition of its shares.

The decision highlights an interesting situation in which a public corporation was entitled to claim an ABIL deduction on the sale of shares of a subsidiary. Although it may be questionable whether, in enacting subsection 256(9), Parliament had intended this result, it appears to be consistent with the provision's ordinary meaning. If, for the purposes of the Act, a person acquires control of a corporation at a particular time, then it follows that, for the purposes of the Act, the person who controlled the corporation prior to that time must have relinquished control. The Crown will not be seeking leave to appeal.

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## Acquisition of Control: "Group of Persons"

In *Crystal Beach Park Limited* (2006 TCC 183), the issue was whether the appellant was entitled to deduct non-capital losses from 1989 in its 1993 and 1994 tax returns. The deductions had been disallowed by the CRA on the basis that there had been an acquisition of control under subsection 111(5) of the Act by two unrelated individuals, T and G. The CRA also argued that the appellant was not carrying on the business in which the loss was sustained. Both arguments were rejected and the appeal was allowed. The case is of particular interest for its discussion of the meaning of the phrase "group of persons" in subsection 111(5).

The CRA took the position that T and G were a "group of persons" that acquired control of the appellant by purchasing all of the company's shares. T and G held 50 percent of the common shares and all of a class of non-voting special shares that were convertible into voting common shares, provided that all of the holders agreed to convert them. In the CRA's view, T and G acting together could have converted their special shares and thereby had control of the appellant as a "group of persons."

The shareholders' register indicated that all of the voting common shares (not just 50 percent) and the non-voting special shares were in the names of T and G. The register had a notation indicating that one-half of the common shares were held in trust for a corporation controlled by a third party; the notation was in accordance with a trust agreement between T and G and that corporation. T and G maintained that they were not the beneficial owners of this 50 percent of the issued common shares.

Sheridan J found as a fact that T and G held 50 percent of the common shares in trust for another company and that each was the beneficial and legal owner of only 25 percent of the common shares. Because T and G (either individually or together) did not acquire in excess of 50 percent of the voting shares of the appellant on November 22, 1989, Sheridan J held that they did not have de jure control of the appellant; accordingly, they did not acquire "control" of the appellant under subsection 111(5). Apparently because of the terms of the trust agreement, and relying on *Duha Printers (Western) Ltd.* ([1998] SCR 795), Sheridan J did not include the shares held in trust in deciding the de jure control issue.

Relying on *Silicon Graphics* (2002 FCA 260) and *Lenester Sales Ltd.* (2003 TCC 531; 2004 FCA 217), Sheridan J found that there was not a "sufficient common connection" between T and G to constitute a "group of persons" and therefore T and G did not have de jure or de facto control. (It should be noted that de facto control is not relevant to the issue of an acquisition of control.)

The *Silicon Graphics* case dealt with de jure and de facto control of a corporation by non-resident shareholders. To reach his decision, Sheridan J used the criteria suggested by the FCA in that case to determine whether individual shareholders constituted a "group of persons." He considered the family relationship (there was none) and the business relationship of T and G and whether there was an agreement between T and G to act in concert or a voting agreement between them with respect to acting in concert. He also found that the existence of the trust agreement was another factor militating against T and G's agreeing to vote together to exercise their conversion rights.

In *Lenester Sales*, Bowman ACJ, as he then was, rejected the notion that the fact that two independent business persons in pursuit of their own business interests worked together to achieve a mutually beneficial commercial objective meant that they were "acting in concert." Sheridan J relied on those comments to reject the CRA's position that T and G's shared desire to make a success of the business was sufficient to establish that T and G had acted in concert.

In *Lenester Sales*, the issue was whether a franchiser had de facto control of its franchisees under subsection 256(5.1). Bowman ACJ's comments regarding "acting in concert" were in respect of the issue of arm's length. Sheridan J applied those comments in determining whether two individuals constituted a "group of persons" for the purposes of subsection 111(5).

As an alternative position, the CRA argued that after T and G purchased their shares, the appellant carried on a real estate development business that was not the business in which the losses were sustained—namely, an amusement park business. On this issue, Sheridan J held on the facts that the essence of the business both before and after the amalgamation was the exploitation of a recreational site; therefore, the same business was carried on before and after November 22, 1989.

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## Company and Shareholders Convicted of Tax Evasion

In *Alberta Hot Oil Services Ltd.* (2006 ABPC 45), charges of tax evasion were brought against the company and its two shareholders (who were married to each other) in respect of personal expenses that were claimed as expenses by the company. The company was also charged with evading taxes by overstating GST input tax credits (ITCs), bringing the total of taxes allegedly evaded to $70,000. As well, the company and the shareholders were charged with making false or deceptive statements on their tax returns under the relevant sections of the Income Tax Act and the Excise Tax Act.

At trial, the Crown prosecutor alleged that the shareholder couple had implemented several schemes to have the company pay their personal expenses, which operated to evade tax as follows:

- the company claimed personal expenses of the shareholders as corporate business expenses, which reduced the taxable income of the company;
- the company filed GST returns and claimed ITCs relating to these personal expenses, which understated the GST payable by the company; and
- the shareholders received compensation from the company equal to the personal expenses and

corresponding GST paid by the company, which was not declared in their personal tax returns and which reduced their taxable income.

Among the deducted expenses that the Crown pointed to as evasion were the following:

- a wedding gown and graduation photographs ordered by the shareholders' daughter;
- car repair and health-care expenses of the shareholders' children;
- a treadmill;
- items of jewellery;
- residential articles, including dinnerware and a bedroom suite; and
- the shareholders' utility bills.

The evidence was also clear that the shareholders' accountants had made them aware that personal items were not to be paid for (and deducted) by the company unless properly accounted for, and that they understood that advice. Further evidence suggested that in some instances the expenses were falsely recorded in the company's general ledger.

In reviewing the legal elements of the offences charged, the Alberta Provincial Court noted that for an accused to be found guilty of tax evasion (1) there must be proof of an act or course of conduct that has the effect of evading or attempting to evade payment of taxes owed, and (2) the accused must have engaged in conduct intended to avoid the payment of tax owing. The latter element required that the accused know that tax was owed (or be wilfully blind to that fact), and that the accused have intended to avoid or to attempt to avoid payment of that tax: *Klundert* (2004 DTC 6609 (Ont. CA)).

To be found guilty of making false or deceptive statements—another of the charges laid—the accused must have intentionally made, participated in, assented to, or acquiesced in the making of false or deceptive statements.

The court then referred to *Symes* ([1993] 4 SCR 695) for guidelines for determining whether an expense is properly considered a business expense. The court held that the company had improperly deducted personal expenses, thereby understating the income of the company and overstating ITCs in its GST returns. The court also concluded that the company's payment of the shareholders' personal expenses conferred benefits upon the couple as shareholders, and that those benefits should have been disclosed by them as taxable income.

The key factors that the court considered in deciding on the charges included the fact that the shareholders (1) intentionally withheld critical information from their accountants with respect to the personal benefits they were receiving by having the company pay their personal expenses; (2) falsified records to evade the payment of taxes; (3) intended to be secretive and to conceal or deceive third parties regarding the personal expenses paid by the corporation on their behalf; and (4) clearly had a plan to cheat the tax authorities.

Taking all the factors into consideration, the court concluded that the couple knowingly and intentionally devised and participated in schemes to have their personal expenses paid by the company, and that they recognized that they were making false and deceptive statements and wilfully evading taxes. In the result, the company and the shareholders were convicted of all charges.

The lesson appears clear for owner-operated businesses: the line between "business" and "personal" expenses, which is often blurred, cannot be taken lightly. When personal expenses are passed off as business expenses, criminal charges can arise. Although criminal prosecution for tax evasion is still relatively uncommon, the *Alberta Hot Oil Services* case shows that it does occur and that the consequences can be severe. Taxpayers should work with their advisers to maintain a clear distinction between business and personal expenses, and they should seek legal advice when an audit uncovers this type of issue.

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## Potential Circularity Problem with Estate Loss Carryback

In post-mortem estate planning, subsection 164(6) is often used to carry back to the terminal tax return net capital losses incurred by an estate in its first taxation year. A capital loss can be created by the redemption of high-ACB, low-PUC shares of a corporation owned by the estate. However, if the estate is affiliated with the corporation after the redemption, subsection 40(3.6) applies to deny the loss. Effective after March 22, 2004, subsection 40(3.61) counteracts the application of subsection 40(3.6) and the new trust affiliation rules that would otherwise nullify the capital loss available for carryback pursuant to subsection 164(6). (See the paper presented by Chris Ireland, "The New Trust Affiliation Rules," at the 2005 Prairie Provinces Tax Conference, and the reference therein to the February 17, 2005 issue paper of the Conference for Advanced Life Underwriting.)

A technical reading of subsections 40(3.61) and 164(6) grinds the capital loss available to carry back to zero in certain circumstances. The wording of subsection 40(3.61) requires that the amount of the subsection 164(6) election be determined "without reference to" subsection 40(3.6). By virtue of this restriction, the amount of loss for the purposes of subsection 40(3.61) is otherwise determined by the Act, but *before* subsection 40(3.6) is applied. There is no similar limitation in subsection 164(6) in connection with a capital loss; presumably, such a loss is determined *after* the loss denial rules in subsections 40(3.6) and 40(3.61) are applied.

■ **Example 1:** Assume that an estate affiliated with the corporation redeems shares, resulting in a capital loss of $1 million that the estate intends to carry back. No part of the loss is denied by virtue of subsection 40(3.61).

| | |
|---|---|
| Loss otherwise determined before the application of subsection 40(3.61) | $1,000,000 |
| Less loss denied by subsections 40(3.6) and 40(3.61) | nil |
| Capital loss of the estate | $1,000,000 |
| Subsection 164(6) carryback | $1,000,000 |

■ **Example 2:** Assume that the estate carries back only $600,000 of the capital loss. Subsection 40(3.61) applies to deny the excess loss of $400,000, resulting in a capital loss for the purposes of subsection 164(6) of $600,000.

| | |
|---|---|
| Loss otherwise determined before the application of subsection 40(3.61) | $1,000,000 |
| Less loss denied by subsections 40(3.6) and 40(3.61) | $ 400,000 |
| Capital loss of the estate | $ 600,000 |
| Subsection 164(6) carryback | $ 600,000 |

■ **Example 3:** A circularity problem arises if the estate realizes capital gains in its first taxation year. Assume that the estate sold other property for a capital gain of $150,000. The net capital loss available to the estate for a carryback (before the application of the loss denial rules) is $850,000. It should be noted that subsection 40(3.61) does not account for the capital gain of $150,000 because the wording of the subsection refers to a "capital loss" and not to a "net capital loss" as in subsection 164(6). Therefore, subsections 40(3.6) and 40(3.61) deny the excess of the $1 million capital loss over the $850,000 net capital loss, subject to the subsection 164(6) election.

| | |
|---|---|
| Net loss otherwise determined before the application of subsection 40(3.61) | $850,000 |
| Less loss denied by subsections 40(3.6) and 40(3.61) | $150,000 |
| Net capital loss of the estate | $700,000 |
| Subsection 164(6) carryback | ? |

What is the net capital loss for the purposes of subsection 164(6)? Is it $850,000, which is calculated before subsection 40(3.6) is applied, or is it the revised loss of $700,000? There does not appear to be anything in the language of subsection 164(6) that allows the loss to be computed by ignoring subsections 40(3.6) and 40(3.61).

Assuming that the subsection 164(6) election is limited to $700,000, the loss denied under subsection 40(3.61) must be recalculated because that loss is computed without reference to subsection 40(3.6) but taking into account subsection 164(6). As illustrated previously, the available loss for subsection 164(6) is further reduced, which results in a circular calculation that completely grinds the capital loss carryback. A recent discussion with the CRA's Rulings Division reveals that this issue has not been previously discussed and the result was not intended by the drafters of new subsection 40(3.61).

To eliminate the circular calculation, subsection 164(6) would need to be amended to determine the capital loss prior to the application of subsections 40(3.6) and 40(3.61). The effect would be to allow the estate to carry back the $850,000 net capital loss to the terminal return, leaving the $150,000 capital gain taxed in the estate. Whether or not this effect is appropriate tax policy is open to debate.

In the meantime, tax advisers can take one of the following steps:

- write to the Rulings Division for a technical interpretation or an advance tax ruling;
- avoid capital gains in the first taxation year of the estate by deferring the realization of the gain to a later year or distributing the property to a beneficiary so that the gain is realized in the beneficiary's hands; or
- reorganize, if possible, so that the estate is not affiliated with the corporation.

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## SR & ED: All You Need Is an "Infinitesimal Advancement"

*(Editor's note: This is the first of a planned series of articles on SR & ED issues.)*

A common misconception among taxpayers is that their work must result in a significant breakthrough in science or technology in order to qualify under the scientific research and experimental development

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(SR & ED) program. In focusing on this "eureka moment," many taxpayers assume that their day-to-day work is routine in nature and not eligible for SR & ED tax incentives. In fact, a taxpayer need only demonstrate an incremental advance in science or technology to qualify under the SR & ED program.

In *Northwest Hydraulic Consultants Ltd.* (98 DTC 1839 (TCC)), the taxpayer carried on hydraulic engineering in a niche area. Over a period of 11 years, the company carried out 17 projects in which designs were tested through the construction of physical models. The minister argued that none of the projects led to either a generic or a specific technological advancement. The minister was also of the opinion that no real new or improved devices or processes were developed and that standard devices or processes were routinely used in similar design situations. The parties agreed on a sample of 5 of the 17 projects as representative of all the projects, and these were reviewed in terms of their SR & ED eligibility.

Bowman J, as he was then, set out guidelines to follow in determining whether projects fall within the concept of SR & ED. He stated that "[m]ost scientific research involves gradual, indeed infinitesimal, progress." He then went on to say that "Spectacular breakthroughs are rare and make up a very small part of the results of SRED in Canada."

*Information Circular* IC 86-4R3, "Scientific Research and Experimental Development," lists three criteria to be used in evaluating whether or not a project qualifies as SR & ED: (1) scientific or technological advancement, (2) scientific or technological uncertainty, and (3) scientific and technical content. In setting the guidelines to evaluate the eligibility of SR & ED, Bowman J endorsed those three criteria.

Technological uncertainty and technological advancement are inextricably linked, as noted in the CRA's guide "Recognizing Experimental Development," which says, "An attempt to resolve technological uncertainty is an attempt to achieve technological advancement." As noted above, the advancement sought can be infinitesimal. Consequently, the technological uncertainty need not be staggering in its level of difficulty. Even projects that result in small increases in technical know-how can qualify as SR & ED.

In ruling that four of the five projects were eligible, Bowman J stated that "[t]he technological uncertainty is something that exists in the mind of the specialist such as the appellant, who identifies and articulates it and applies its methods to remove that uncertainty." Similarly, IC 86-4R3 states, "Ultimately, the final judgement of what is or is not standard practice in a given field of technology can only be made by specialists familiar with that field." From these two statements, it is clear that technological uncertainty is subjective and is best identified by those who have knowledge and experience in that particular area.

In reviewing the opinions of the experts called to court, Bowman J commented, "I think that what divided them [the two experts] was the question whether the appellant's activities constituted routine engineering or standard practice and whether technological advances were achieved."

A definition of "routine engineering" or "standard practice" is not provided in the Income Tax Act or in any CRA guidance documents.

The expert for the Crown referred to IC 86-4R3, which states that "[s]tandard practice refers to directly adapting a known engineering or technological practice to a new situation when there is a high degree of certainty that the known technology or practice will achieve the desired objective."

In setting out the guidelines to follow in determining whether certain projects constitute SR & ED, Bowman J stated that the term "routine engineering" "describes techniques, procedures and data that are generally accessible to competent professionals in the field." In many situations, the distinction between routine engineering or standard practice and work that is eligible for the SR & ED tax credit is difficult and very subjective: "What may appear routine and obvious after the event may not have been before the work was undertaken." The presence of technological uncertainty is key in differentiating routine work from SR & ED and in demonstrating an infinitesimal advance.

The "scientific and technical content" criterion is mostly about the systematic process used in eliminating uncertainties and achieving an advance. In our next article, we will review requirements and best practices in gathering evidence to support SR & ED claims.

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