TAX FOR THE Owner-Manager

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Volume 6, Number 4, October 2006

The New Dividend Tax Credit Rules: Coming to GRIPs

The proposed dividend tax credit rules released on June 29, 2006 (Department of Finance, *News Release* 2006-028) are geared to a corporation's general rate income pool (GRIP). A number of planning opportunities (and traps) are buried in the draft legislation.

Similarities to CDA Planning

There is no requirement in the draft legislation that a CCPC pay out an eligible dividend from its GRIP first and its default pool second, or vice versa. This presents an opportunity to stream eligible dividends to Canadian-resident individual shareholders and ineligible dividends to non-residents or other shareholders who would not benefit from the enhanced dividend tax credit.

The proposed legislation will allow a CCPC to preserve its GRIP in expectation of a loss year, for fiscal years after 2005. Assume that Opco has $100 of GRIP at the end of year 1. Opco pays a $100 eligible dividend to its parent Holdco in year 1. In year 2, Opco has a loss of $100. At this point, Holdco will have a GRIP of $100 and Opco a negative GRIP of $100. Generally speaking, it will be attractive for Opco to distribute a positive GRIP balance at or before year-end to avoid the possible erosion that will occur if it sustains a loss in year 2. In other words, if the $100 eligible dividend was not paid to Holdco in year 1, then the GRIP balance in year 2 will be nil in Opco. A future $100 of GRIP in Opco after year 2 will bring its GRIP balance at the end of year 3 to zero.

A capital dividend election must be filed with the CRA on or before the payment date of the capital dividend, along with a certified copy of the directors' resolution bearing the same date as the date of payment of the capital dividend. Careful attention must be paid to the dating of the election and directors' resolution if the dividend is to qualify as a capital dividend. Similarly, the recipient of an eligible dividend must be notified of the receipt of an eligible dividend *as of the date of its payment* in order to benefit from the enhanced dividend tax credit. If the notification is received by the recipient after the payment of the eligible dividend, the dividend is not entitled to preferential tax treatment. The draft legislation does not contain an amendment to regulation 600 to allow for late-filed notifications of eligible dividends. Finance has indicated in informal discussions that the word "notification" is intended to be broad and can include a directors' resolution copied to the shareholder or a simple letter to the shareholder. Nonetheless, this notification must be made contemporaneously with the payment of the eligible dividend in order for the recipient to qualify for the enhanced dividend tax credit.

One-Time GRIP Adjustment: Technical Inconsistency?

For creditor-proofing and other non-tax reasons, it is common for Opco to pay a dividend to Holdco. In the GRIP formula in proposed subsection 89(1) for taxation years ending after 2005 ("the regular GRIP formula"), the payment of an eligible dividend to Holdco reduces Opco's GRIP and increases Holdco's GRIP by identical amounts. Thus, as illustrated by the preceding example, Holdco's GRIP is increased, and Opco's GRIP is reduced, by $100.

However, the one-time GRIP adjustment formula (proposed subsection 89(7)) that computes the beginning GRIP balance for a corporation's first taxation year ending after 2005 to include the GRIP for taxation years ending after 2000 and before 2006 yields a different result for the same fact pattern: both Opco's and Holdco's GRIPs will be zero. Opco's GRIP is zero for the reason mentioned previously; Holdco's GRIP remains at zero because, unlike the regular GRIP formula, the one-time GRIP adjustment formula does not include eligible dividends received from other corporations. Finance is aware of the issue and is in the process of resolving it.

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Potential Differences Between Federal and Provincial GRIPs

Generally speaking, GRIP is defined for a particular taxation year as taxable income less the aggregate of income subject to the small business deduction and investment income. The income subject to the small business deduction is defined as income subject to the subsection 125(1) deduction for the purposes of the GRIP calculation and the Act. Between 2000 and 2005, the period that coincides with the one-time GRIP adjustment, Quebec did not have a small business rate. Assume that for taxation years from calendar 2000 to calendar 2005, a corporation resident in Quebec had annual taxable income of $200,000 that was entirely subject to the federal small business deduction. The corporation will not have a federal GRIP, but will it have a Quebec GRIP?

Quebec's most recent budget indicated that the province would harmonize its rules with the federal rules when they were announced. Therefore, it appears that there will be a one-time GRIP adjustment for Quebec purposes of $1.2 million ($200,000 per year × 6 years). The result does not appear logical; however, it is consistent with the information that is available to date. It is hoped that Quebec will announce its position on this issue before the end of the year.

GRIPs might also differ for federal and provincial purposes because of the differences in federal and provincial small business limits. Ontario, for example, like many provinces, has long had a small business limit of $400,000. The federal business limit is not proposed to increase to $400,000 until January 1, 2007. Will Ontario, in arriving at its GRIP, deduct the federal small business limit of, say, $300,000 or the provincial limit of $400,000? If it deducts the provincial limit, there will be different federal and provincial GRIP amounts for periods up to January 1, 2007. Unofficially, Ontario has said that it will adopt the federal small business limit to avoid this conflict. It is hoped that all provinces will state their positions in writing in order to minimize confusion before the end of the year.

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Stock Dividends and GAAR

On April 27, 2006, the CRA released *Income Tax Technical News* no. 34, a document that presented the CRA's comments in connection with many income tax issues. Among these was commentary that indicated that GAAR could be applied where stock dividends were utilized to create capital losses to offset capital gains, to create loss carrybacks that could be used in conjunction with subsection 164(6), and to avoid the kiddie tax. (On the use of stock dividends to circumvent the kiddie tax, see "Kiddie Tax: The Income-Splitting Dance," *Tax for the Owner-Manager*, April 2001.) This article will describe how stock dividends can be used to create capital losses.

The keys to using stock dividends in planning these types of transactions are twofold. Paragraph (c) of the definition of "amount" in subsection 248(1) of the Act provides that, generally, the amount of a stock dividend for income tax purposes is equal to the increase in the paid-up capital (PUC) of the corporation that arises by virtue of the payment of the dividend. In jurisdictions where the corporate law sanctions the issue of par value shares, a corporation can pay a stock dividend in the form of preferred shares that are redeemable and retractable for, say, $1,000 but that have a nominal par value. In jurisdictions where the corporate law does not contemplate par value shares, a corporation can pay a stock dividend in the form of preferred shares that are redeemable and retractable for, say, $1,000 and may, subject to certain requirements of the corporate law, state the capital of each such share to be a nominal amount. As a consequence, a taxpayer in receipt of a stock dividend with nominal PUC will be deemed to have received a dividend of only a nominal amount for income tax purposes even if the shares are redeemable for a much larger amount. The following example illustrates how, subject to the CRA's ability to successfully apply GAAR, this strategy can yield tax-planning benefits.

Assume that Mr. A, a person without a spouse or common-law partner, dies owning all of the common shares of A Co. Assume further that the tax value and PUC of the shares are both nominal. Finally, assume that the value of the shares is $1 million because A Co's only asset is $1 million of cash, and that A Co is debt-free.

Mr. A's terminal return reflects a capital gain of approximately $1 million. (The tax value of the shares to the estate is $1 million.) If it is considered advisable to utilize subsection 164(6) to create a $1 million capital loss to offset the terminal capital gain, the conventional plan will proceed along the following lines.

Assume that the estate winds up A Co within the estate's first taxation year. Pursuant to subsection 84(2), the estate is deemed to have received a dividend of approximately $1 million. Pursuant to paragraph (j) of the definition of "proceeds of disposition" in section 54, the amount of the deemed dividend is excluded from proceeds for capital gains tax purposes. Therefore, the estate will be deemed to have received proceeds of a nominal amount—$1 million of actual proceeds less the $1 million deemed dividend. Because the tax value of the shares to the estate is $1 million, the estate incurs a capital loss of $1 million. Subsection 164(6) allows such a loss to be applied against the deceased's $1 million capital gain on an amended terminal return.

An alternative approach allows the estate to generate the desired capital loss without receiving the $1 million taxable dividend. Assume that A Co pays the estate a stock dividend in the form of preferred shares that are redeemable and retractable for $1 million. The par value or stated capital of those shares, as the case may be, is nominal. The common shares are then disposed of for their now nominal value in a transaction designed to avoid the stop-loss rules. The estate incurs a $1 million capital loss because its tax value of the common shares is still $1 million.

It should be noted that the estate will realize a dividend of $1 million when the preferred shares are redeemed. The advantage of the strategy depends on whether the estate or its beneficiaries intend to continue to hold the preferred shares in A Co rather than cause them to be redeemed at an early date.

It remains to be seen whether or not a court will find this type of arrangement as offensive as the CRA does.

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Retractable Shares: Boilerplate or Oppression?

Redeemable, retractable preferred shares are a common feature of estate planning and estate freeze transactions. Most practitioners automatically accede to the CRA's view that both a redemption feature and a retraction feature are critical to establishing the value of the preferred shares. However, blind reliance on the CRA's policy often causes us to forget that shareholders (usually parents who are transferring future growth to their children) might want to cash in those shares to fund their living expenses or to disassociate themselves from the children's business decisions.

What happens when the parents want out, but the children want to keep the cash in the company? The answer ultimately depends on the reasonable expectations of the parties to the freeze transaction. Do the parents really plan to leave their accumulated capital in the business? Are the shares "never-never" capital that will remain forever in the company, or do the parents expect to actually receive the value of the business that they created and gave to their children?

In a recent Ontario case (*Itak International Corp. v. CPI Plastics Group Ltd.*, 2006 CanLII 22117), the Ontario Superior Court considered whether a refusal to honour a retraction request was a valid business decision or whether it was oppressive to the retracting shareholders. The original owners of a privately held predecessor to CPI Plastics sold their shares to a new company as part of a going-public transaction. The original shareholders wanted a combination of cash and shares of the public corporation as consideration for their shares; ultimately, they agreed on a combination of cash, common shares, and retractable preferred shares. Since the ultimate purchaser was a public corporation, the retraction feature carried restrictions. Specifically, the share conditions provided that "[i]f the Corporation is not permitted, by insolvency provisions or other provisions of applicable law, or otherwise, to redeem all the [shares tendered for retraction] . . . the Corporation shall redeem only the maximum number of First Preference Shares which the directors of the Corporation determine the Corporation is then permitted to redeem."

The original owners tendered their first preference shares for retraction. The board of directors apparently considered the impact of such a retraction on the corporation's banking covenants, financial position, and remaining shareholders. Although the relevant banking and commercial documents did not include any restrictions on retraction by reference to any financial parameters, the board of directors refused to honour the retraction demand, relying on the "or otherwise" language in the retraction conditions. The directors felt that the corporation was facing challenging financial circumstances because of the seasonal nature of its business, the rising cost of raw materials, and fluctuating exchange rates. The original owners applied to the Ontario court for an order directing the corporation to retract their shares.

The application raised two questions. First, did the corporation's failure to honour the retraction demand on the basis of the board's business judgment constitute oppressive conduct that triggered the applicable OBCA remedies? Second, assuming that the corporation was entitled to exercise its business judgment not to retract, was that judgment exercised reasonably?

With respect to the first question, the court concluded that there was no reasonable basis for the board to rely on the "or otherwise" language to import financial considerations substantially different from insolvency or other debtor-creditor law. Since the corporation was not facing financial distress, the "business judgment" rule could not justify postponing or not honouring the retraction demand.

With respect to whether any business judgment had been reasonably exercised, the court noted that there had been no offer to make a partial retraction or to set up a retraction schedule (although the corporation apparently retracted 10 percent of the shares on the eve of the court hearing). Further, the directors did not act as reasonably prudent directors in the circumstances; instead, they sought to avoid a clear contractual obligation.

The court found that the refusal to honour the retraction rights of the applicant shareholders resulted in preferential treatment of one class of shareholder (the remaining shareholders, and in particular the largest common shareholder) over another (the applicants). The largest single shareholder of the corporation thought the retraction of the applicants' shares would be oppressive to the other shareholders (including himself). That consideration missed the point of the reasonable expectations of the applicant shareholders as expressed in the share conditions.

Retraction rights are more than just indicators of share value. They are positive obligations of the corporation, and they lead to expectations on the part of the shareholders. Those obligations and expectations are enforceable and cannot be ignored. Although the case dealt with retractable shares issued by a public corporation, the reasoning should apply in most estate-planning situations involving family-owned corporations.

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Mortgage, Visa, and Cash Payments Subject to Derivative Assessment

A taxpayer may transfer property to his or her spouse, children, or relatives for no consideration, or for consideration less than fair market value. Doing so while indebted to the CRA can trigger the application of specific anti-avoidance provisions in the Income Tax Act (ITA) and the Excise Tax Act (ETA).

Subsections 160(1) of the ITA and 325(1) of the ETA both operate to make the related transferee jointly and severally liable for the outstanding tax liability of the transferor, to the extent of the value of the property transferred, if all of the following conditions are met:

1) the transferee does not deal at arm's length with the transferor (or is 18 years of age, or is the transferor's spouse);
2) the transferor has transferred property to the transferee for consideration at less than fair market value; and
3) the transferor has an unpaid tax debt for the year in which the transfer occurred, or for a prior year.

A number of issues can arise in terms of the application of these provisions, including (1) the ability of the transferee to challenge the original assessment or tax position of the transferor; (2) whether the receipt of property is a transfer of property subject to subsection 160(1); and (3) the quantum of any amounts that were paid as consideration for the transfer of the property by the transferee (and that are therefore deductible from any derivative liability assessment).

In an important decision on section 160, *Addison & Leyen Ltd.* (2006 FCA 107), the Court of Appeal held that the transferee has the right to challenge the minister's decision to assess under subsection 160(1). More recently, ***Parker*** (2006 TCC 387) highlighted the broad reach of the provision and a number of the practical obstacles faced by a taxpayer who contested a section 160 assessment.

In ***Parker***, the husband of the appellant taxpayer made several mortgage payments on a home owned by his wife; he also made payments in respect of amounts charged on her credit card, along with various cash payments to her during a period between 1996 and 2000, when he owed a substantial amount of unpaid tax. The CRA assessed the wife under section 160 of the ITA.

At the Tax Court, the issues were as follows:

1) In making the mortgage payments, the Visa payments, and the cash payments, did the husband transfer property to the appellant?
2) Did the value of the property that was transferred exceed the fair market value of the consideration given by the appellant?
3) Were the transfers made at a time when the husband had an outstanding tax liability for the year or for prior tax years?

With respect to the Visa and cash payments, the appellant argued that all amounts paid to her, or on her behalf, by her husband were amounts that he owed and that she had paid on his behalf; the payments were therefore reimbursements, not transfers of property within the meaning of the section. With respect to the mortgage payments, the appellant initially argued that they were in the nature of rent paid to her by her husband; at trial, she amended her notice of appeal to allege instead that her husband was a beneficial part owner of the home in order to justify the husband's payments on the mortgage, notwithstanding that she was the sole registered owner of the property.

The Tax Court rejected the wife's appeal on all points, finding discrepancies in the evidence provided by her and her husband. The court pointed to a general lack of documentary evidence for the years in question and to inconsistencies in the oral evidence. The court found that the mortgage payments, Visa payments, and cash payments were property that the husband had transferred to the appellant for no consideration during a time when the husband was a tax debtor, and it upheld the section 160 assessment.

The *Parker* case illustrates how the related-party transfer rules in the ITA (and the ETA) can operate in the context of run-of-the-mill family transactions. In many households, one member may habitually pay the debts of another—for example, a spouse may pay the other spouse's credit card account, or a parent may pay a child's cellphone bills. If the person who makes the payments owes unpaid taxes, the rules can result in the transferee becoming liable for tax on the payments.

The case also illustrates the problems that taxpayers will face in the Tax Court when they have a weak or poorly prepared case, and it demonstrates the importance of maintaining adequate documentation. While many taxpayers keep most of their tax-related records, if the case involves a derivative assessment, non-tax records may turn out to be essential. These include records of transfer payments between family members, evidence of true household expenses, and the like. Depending on the circumstances, it may be necessary to retain those records for a longer period than is statutorily required by the ITA or the ETA. Failure to produce such records may, as this case demonstrates, prove fatal on an appeal.

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Interest Deductibility in Exceptional Circumstances

The Tax Court's decision in *Lipson* (2006 TCC 148) raises again the scope of the interest deductibility provision in paragraph 20(1)(c) of the Act. Generally, that paragraph permits the deduction of interest provided that, among other things, a direct link is established between the borrowed money or the unpaid purchase price and an income-producing use.

Although the direct use test in paragraph 20(1)(c) will usually be satisfied in an acquisition of assets or shares, the question of interest deductibility often arises where interest is paid or payable on borrowed money or a note payable used to redeem or repurchase shares, pay dividends, or return capital. In such circumstances, the direct use of the borrowed money or note payable is less clear.

In *Trans-Prairie Pipelines Ltd.* (70 DTC 6351 (Ex. Ct.)), the taxpayer borrowed money to redeem preferred shares. Prior to this redemption, the taxpayer's capital used in its business consisted in part of an amount received on the subscription for its preferred shares. On this basis, the court concluded that interest was deductible because the borrowed money replaced capital that was used for the purpose of earning income from a business.

The *Trans-Prairie* principle has not been restricted to a corporate setting but has been applied where partnership capital was returned. In *Singleton* ([2001] 2 SCR 1046), the taxpayer, a partner in a law firm, withdrew money from his capital account to purchase a home for personal use. On the same day, he borrowed approximately the same amount from a bank and contributed the funds to his partnership capital account. The minister claimed that the taxpayer borrowed the money for the purpose of purchasing the home. The Supreme Court, however, accepted the form of the transaction and allowed a deduction for interest because the direct use of the borrowed money was to refinance the taxpayer's capital account for use in the business of the partnership.

Although a deduction for interest was allowed in the foregoing decisions, other cases indicate that the deduction may be denied in other circumstances.

In *The Chase Manhattan Bank of Canada* (2000 DTC 6018 (FCA); leave to appeal to the Supreme Court refused), the taxpayer obtained an interest-bearing loan from its parent and used the proceeds to pay a cash dividend to the parent in an amount that exceeded its retained earnings. The court held that except for the portion calculated by reference to the taxpayer's retained earnings, interest was not deductible because the borrowed money was not a replacement of capital used in the business for the purpose of earning income. With respect to the excess, there was no link between the borrowed money and an income-producing use.

A deduction for interest also will not be available when a promissory note is issued by the taxpayer to pay a dividend. In *Parthenon Investments Ltd.* (97 DTC 5342 (FCA)), the corporate taxpayer paid a dividend to its parent corporation by delivering an interest-bearing promissory note. The court held that interest on the promissory note issued by the taxpayer was not deductible because the promissory note was not borrowed money and property had not been acquired by the taxpayer. (Compare *Penn Ventilator*, 2002 DTC 1498 (TCC), noted below.) In *T.E. McCool Limited* (49 DTC 700 (SCC)), a shareholder sold certain assets to his company. As part of the consideration for the assets, the company issued a promissory note to him. The Supreme

Court concluded that a deduction for interest was not available to the taxpayer because the promissory note was not borrowed money within the meaning of the predecessor of subparagraph 20(1)(c)(i). The case would likely be decided differently today because of the addition of what is now subparagraph 20(1)(c)(ii).

In *Penn Ventilator*, a deduction for interest was allowed where the taxpayer issued an interest-bearing promissory note to its shareholders to redeem their common shares because (1) the promissory note effectively replaced the paid-up capital and the retained earnings used in the business, and (2) property (the redeemed shares) was acquired by the taxpayer.

The CRA generally agrees with the principles discussed above. In *Interpretation Bulletin* IT-533, the CRA recognizes that interest is deductible where borrowed money replaces contributed capital or accumulated profits used to "fill the hole" left by redeeming shares, returning capital, or paying dividends and where a promissory note is issued by the taxpayer to redeem shares, provided that such capital was used for an income-earning purpose.

In *Lipson*, the taxpayer and his wife entered into a series of transactions that relied on the spousal rollover and attribution rules in the Act to obtain an interest deduction in respect of money borrowed in connection with the purchase of a home. The taxpayer's wife borrowed money from a bank to purchase certain shares in the family corporation owned by her husband. The next day, the taxpayer and his wife borrowed the same amount of money, secured by a mortgage on their house, from the bank and used the money to repay the wife's bank loan. The taxpayer, by virtue of attribution, in effect claimed a deduction for the interest expense on the basis that the mortgage proceeds refinanced the bank loan, which was used to purchase the shares (an income-earning purpose). The court held that GAAR applied, and as a result interest was not deductible because the taxpayer misused, among other provisions, paragraph 20(1)(c) to obtain a deduction for interest on money borrowed effectively used for an ineligible purpose. In applying GAAR, the court found that there were no redeeming commercial or estate-planning considerations in the circumstances.

Accordingly, even where commercial, estate-planning, or other considerations exist, considerable care must be exercised in structuring a transaction to maximize the deduction of interest expense. The decision in *Lipson* has been appealed, and it will be interesting to see what gloss, if any, the Court of Appeal puts on the issue of interest deductibility in cases such as this one.

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Fees for Shareholders' Agreement Deductible

Two recent Tax Court cases heard together under the informal procedure, *Truckbase Corporation v. The Queen* and *Tom Grabowski v. The Queen* (2006 TCC 215), dealt with the deductibility of legal and accounting fees for services relating to shareholders' agreements and other matters.

With respect to the corporate appellant (Truckbase), a member of the Silvacom Group, the issue was whether a portion of professional fees paid by the appellant was deductible in the 2001 taxation year, and whether another portion could be treated as an eligible capital expenditure. With respect to the individual appellant (Grabowski), one of the principals of the Silvacom Group, the issue was whether certain of the legal and accounting fees paid by the companies in the Silvacom Group were properly included in his income as shareholder benefits in the 2000 and 2001 taxation years.

The fees incurred by the Silvacom Group for the 2000 and 2001 taxation years, a portion of which was allocated to Truckbase, were for a variety of services, including work of a general nature, a comprehensive review of pre-existing unanimous shareholders' agreements (USAs), the redrafting of all of the USAs, the implementing of an estate freeze of Truckbase, and the creation of family trusts for Grabowski and his partner. It appears that the fees that were the subject matter of the appeals related to the business reorganization (presumably, the estate freeze) and the work related to USAs for Truckbase.

The appellants' position was that the corporate reorganization was a necessary business expense and not a personal shareholder benefit, and that the legal fees related to the family trust were a shareholder benefit of the trust, not of Grabowski. Citing *Duha Printers (Western) Ltd.* ([1998] 1 SCR 795), where Iacobucci J commented on the important role of USAs in the management of corporations, the appellants argued that the costs incurred for the USAs were currently deductible under subsection 9(1) of the Act, and therefore did not constitute shareholder benefits under subsection 15(1). The appellants argued that the existing USAs were flawed, and that the costs of drafting new USAs were deductible as current expenses in the same way that costs of ongoing roof repairs and maintenance were deductible. They also relied on *BJ Services Co. Canada* (2003 TCC 700), in which professional fees incurred to respond to a hostile takeover bid were held to be deductible.

The Crown argued, among other things, that the purpose of the USAs was to preserve the business structure, and that the fees relating thereto were not deductible by virtue of paragraph 18(1)(b). The Crown also took the position that Truckbase could not deduct or treat as eligible capital expenditures any fees that were held to be a shareholder benefit to Grabowski.

McArthur J allowed both appeals. He concluded that the original USAs were poorly drafted, deficient, and inconsistent; that the new USAs made the company more productive; and that the USAs were for the purpose of a bona fide business reorganization that facilitated effective management, good governance, and protection for the Silvacom Group against any disruption due to the disability of key employee-shareholders. Therefore, McArthur J, apparently relying in part on the *BJ Services* case, held that the fees related thereto were currently deductible and were not personal or living expenses of Grabowski pursuant to paragraph 18(1)(h) or a shareholder benefit to him.

McArthur J also rejected the Crown's position that the expenses were on account of capital and were not deductible under paragraph 18(1)(b). He concluded that the original USAs were not functioning properly and that the fees paid in respect of the USAs so that they met their initial goals were current expenses deductible under subsection 9(1).

While some aspects of the judgment are unclear, the case, though lacking precedential value, provides support for the view that professional fees relating to preparing or amending a shareholders' agreement are a deductible expense to the corporation and not a taxable benefit conferred on the shareholders.

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Purchased Losses Denied: No Genuine Commercial Animus

In *Backman* ([2001] 1 SCR 367) and *Spire Freezers* ([2002] 1 SCR 391), the Supreme Court held that a taxpayer claiming a share of the losses of an existing partnership must show that the interest was acquired with the intention of carrying on the business of the partnership with a view to profit. Absent such an intention, the arrangement between the participants will not meet the legal test for establishing a partnership, and the underlying losses will not be available. The Supreme Court said that the intention to carry on the business of the partnership for profit may be ancillary to the intention to access the losses, but the intention must be a real, not an imaginary, one.

Makuz (2006 TCC 263) is the latest in a line of cases in which Canadian residents sought to deduct losses initially incurred in a US partnership. It follows the earlier cases in denying the losses to the new participants and in this respect is unremarkable. However, Bowman CJ made obiter remarks that could, if applied in other circumstances, have far-reaching consequences. Viewed in this light, the decision is of special interest to tax planners.

In *Makuz*, Claridge Associates (CA) and Claridge Holdings no. 1 (CH 1) were general partnerships formed under Texas law. CA had a fiscal period ending December 31, 1987, and it sustained a loss in that period. CH 1 had a fiscal period ending March 31, 1998, and it acquired an interest in CA on December 31, 1987. On March 28, 1998, the taxpayer and others acquired interests in CH 1 and claimed the share of CH 1's losses (which were CA's losses) equal to their proportionate interests in CH 1.

After tracing a series of complex transactions, Bowman CJ concluded that for a total outlay of approximately US $3.73 million the taxpayers attempted to access losses of approximately US $43 million and a 5.4 percent contingent interest in unsold condominiums having an estimated value of US $1.24 million. In response to the taxpayers' testimony that they invested in CH 1 primarily to profit from a real estate investment, Bowman CJ said that the potential writeoff of the losses was the real reason for the investment and was, like the "proverbial elephant in the living room," something that no one wanted to talk about or acknowledge. Given that the project was so commercially questionable, he had no difficulty in concluding that the real purpose of the investment was to gain access to the losses and not to earn income from the sale of the condominiums.

Bowman CJ held that the losses were unavailable to the taxpayers on the basis of the decisions in *Witkin* (2002 FCA 174) and *Backman*. *Witkin* involved the same partnerships that were considered in *Makuz*. There the FCA held that the taxpayer was not carrying on business with a view to profit in respect of his participation in CH 1 and was therefore not a member of a partnership. In *Backman*, the Canadian taxpayers acquired interests in the US partnership directly from the US partners. Because the purported partnership held only minimal assets after the taxpayers acquired their interests, the Supreme Court found that the taxpayers did not have the necessary "view to profit" when they acquired their interests.

Bowman CJ said that the courts in *Witkin* and *Backman* denied the losses because the taxpayers invested in a partnership with a loss through the vehicle of another structure that had the appearance of possessing the legal attributes of a partnership, but that lacked the essential ingredient of carrying on business in common with a view to profit. That rationale focuses on the CH characterization of the vehicle that did the investing (CH 1) rather than on the status of the underlying entity (CA). While this may be an accurate portrayal of the facts and the rationale in *Witkin*, this characterization of *Backman* is somewhat puzzling. In *Backman*, the would-be Canadian partners acquired their interests directly in the US partnership, not in an intermediary entity.

Apart from the *Witkin* and *Backman* decisions, Bowman CJ said, he would have approached the issue somewhat differently by asking, "Did the investment have any 'genuine commercial animus' apart from utilizing losses?" If it had none, he would have dismissed the appeal regardless of the vehicle used to make the investment. He also said that one cannot access losses that one has "purchased" in a transaction that has no "credible genuine commercial motivation" other than the utilization of losses that accrued when the partnership was composed of different persons. These comments are interesting because they are broadly framed and strongly suggestive of a business-purpose test for the tax validity of transactions, an approach that has been consistently rejected by the Canadian courts.

Bowman CJ queried what the result would have been if the taxpayers had invested directly in CA instead of through CH 1. Presumably, if the partners had invested directly in CA, the analysis in *Backman* and *Spire Freezers* would apply. That is, at the time that the taxpayers purportedly entered the partnership, were they carrying on business in common with a view to profit? Bowman CJ would have taken a different approach: he said that he would have denied the losses on the basis that there is no provision of the Income Tax Act that permits one to claim a loss when one's only purpose in investing is, as a matter of commercial reality, to use someone else's loss.

One might argue that Bowman CJ is really saying nothing different here from what the Supreme Court said in *Backman*. It is difficult to imagine a scenario in which a taxpayer could enter a partnership without a genuine commercial motivation and still be said to be carrying on a business with a view to profit. Therefore, in the partnership context, Bowman CJ's comments in *Makuz* relating to a "genuine commercial motivation" appear simply to reaffirm the "view to profit" component of the partnership test.

However, his comments on a "credible genuine commercial motivation" and a "genuine commercial animus" were made in the context of what he said was an approach to denying the losses that was different from the approach taken in *Backman*. If his comments stand for the proposition that a genuine commercial animus is a precondition for tax-effectiveness generally, then they are indeed remarkable. The Supreme Court has made it clear that aside from the GAAR context there is no room for a general business-purpose test in Canada. Although Bowman CJ's remarks were clearly obiter, they are nonetheless likely to prove controversial.

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Supporting SR & ED Claims

When should a taxpayer decide not to file an SR & ED claim because of a lack of "appropriate" supporting evidence? There is no doubt that a well-supported claim will facilitate the process for the CRA to review the work done and assess the reasonableness of the expenditures claimed. The taxpayer should be aware of the need for supporting documentation and other evidence, the various forms that the evidence may take, and how to make the best of what already exists.

It may sometimes seem that the burden of producing documentation to support SR & ED claims outweighs the benefits of claiming the SR & ED credit. The CRA prefers that taxpayers support their claims with documentation and other evidence that exists as part of the normal business process. Ideally, no additional documentation should have to be created—except, of course, for the technical project description that is filed as part of the SR & ED claim. When additional documentation is required, it can generally be traced to an operational need.

The Income Tax Act does not explicitly state that documentation is required to support SR & ED claims. However, the definition of "scientific research and experimental development" sets an expectation for evidence by requiring the taxpayer to carry out a "systematic investigation." Various court cases have commented on documentation and other evidence in resolving SR & ED eligibility issues.

In *116736 Canada Inc.* (98 DTC 1816 (TCC)), the minister had disallowed the taxpayer's SR & ED claims on the basis that the taxpayer had not provided any evidence that SR & ED work was ever performed. Because of a fire that took place on the taxpayer's premises, the taxpayer was unable to provide evidence to satisfy the minister of the work performed. The Tax Court allowed the claim on the basis of verbal evidence provided in court. In ruling that the work performed was SR & ED, Archambault J said that "the Act and the Regulations do not require that such written reports be produced in order for a taxpayer to qualify for the deduction of such expenditures: it is possible to adduce evidence by way of oral testimony. Whether the Minister or a judge could conclude that the activities purported to have been carried out by the taxpayer were actually carried out then becomes a question of credibility."

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.
Published quarterly

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ISSN 1496-0427

Archambault J went on to say that he did not reach his conclusion without hesitation and that he was surprised that the taxpayer could not produce the prototypes built during the audit. In ruling for the taxpayer, he stated that he believed the oral testimony of the taxpayer for a number of reasons: he was an inventor; the work involved in the projects resulted in the creation of new technologies being commercially marketed; and his testimony and the detailed reports written after the fact to describe the work were credible.

In *RIS Christie Ltd.* (99 DTC 5087 (FCA)), Robertson J said the following:

> Although both documentary and viva voce evidence are admissible, the only sure-fire way of establishing that scientific research was undertaken in a systematic fashion is to adduce documentary evidence which reveals the logical progression between each test and preceding or subsequent tests. . . . However, in my view, it should also be permissible to infer that a taxpayer had conducted systematic research where it is established that such research led to a technological advancement.

The CRA should and does require taxpayers to support their claims. Although some latitude is generally provided in certain circumstances on the quality of the evidence, a minimum of evidence is not an unreasonable request. The CRA's "Guide to Supporting Technical Aspects of a Scientific Research and Experimental Development (SR & ED) Claim" provides that contemporaneous dated technical documentation should be used to support a claim and substantiate the work done. Such documentation includes project plans and objectives, descriptions of problems, resource allocation records, meeting minutes, e-mails, notebooks, trial records, drawings, photos, patent applications, contract work statements, and other documents outlining information pertinent to the eligibility of the work. In reality, such documents are generally produced by organizations in the normal course of carrying on specific projects, and therefore the documentation requirement should not be a burden to the taxpayer. A best practice is to set aside key evidence as the work is carried out, which requires very little additional time. This is much easier than having to go back and dig up information many months after the work was conducted. The taxpayer should determine what work will be eligible at the planning stage of the project and make the archiving of SR & ED evidence part of the project management process.

In "Allocation of Labour Expenditures for SR & ED," the CRA states that "documentation of the labour effort and the related financial information is required to support the reasonableness of the expenditures included in a claim." The CRA recognizes that support for the labour allocation methodology will be affected by the business environment in which the SR & ED is carried out. Support can come from various "levels" of information. The CRA again suggests examples of documentation, including development plans, timesheets, supervisors' summaries, and documentation of a more technical nature such as contracts, project specifications and objectives, resource allocation records and budgets, e-mails, meeting minutes, personal notebooks, progress and final project reports, and organizational charts. Ultimately, the documentation supporting the labour allocations should demonstrate that the allocations are appropriate for the company's environment, are consistent with the legislation and the CRA's administrative practices, and are functional throughout the year.

It is important to note that while timesheets are typically an effective way of documenting labour, other types of documentation such as those mentioned above can be used to support labour expenditures. The key is that the documentation must provide the CRA with "a reasonable level of assurance that there is minimal risk of material error in the labour expenditure being allocated to an SR & ED project."

Adequate support for SR & ED claims can significantly reduce the time required to defend the claim. The existence of a methodical process of identifying and supporting the claims is an important element considered by the CRA when deciding whether to review a taxpayer's future claims or to assess without review. Taxpayers should keep in mind that the evidence available to support a claim will vary from project to project and may not necessarily be in the form recommended by the CRA. If you have supporting evidence that substantiates the work done, even if the evidence is not ideal, you should not hesitate to make a claim.

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