TAX FOR THE Owner-Manager

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## Contributed Surplus ACB Trap

Consider the following typical fact scenario: Mr. X owns 50 percent of all of the issued common shares of Opco. The ACB of his shares is nil and the FMV is $1 million. He transfers his shares of Opco to Holdco on a rollover basis. No contributed surplus is booked on the financial statements of Holdco on the transfer. Several years later, Holdco wishes to sell its Opco common shares for $10 million. There is safe income on hand (SIOH) of approximately $5 million on Holdco's common shares in Opco.

Depending on the method of crystallizing the SIOH just prior to the sale, the income tax consequences to Holdco can be unexpectedly different.

■ **Option 1:** Reorganize Holdco's common shares into preferred shares and pay cash dividends up to the amount of the SIOH on the preferred shares.

■ **Option 2:** Have Opco purchase for cancellation its common shares held by Holdco for cash and/or a note.

■ **Option 3:** Increase the PUC of all common shares of Opco up to the amount of the SIOH in multiple increments.

■ **Tax impact 1:** The FMV of the Opco common shares is decreased to $5 million because of the safe income dividend. Holdco realizes a capital gain of $5 million on the sale.

■ **Tax impact 2:** Holdco files a paragraph 55(5)(f) designation (or designations) to treat $5 million of the $10 million purchase for cancellation as a safe income dividend. Holdco realizes a capital gain of $5 million on the sale.

■ **Tax impact 3:** Prior to the November 9, 2006 technical amendments, the PUC increase of $5 million on Holdco's common shares would have been deemed to be a dividend pursuant to subsection 84(1), and there would have been a concomitant increase in the ACB of the common shares to $5 million pursuant to old paragraph 53(1)(b). This transaction would not have resulted in any corporate-level tax because the deemed dividend would be subject to the subsection 112(1) deduction. Holdco would have realized a $5 million capital gain on the sale. However, because of amended paragraph 53(1)(b), the dividends received after November 8, 2006 will grind the ACB of the common shares to $4 million ($5 million PUC increase less the $1 million PUC increase that arose because of contributed surplus). This is because a portion of the deemed dividend may be said to have arisen (indirectly) as a consequence of a conversion of contributed surplus into PUC. In option 3, $1 million of the $5 million subsection 84(1) deemed dividend is indirectly attributable to the conversion of the contributed surplus of $1 million into PUC. The contributed surplus in question arose on the transfer of the Opco shares into Holdco without the incurring of corporate-level tax. Accordingly, Holdco will realize a capital gain of $6 million on the sale even though the SIOH of the common shares in question is $5 million.

## Definition of "Contributed Surplus" Needed

On the basis of a reading of the technical notes accompanying the November 9, 2006 amendments and discussions with Finance, contributed surplus represents an untaxed economic gain on the shares. It is irrelevant for the purposes of the Act whether or not such contributed surplus is booked on the financial statements of Holdco. Finance is concerned that transactions designed to circumvent subsection 55(2) can have the effect of converting contributed surplus into a tax-free dividend that completely avoids corporate-level taxation. It is unclear, however, why a safe income crystallization would be considered offensive to subsection 55(2) and the Act as a whole. In option 3, why should $1 million of the increase in ACB of the common

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shares be denied if it represents SIOH relating to those shares?

In my view, Finance should issue a clarifying amendment to define precisely what is meant by "contributed surplus" for the purpose of amended paragraph 53(1)(b) instead of relying solely on the technical notes for that express purpose. Further, the definition of "contributed surplus" should explicitly exclude any amount that corresponds to SIOH of a particular share in view of the fact that such an amount represents previously realized gains of the corporation that have been taxed.

## Possible Solution or Trap?

One means of circumventing the application of paragraph 53(1)(b) is to reorganize Holdco's common shares of Opco into two classes of shares. The first class of preferred shares traps the contributed surplus of $1 million into a fixed redemption amount of $1 million. The second class of shares can be either common shares or another class of preferred shares with an FMV of $9 million. Either of the alternatives presented in option 1 and option 2 above can be implemented on the "contributed surplus" shares. This strategy will not offend amended paragraph 53(1)(b) because there is no subsection 84(1) deemed dividend subject to the subsection 112(1) deduction. Presumably, the payment of the dividends in option 1 or the redemption of shares in option 2 would also be entirely out of safe income and not attract subsection 55(2).

A PUC increase could then be done on the second class of shares, which are not tainted with the offensive contributed surplus. Technically, the ACB limitation of amended paragraph 53(1)(b) should not apply on the second class of shares because no portion of the deemed dividend results from the conversion of contributed surplus inherent in the original common shares. Query whether GAAR would apply to such a transaction. In informal discussions, Finance was of the opinion that such a transaction would be caught by amended paragraph 53(1)(b) because of the phrase "that arose directly or indirectly." It is hoped that Finance will issue a clarifying amendment in this regard.

## CDA Surprise

A related and unexpected provision of the November 9, 2006 ACB technical amendments is revised subsection 89(1), the definition of "capital dividend account" (CDA). The untaxed portion of the capital gain arising because of amended paragraphs 52(3)(a) and 53(1)(b) is not credited to the CDA. What this means is that the capital gain is only 50 percent taxable; however, the shareholders of a CCPC cannot access the untaxed portion of the capital gain as a capital dividend. The policy reason for denying access to the CDA for the untaxed portion of a capital gain, regardless of how it arises, is unclear.

The Joint Committee on Taxation made a submission to Finance in March of this year regarding the tax community's concerns about proposed paragraphs 52(3)(a) and 53(1)(b). It is hoped that Finance will address the major concerns, particularly the overriding effect of the proposed amendments on subsection 55(2) and the concept of SIOH.

*Manu Kakkar*
Kakkar and Associates Limited
London, Ontario

# Ceasing To Be a CCPC: Impact on QSBC Status

The amendments to the Income Tax Act implementing the new system of dividend taxation, including new subsection 249(3.1), are now law (SC 2007, c. 2). In general terms, subsection 249(3.1) provides that if a corporation becomes or ceases to be a CCPC (otherwise than because of an acquisition of control), the corporation's taxation year is deemed to end immediately before the time at which it ceases to be a CCPC, and a new taxation year is deemed to begin at that time.

In a technical interpretation dated April 20, 2007 (document no. 2006-0214691E5), the CRA was asked whether, in the hypothetical situation described below, the operation of subsection 249(3.1) would cause shares not to be qualified small business corporation (QSBC) shares, as defined in subsection 110.6(1), at the time of their sale. The CRA was specifically asked whether subsection 249(3.1) would override the application of paragraph 110.6(14)(b).

Paragraph 110.6(14)(b) provides that in determining whether a corporation is a small business corporation or a CCPC for the purposes of the definition of QSBC shares, a right referred to in subsection 251(5) does not include a right under a purchase and sale agreement relating to a share of a corporation.

In the example given in the technical interpretation, the shareholders of a CCPC entered into a share purchase agreement with a public corporation under which the public corporation would acquire all of the CCPC's shares at the end of the year. As a consequence, the CCPC would cease to be a CCPC on the date the share purchase agreement was made, by virtue of the operation of subparagraph 251(5)(b)(i).

Subparagraph 251(5)(b)(i) provides that for the purposes of subsection 251(2) and the definition of "Canadian-controlled private corporation" in subsection

125(7), where a person has a right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently to, or to acquire, shares of a corporation, then (with certain exceptions that are not relevant here) that person is deemed to have the same position in relation to control of the corporation as if the person owned the shares of that corporation.

The CRA concluded that, assuming that all of the other requirements of subsection 110.6(2.1) are met, the capital gains deduction can still be claimed in respect of the sale of the CCPC's shares, notwithstanding that the corporation has ceased to be a CCPC because of the operation of the share purchase agreement. In the CRA's view, even though the taxation year of the corporation may be deemed to have ended by virtue of subsection 249(3.1), the shares of the corporation are not precluded from being considered to be QSBC shares at the time of sale solely because the public corporation acquired rights to acquire the shares under the agreement. The CRA was of the view that the operation of paragraph 110.6(14)(b) was not affected by subsection 249(3.1).

In my view, the CRA's position is correct. The technical interpretation illustrates the possibility of the deeming rule in subsection 249(3.1) having unintended or adverse tax consequences. Accordingly, tax advisers need to review the implications of a corporation becoming or ceasing to be a CCPC before proceeding with the actions that will cause the acquisition or the loss of CCPC status.

*Philip Friedlan*
Friedlan Law, Toronto

## Electing Out of CCPC Status in Share Sale Planning

Subsection 89(11) provides the opportunity for a corporation that would otherwise be a CCPC for a particular taxation year to make an election to cease to be a CCPC from the commencement of that year for certain purposes, including for the purposes of the eligible dividend rules and the small business deduction (SBD). Making the non-CCPC election does not affect the status of the corporation for the purposes of the refundable investment income tax rules or the lifetime enhanced capital gains deduction (CGD) on the disposition of a qualified small business corporation share.

Upon ceasing to be a CCPC, the corporation is required to compute an amount under subsection 89(8) to add to its opening low-rate income pool (LRIP) balance. The amount added under subsection 89(8) is intended to reflect what the corporation's LRIP balance would have been at the end of the immediately preceding taxation year if the corporation had not been a CCPC at that time, as determined by reference to the corporation's tax balance sheet. In very general terms, the subsection 89(8) addition is equal to the amount by which the aggregate of the cost amount of all of the corporation's property, money, and unused and unexpired losses exceeds the aggregate of the corporation's debts, paid-up capital, reserves, capital dividend account, and general-rate income pool (GRIP) balance, at the end of the immediately preceding taxation year.

When a corporation ceases to be a CCPC, it generally will not pay an eligible dividend unless its LRIP balance is nil to avoid making an excessive eligible dividend designation (EEDD) resulting in tax under part III.1; however, the corporation can reduce its LRIP balance to nil by paying "regular" non-eligible dividends. Subject to applicable corporate solvency requirements, once the corporation's LRIP balance is nil, it can pay an unlimited amount of eligible dividends without making an EEDD. (This is so unless the anti-avoidance provision in paragraph (c) of the EEDD definition in subsection 89(1) applies, in which case the eligible dividend will result in an EEDD and trigger a punitive 30 percent tax under part III.1.) If the corporation does not make the non-CCPC election, it will be able to pay an eligible dividend amount only to the extent of the positive balance of its GRIP (subject to the anti-avoidance provision) before triggering an EEDD. As a result of this difference in capacity to pay an eligible dividend without making an EEDD, making the non-CCPC election may produce attractive tax savings in certain circumstances.

For instance, making the non-CCPC election may produce overall tax savings for an owner-manager selling his or her shares of a CCPC if the corporation has a low GRIP balance, and would have, if the non-CCPC election were made, a low LRIP balance, relative to the FMV of the shares of the corporation. A difference between GRIP or LRIP and the FMV of the shares of the corporation may occur where internally generated corporate goodwill exists or other corporate assets have untaxed appreciation. If the owner-manager is selling shares of a corporation with the above tax attributes, making the non-CCPC election could produce overall tax savings if he or she is subject to a higher applicable tax rate on capital gains than on eligible dividends (for example, in Alberta, the highest aggregate federal and provincial individual tax rate in 2007 for capital gains is 19.5 percent, versus 17.45 percent [decreasing to 14.56 percent by 2009 and thereafter] for eligible dividends).

Consider the following example:

- An individual resident in Alberta (Owner) and a corporation (Holdco) (all of the shares of which are owned by Owner) own all of the shares of a CCPC (Opco).
- Owner and Holdco own different classes of common shares of Opco.
- All of the shares of Opco have a nominal adjusted cost base.
- Opco has a low GRIP balance, and if it makes the non-CCPC election, it will have a low LRIP balance, relative to the FMV of the shares of Opco.

Assume that a sale of all of the Opco shares is carried out as follows:

1) Opco pays to Holdco, to the extent that Opco has safe income on hand attributable to Holdco's Opco shares, safe income eligible dividends (reducing Opco's GRIP balance to nil) and thereafter safe income non-eligible dividends.
2) Holdco and Owner sell their shares of Opco.

Now assume that Opco makes the non-CCPC election and the sale of all of the Opco shares is carried out as follows:

1) Opco pays to Holdco, to the extent that Opco has safe income on hand attributable to Holdco's Opco shares, safe income non-eligible dividends (reducing Opco's LRIP balance to nil) and thereafter safe income eligible dividends.
2) Opco pays eligible dividends to Owner equal to the remaining FMV of Opco.
3) Holdco and Owner sell their shares of Opco.

In certain circumstances, making the non-CCPC election will be preferable for owner-managers selling shares of their corporations because of the resultant substitution of capital gains income for lower-rate eligible dividend income. Being mindful of the anti-avoidance provision in all cases, structuring variations can produce the lower-rate eligible dividend tax savings while also availing or improving CGD or SBD utilization.

In view of the potential for overall tax savings, we anticipate that there will be increased use of the non-CCPC election in planning for sales of shares and in other circumstances.

*Jason M. Stephan*
Felesky Flynn LLP, Calgary

## CCPC Status: Effect of Agreement To Vote Shares

In *Sedona Networks* (2007 FCA 169), the Federal Court of Appeal considered the definition of "Canadian-controlled private corporation" in subsection 125(7) of the Income Tax Act. The court held that the taxpayer, Sedona, was not a CCPC even though the voting rights of its shares held by a subsidiary of a public corporation were exercised under contract by a Canadian private corporation. The decision is of interest for what it says about the interaction of paragraph 125(7)(b) and the deemed control provisions in paragraph 251(5)(b).

In *Sedona*, the taxpayer was a high-tech company seeking to claim a refundable tax credit for scientific research and experimental development expenditures. Sedona would be entitled to the tax credit only if it was a CCPC throughout the relevant year.

A CCPC is a corporation that is not controlled by a disqualifying shareholder, such as a public corporation, a non-resident, or a combination of them. Of importance to this case is paragraph (b) of the definition of a CCPC, which attributes ownership of shares owned by public corporations and non-residents to a fictional "particular person." Where, as a result of such an attribution, the particular person controls the corporation at any time in the year, the corporation is not a CCPC. Paragraph (b) of the CCPC definition was included in the Act in 1998, applicable to taxation years after 1995, to address the situation in which a company could be a CCPC if the majority of its shareholders were non-residents, or public corporations, that did not have either a common link or a connection (see *Silicon Graphics Limited v. The Queen*, 2002 DTC 7112 (FCA)).

The court's decision in *Sedona* turned on the sole issue of whether the 438,597 class B preferred shares of Sedona owned by the Bank of Montreal Capital Corporation (BMCC), a wholly owned subsidiary of the Bank of Montreal (BMO), were to be attributed to the fictional "particular person" described in paragraph (b) of the definition of a CCPC. If so, in the court's analysis, then Sedona was not a CCPC throughout 1999. The voting rights attached to BMCC's shares in Sedona were contractually held by a Canadian-resident private corporation, Venture West Management TIP Inc. (Venture). Throughout Sedona's 1999 taxation year, BMCC's shares in Sedona were subject to a management agreement between BMCC and Venture that gave Venture the right to exercise, at its sole discretion, the voting rights with respect to BMCC's shares in Sedona, as well as the right to acquire those shares if BMCC terminated the agreement without proper cause.

The court looked through BMCC to BMO to determine that the public corporation controlled the Sedona shares despite the arrangement between BMCC and Venture. The court was not convinced that the management agreement affected the "control" of BMCC's shares in Sedona for the purposes of determining its status as a CCPC. The court held that this determination required de jure control and that the management agreement did not constitute de jure control because it did not divest BMCC of its voting rights. Relying on Iacobucci J's reasons in *Duha Printers (Western) Ltd. v. Canada* ([1998] 1 SCR 795), the court held that for BMCC's voting rights in the shares of Sedona to have been divested to Venture, they would have to have been restricted either by Sedona's constating documents or by a unanimous shareholders' agreement. The court did not find that the management agreement passed for a unanimous shareholders' agreement because BMO was not a party to it and it did not restrict the powers of BMCC's board of directors.

Unfortunately, the court gave no attention to the possible application of subparagraph 251(5)(b)(i) in its analysis of the management agreement's effect on Sedona's CCPC status. That relevant portion of subparagraph 251(5)(b)(i) reads as follows:

> For the purposes of subsection (2) and the definition "Canadian-controlled private corporation" in subsection 125(7), . . . (b) where at any time a person has a right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently, . . . (i) to, or to acquire, shares of the capital stock of a corporation or to control the voting rights of such shares, the person shall . . . be deemed to have the same position in relation to the control of the corporation as if the person owned the shares at that time.

The management agreement is a "right under a contract" that "control[s] the voting rights" of BMCC's shares in Sedona. The term "control" in subparagraph 251(5)(b)(i) should not be interpreted in the same way as the term is found in subsection 125(7), because in the former provision "control" can acquired be by "a right under a contract, in equity or otherwise." It follows that the term "control" in subparagraph 251(5)(b)(i) is something that is acquired by less exclusive means than constating documents or a unanimous shareholders' agreement. As a result, the "particular person" in paragraph (b) of the definition of a CCPC may own the majority of the shares in Sedona but, in light of subparagraph 251(5)(b)(i), may not control all of those shares by virtue of the management agreement.

The question whether the deeming rule in paragraph 251(5)(b) was applicable to deem Venture the owner of the BMCC shares was considered, and expressly rejected, by the Tax Court (2006 TCC 80). The court held that the focus of paragraph 251(5)(b) is control of a corporation, not the ownership of shares per se. The trial judge concluded that BMCC remained the owner of the shares notwithstanding that the management agreement gave Venture the voting rights. The Court of Appeal did not find it necessary to deal with this question. As noted above, that court confined its analysis to the question whether the management agreement gave Venture de jure control of Sedona and concluded that it did not.

In the result, it seems that when the issue is CCPC status, the registered owner of shares will be regarded as the owner notwithstanding a voting agreement with a third party. If the registered owner is a non-resident person or a public company, that fact will be relevant in determining the degree of ownership by the fictional "particular person" described in paragraph 125(7)(b). At first glance, this might seem to open the door to structuring a non-resident's involvement in a Canadian corporation to give it the right to vote (but not own) voting shares registered in the name of a resident person. However, in such a case, CCPC status might be lost under paragraph 125(7)(a) if the effect of the arrangement was to give the non-resident de facto control of the Canadian corporation.

*Steven McLeod*
Thorsteinssons LLP, Toronto

## Dividend Refund: A Matter of Interest

When does interest start to run on a taxpayer's claim for a dividend refund? Subsection 129(2.1) seems to provide the answer, although the drafting of the provision is less than elegant. There is, however, an apparent conflict between the wording of the subsection and the Department of Finance's technical note about it.

The subsection reads as follows:

> Where a dividend refund for a taxation year is paid to, or applied to a liability of, a corporation, the Minister shall pay or apply interest on the refund at the prescribed rate for the period beginning on the day that is the later of
>
> (a) the day that is 120 days after the end of the year, and
>
> (b) the day that is 30 days after the day on which the corporation's return of income under this Part for the year was filed under section 150, unless the return was filed on or before the day on or before which it was

required to be filed, and ending on the day on which the refund is paid or applied.

Consider a corporation with a December 31 year-end. How is subsection 129(2.1) applied if the corporation becomes entitled to a dividend refund? At first glance, paragraph (b) seems to say that if the taxpayer files its return on time ("on or before the day on or before which it was required to be filed"), then paragraph (b) does not apply. Therefore, on a plain reading of subsection 129(2.1), interest appears to run 120 days after the end of the taxpayer's taxation year, unless the taxpayer files its income tax return after its due date, in which case interest begins to run 30 days after the day on which its return is filed. If the corporation with a December 31 year-end files its return on or before June 30, its entitlement to interest on a dividend refund is governed by paragraph (a), which provides that interest will be calculated from April 30, the day that is 120 days after the year-end.

However, suppose the corporation files its return one day late, on July 1. In that event, paragraph (b) should apply, and interest should start to run from July 31, the day that is 30 days thereafter. However, this is not the result suggested by the technical notes to subsection 129(2.1). The text of the note, following the amendment to the subsection in 2003, reads as follows:

> Subsection 129(2.1) provides that the Minister of National Revenue is to pay interest on dividend refunds. The period in respect of which interest is payable starts on the later of the day that is 120 days after the end of the taxation year to which the dividend refund relates, and the day on which the corporation's income tax return for that year is filed. The period ends on the day on which the dividend refund is paid to the corporation or applied to another liability of the corporation.
>
> Subsection 129(2.1) is amended to provide that the period in respect of which interest is payable starts on the later of the day that is 120 days after the end of the taxation year to which the dividend refund relates, and 30 days after the day on which the corporation's income tax return for that year is filed.

The department's interpretation suggests that if a taxpayer files its return on, say, June 29, the day that is 180 days after its year-end, refund interest will begin to run on July 29, the day that is 30 days after the day on which the return is filed. This assumes that paragraph (b) applies when, on its wording, it does not. According to paragraph (a), if the return is filed on or before June 30, interest starts to run on April 30, the day that is 120 days after year-end. If a taxpayer files its return by its filing deadline but after the first 120 days, the difference between the department's view and the plain text can result in about a quarter-year's worth of interest. On a very large dividend refund, the amount of interest at issue certainly could be material.

*Robert F. Madden*
Thorsteinssons LLP, Toronto

## GAAR and Tax Planning

The purpose of this article is not to analyze GAAR. (A full GAAR analysis can be gleaned from *Canada Trustco*, 2005 DTC 5523 (SCC).) Suffice it to say that for GAAR to apply, there must be a tax benefit that arises out of a transaction (or a series of transactions) that is an avoidance transaction the result of which is inconsistent with the object and spirit of the relevant provisions of the Act.

Intention is important: accidentally triggering a tax benefit appears to be fine, whereas planning to achieve one may not be. This is illustrated by a comparison of two GAAR cases, *OSFC Holdings Ltd.* (2001 DTC 5471 (FCA)) and *MacKay et al.* (2007 DTC 425 (TCC)). The Crown was successful in the former; the taxpayer succeeded in the latter, even though the facts were similar. The cases should be read carefully for their precise details.

### OSFC

Standard Life (Standard) owned a mortgage portfolio that it wanted to sell. The portfolio had declined in value below its face value. Standard's advisers evolved a plan that would allow it to transfer the losses inherent in the portfolio to the purchasers of the portfolio. The plan was implemented without a buyer on the horizon. When a buyer was found, the buyer participated in the plan and, effectively, acquired the portfolio and the tax losses associated therewith. The essence of the plan was as follows.

Standard incorporated a wholly owned subsidiary with which it formed a partnership. The profit-sharing ratio was Standard 99 percent, subsidiary 1 percent. Standard then sold the portfolio to the partnership for proceeds equal to FMV. Subsection 18(13) of the Act, as it then read, denied the loss to Standard and required the loss to be added to the tax value of the portfolio in the hands of the partnership. That tax value was therefore equal to the face value of the portfolio, even though the FMV was much lower.

The taxpayer (OSFC) acquired Standard's partnership interest rather than the portfolio. The partnership realized the losses inherent in the portfolio by a combination of sales and writedowns and allocated 99 percent thereof to OSFC and to others to whom OSFC had syndicated a portion of its partnership interest.

The FCA denied the losses to the buyers on the basis that GAAR applied. The court held that there was a series of transactions (within the definition in subsection 248(10) of the Act) the primary purpose of which was not bona fide but was to secure a tax benefit for someone, not necessarily the implementer of the first part of the series. Furthermore, the taxpayer took the benefit into account when it decided to acquire the partnership interest.

## MacKay

The National Bank (National) owned debt secured by a shopping centre. The debt had declined in value below its face value because the shopping centre had declined in value. In essence, in the following manner, National sold the debt to buyers who actually intended to acquire the shopping centre for resale.

National incorporated a wholly owned subsidiary with which it formed a partnership. National then transferred the debt to the partnership for proceeds equal to FMV. Subsection 18(13), as it then read, denied the loss to National and required the loss to be added to the tax value of the debt in the hands of the partnership. That tax value was therefore equal to the face value of the debt, even though the FMV was much lower.

The taxpayers acquired National's partnership interest. The partnership then acquired the shopping centre via foreclosure. The tax value of the shopping centre was therefore equal to the tax value of the debt, an amount that exceeded the FMV of the shopping centre. Pursuant to subsection 10(1), the tax value of the shopping centre was written down for income tax purposes and the losses were allocated to the taxpayers.

The TCC allowed the taxpayers to utilize the losses on the basis that GAAR did not apply. The taxpayers conceded that there was a tax benefit. However, the court held that the primary purpose of the series of transactions as a whole was to enable the taxpayers to acquire the shopping centre; significantly, the court held that there was no need to assess the purpose of each transaction within the series. In the court's view, the taxpayers did not take the benefit into account when deciding to participate in the series of transactions; apparently, neither tax considerations nor the eventual structure was discussed at the time the decision was made. (The case is under appeal to the Federal Court of Appeal.)

## Commentary

The decisions in these two cases suggest that the intention with which a taxpayer undertakes a transaction (or series of transactions) will be important when the issue is the applicability of GAAR. The very recent decision of the Court of Appeal in *Lipson* (2007 FCA 113) underlines this conclusion. There, the court held that giving significant weight to the "overall purpose" of a series of transactions was appropriate in the GAAR context. The exact relevance of purpose in a GAAR case is still somewhat uncertain, however. It is clear from the wording of subsection 245(3) that where the issue is whether or not there is an "avoidance transaction," purpose is all-important. However, when the focus shifts to whether the transaction is a misuse or abuse for subsection 245(4) purposes, the subsection speaks of the "result" of the transaction, not the purpose. At least in theory, a transaction could be implemented without knowledge of the beneficial tax consequences, and therefore would not be an avoidance transaction. Even if the result of the transaction was abusive (in an objective sense), GAAR should not apply because the subsection 245(4) analysis is relevant only if there is an avoidance transaction to begin with.

The courts have not been precise (as yet) about the role of subjective intention in these cases. Leave to appeal has been applied for in *Lipson.* If it is granted, the Supreme Court will have an opportunity to clarify the matter.

*Perry Truster*
Truster Zweig LLP
Richmond Hill, Ontario

# Ontario Commercial Law Update: Cents and Nonsense

Effective August 1, 2007, a number of amendments take effect to modernize commercial law in Ontario. Two of these amendments are particularly important for tax practitioners.

The first amendment introduces "full shield" limited liability partnerships to Ontario. At the moment, partners enjoy "partial shield" liability, so that one partner is not liable for the debts or obligations stemming from the negligent acts or omissions of another partner or employee. Under new section 10(2)(b) of the Ontario Partnerships Act, a partner is relieved not only of these obligations, but also of "any other debts or obligations of the partnership that are incurred while the partnership is a limited liability partnership," unless those obligations are due to the partner's negligent acts or omissions or the acts or omissions of persons under the direct supervision of the partner. Further, a partner is liable if the loss or liability stems from criminal or fraudulent conduct of a partner or employee, or if the partner knew or should have known of the act or omission and did nothing to prevent it.

While partners may revel in their newfound protection from commercial liability, they may be concerned about their personal financial affairs, since they will now be "limited partners" for tax purposes and subject to all the rules affecting art and donation schemes, tax shelters, and limited-recourse debt. The consequences range from a capital gain if their partnership ACB goes negative to disallowed expenses paid with borrowed money. (In this regard, think of the consequences of paying wages and salaries out of the operating line of credit.)

Some LLPs are considering replacing partner capital with partner debt. However, if partner capital is withdrawn before the income allocation for the particular year has been made, that withdrawal could result in a negative ACB and a deemed capital gain. The Department of Finance issued a comfort letter on June 11, 2003 indicating that it would support an amendment to the timing of ACB adjustments, which could largely prevent this problem. In the past four years, however, no technical amendment has found its way into a budget or technical bill.

A bigger problem is the impact of section 143.2 on expenses paid with borrowed money. The language of that section is overwhelmingly far-reaching. Expenses paid or assets acquired with debt may not be recognized for tax purposes if the debt has no fixed terms of repayment (for example, partner debt, or revolving lines of credit) or has favourable interest or long repayment terms (over 10 years). This commercial change may come at a significant tax or operating cost.

Another nonsensical change is the proposal to add a new section 22(7) to the Ontario Business Corporations Act. The amendment states that "[t]he articles may provide that two or more classes of shares or two or more series within a class of shares may have the same rights, privileges, restrictions and conditions." This means that one can create two classes of shares with identical terms and conditions merely by giving them different names. The stated rationale for this amendment is to avoid the necessity of creating artificial distinctions in order to legally segregate classes of shares. But the courts seem clear that it is exactly those differences that are essential in defining and distinguishing different classes of shares for the purposes of income splitting, calculating and separating PUC and ACB, and general tax planning. At the 2007 STEP National Conference, the CRA was asked how it would interpret this change in the context of the attribution and income-splitting rules. Not surprisingly, its response was that tax consequences depend on more than just a name, and it would not necessarily recognize a distinction between classes of shares on that basis alone. Fortunately, tax planners have well-established precedents for creating a distinction without a difference. This is one amendment that should be ignored (or repealed).

*Robin MacKnight*
Wilson Vukelich LLP
Markham, Ontario

## Illegally Obtained Evidence Excluded Under Charter

Evidence that a taxpayer has committed a tax-related offence may come to the attention of the CRA in any number of ways. If charges and prosecution result, how that evidence was initially obtained can be a critical factor in the taxpayer's ultimate acquittal or conviction. Before the Crown can introduce evidence in court, the evidence must be admitted. Although the manner in which the evidence was obtained generally does not prevent it from being admitted, there are important exceptions.

Under the Canadian Charter of Rights and Freedoms, a taxpayer (or any other accused) may challenge the admissibility of evidence and succeed in having it excluded if that evidence was obtained through a violation of the taxpayer's constitutional rights. (Evidence may also be excluded on other grounds such as the hearsay rule or privilege.) *R v. Chen* (2007 ONCJ 177), a recent case of the Ontario Court of Justice, illustrates some of the issues that arise when the CRA obtains evidence of a tax offence gathered in the course of an unrelated criminal investigation.

### The Facts

The taxpayer was the subject of a criminal investigation into fraud. The police obtained search warrants from a judge and seized business journals from the taxpayer's residence and place of business. The fraud charges against the taxpayer were eventually dropped. However, the investigation came to the attention of the CRA, which obtained a court order (under section 490(15) of the Criminal Code) to examine the seized materials, including the journals. After inspecting these materials, the CRA issued requirements to provide information (under section 231.2 of the Income Tax Act) to compel the taxpayer's banks to turn over her financial records.

The taxpayer was eventually charged under the ITA and the Excise Tax Act with tax evasion and making false statements. The journals and the banking records obtained by the CRA formed the basis of the prosecution against the taxpayer. The taxpayer sought (by application to court) to have those materials excluded from the evidence against her in the tax prosecution, on the basis that the manner in which they were obtained violated her Charter rights.

## The Decision

The main issues before the Ontario Court of Justice were

1) whether the search warrants used to seize the journals were validly issued,
2) whether the requirements issued by the CRA to obtain the banking records were valid, and
3) whether the journals and banking records should be excluded from evidence under the Charter.

On the first issue, the court examined whether the information presented by the police to the judge to obtain the warrants disclosed reasonable grounds to search the taxpayer's residence and business premises (the proper issuance of a warrant requires "reasonable grounds").

The court noted that whether reasonable grounds exist will depend in part on the currency or "freshness" of the information relied upon. The information must show that it is probable—and not merely possible—that the material sought will be at the location to be searched.

In this case, the information relied upon by the police was more than two years old at the time the warrants were obtained. Given the length of time that had passed, the information was "seriously outdated" and could not support a reasonable belief that there was, at the time the warrants were sought and issued, evidence of the offence under investigation at the places to be searched. The court therefore concluded that the warrants should not have been issued by the initial judge to search either the taxpayer's residence or her business premises. Accordingly, the seizures of the journals from those locations were essentially warrantless and violated the taxpayer's right against unreasonable search and seizure under section 8 of the Charter.

Before addressing the second main issue, the court expressed its concerns about how the CRA obtained access to the journals that were illegally seized by the police. The CRA had applied for an order under section 490(15) of the Criminal Code, which allows a person to apply to a court for access to anything seized under a warrant. The order effectively transferred materials seized by the police to the CRA, which was engaged in a completely different and unrelated investigation. While the police were required to establish reasonable and probable grounds in obtaining the warrant (which the court concluded did not exist), the CRA was not required to meet the same standard in order to access the same materials, even though its investigation was also criminal in nature. The court noted that this raised "serious constitutional problems" in light of earlier cases (see *R v. Jarvis*, 2002 SCC 73, and *R v. Ling*, 2002 SCC 74, discussed below).

On the second main issue (whether the requirements issued by the CRA to obtain the banking records were valid), the Crown conceded that the taxpayer's rights were infringed by the issuing of the requirements under ITA section 231.1 in light of the Supreme Court of Canada's decisions in *Jarvis* and *Ling* (which held that the CRA's powers to audit and issue requirements violate a taxpayer's Charter rights against self-incrimination [section 7] and unreasonable search and seizure [section 8] when their predominant purpose is an investigation into penal liability). The CRA acknowledged that it was engaged in a criminal investigation when it issued the requirements to the taxpayer's financial institutions.

Having concluded that the taxpayer's rights under sections 7 and 8 of the Charter had been violated by the issuance of the search warrants and the requirements, the court then considered whether the evidence obtained should be excluded under subsection 24(2) of the Charter (which requires that evidence obtained in a manner that infringed the Charter be excluded if its admission would bring the administration of justice into disrepute).

The main factor considered by the court was the seriousness of the breach of the taxpayer's Charter rights. The right to protection against unreasonable search and seizure safeguards one's expectation of privacy, which the court noted is extremely high in a person's home. The warrantless search of the taxpayer's residence was therefore a very serious breach. Accordingly, the court concluded that the journal seized from the residence should be excluded.

The court held that the journal obtained from the business premises should also be excluded, although the expectation of privacy is generally reduced in a place of business.

With respect to the banking records, the court focused on the CRA's conduct. The CRA issued the requirements shortly after the *Jarvis* and *Ling* cases were argued, but before the Supreme Court's decisions were released.

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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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However, the court reasoned that the CRA and the Department of Justice must have known that serious constitutional issues about the propriety of using requirements in criminal investigations were under judicial consideration, and should have either awaited the Supreme Court's decision or obtained proper warrants.

The court observed that had it not been for the CRA's access to the materials seized under the invalid warrants, there would have been no basis to issue the requirements. The issuance of the requirements was therefore "seriously tainted" by the invalid issuance of the warrants. Accordingly, the court concluded that the breach involving the issuance of the requirements was sufficiently serious to exclude the banking records.

In the result, the court concluded that all of the evidence obtained in breach of the Charter must be excluded, even though the evidence was "essential" to the Crown's case, and without it, the Crown "will be unable to establish liability."

## Commentary

*Chen* demonstrates the power of the Charter as an ally in the unfortunate situation where the state pits its superior resources against the taxpayer and violates the taxpayer's rights in the process. The Charter ensures that when an individual faces investigation and prosecution, his or her basic rights are respected.

In this case, the entire basis of the Crown's case against the taxpayer was illegally obtained evidence. The taxpayer's successful application to have the evidence excluded under the Charter therefore completely undermined the Crown's case.

On the one hand, it may seem that the Crown's case crumbled on a technicality. However, it is important to remember, as the court noted, that the otherwise laudable goal of encouraging tax compliance "cannot justify an approach to tax prosecutions that completely de-values *Charter* rights."

*Simon Thang*
Millar Kreklewetz LLP, Toronto