TAX FOR THE Owner-Manager

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"Mirror Image" Rule for Eligible Capital Amounts Quietly Replaced

Amounts that are eligible capital amounts of a taxpayer for the purposes of the Income Tax Act reduce the taxpayer's cumulative eligible capital balance and, if that balance becomes notionally negative, effectively result in an income inclusion at a capital gains rate. Until May 1, 2006, the test for whether a capital receipt was an eligible capital amount was the "mirror image" test, which involved "the curious technique of . . . notionally considering the recipient of the payment as the payor for the consideration which was given in return for the payment" (*The Queen v. Goodwin Johnson (1960) Ltd.*, [1986] 1 CTC 448 (FCA)). If the payment would not be an eligible capital expenditure in the hypothetical situation, the receipt could not be an eligible capital amount.

As a result of recent changes to variable E of the definition of "cumulative eligible capital" in subsection 14(5), the mirror image rule has been replaced with an apparently broader rule. Under the new rule, any receipt that is on account of capital in respect of a business carried on or formerly carried on by a taxpayer is an eligible capital amount unless (1) it is included in income or deducted in computing any balance of undeducted outlays, expenses, or other amounts; (2) it reduces the cost of a property or the amount of an outlay or expense; or (3) it is included in computing a gain or loss from the disposition of a capital property. Previously, that variable only included receipts in respect of a business carried on (or formerly carried on) where, as a result of a disposition, the consideration given by the taxpayer for that receipt (that is, the property or rights given up) was such that if any payment had been made by the taxpayer for that consideration, the payment would have been an eligible capital expenditure of the taxpayer. The references to "disposition," "consideration," and "eligible capital expenditure" have now been eliminated.

The mirror image rule had led to the possibility, in some instances, of capital receipts being treated as non-taxable windfalls to the recipient. For example, where a taxpayer transferred land that it had been using in its business to a municipality and later received a settlement award from the municipality as compensation for being unable to relocate that business, it was held that the receipt, which was on capital account, was not an eligible capital amount (*The Queen v. Toronto Refiners & Smelters Ltd.*, [2003] 1 CTC 365 (FCA)). In particular, under the mirror image rule, the payment—which was made for a civic purpose and not for a business purpose—would not be an eligible capital expenditure of the taxpayer if it had been made by the taxpayer. If the new rule were to be applied and the case decided again, the settlement award likely would be an eligible capital amount.

When the amendment to variable E was proposed as part of the 2006 federal budget proposals, the Department of Finance indicated that the change was clarifying and consequential to the extension of the capital gains deduction to fishers. While the amendment very likely brings about a substantive change in the law, it is clarifying in the sense that it greatly simplifies the test for determining an eligible capital amount.

As for the connection to fishers, there may have been a concern that the proposed restrictive covenant rules in section 56.4 could apply where, for example, a fisher sells a fishing licence to the Crown. If those proposed rules were to apply, the entire receipt would have to be included in income. Although the proposed restrictive covenant rules contain an exception for eligible capital amounts where an election is filed (see proposed paragraph 56.4(3)(b)), on the reasoning in *Toronto Refiners* these types of proceeds might not be eligible capital amounts under the mirror image rule. Accordingly, the amendment to variable E appears

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to be beneficial for recipients of certain capital amounts; it clarifies that a full income inclusion under the proposed restrictive covenant rules will not arise. (As an aside, proposed subsection 14(5.1), which provides that an amount is not described in variable E if that amount is required to be included in income under the restrictive covenant rules, appears to now be redundant.)

The new rule for eligible capital amounts is effective for amounts that became receivable after May 1, 2006 (after August 31, 2006 if an election is filed by the taxpayer's filing due date for the year that includes August 31, 2006).

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Letters of Intent: All or Nothing?

A recent Ontario case reminds us of some basic principles of contract law—especially that nothing counts until the parties sign. In *Wallace v. Allen* ((2007), 85 OR (3d) 88 (SCJ)), the parties were (at least at the outset) neighbours and friends. Mr. Allen was considering selling his business interests, and his neighbour, Mr. Wallace, seemed like the ideal successor. On September 24, 2004, Mr. Wallace and Mr. and Mrs. Allen signed a "letter of intent" prepared by Mr. Wallace in which the parties agreed that "there will be much legal work to be done upon acceptance by both sides and that wording of this agreement may alter somewhat." This letter of intent was to be "reduced into a binding agreement of purchase and sale by the parties within 40 days."

The next day, and until December 22, 2004, Mr. Wallace was at Mr. Allen's side meeting employees, customers, and other contacts necessary for the transition of the business. This arrangement allowed Mr. Wallace to undertake his due diligence and Mr. Allen to mentor him, thus protecting his intended takeback mortgage. It also allowed Mr. Allen to transfer responsibility for some business decisions that had become increasingly stressful to him.

The 40-day period had nearly passed before Mr. Wallace's solicitor began to gather the necessary documentation or draft the agreement to send to Mr. Allen's lawyer. Although the parties were eager to get the agreement finished, no one insisted on the 40-day requirement. Not surprisingly, a number of problem areas were identified, and largely resolved. On December 9, the parties met with their lawyers and the company accountant to hammer out the last details. On December 22, the lawyers exchanged a final draft of a share purchase agreement which they could both recommend to their clients. At the same time, Mr. Wallace and Mr. Allen continued to meet with banks and bonding companies to ensure a smooth transition. It seemed that December 29 was set as the date to close the purchase.

Not all the details necessary for an uncomplicated closing were ready by December 29, but the Allens showed up for closing. A number of minor issues coupled with bad weather and Mr. Wallace's last-minute decision to go to Florida for a previously planned holiday (a decision that Mr. Allen apparently encouraged) all combined to create uncertainty about the viability of the deal. Mr. Wallace's solicitor had no instructions from his client and lacked basic information, such as the location of the closing funds and how to get the deal documents signed. Mr. Allen announced that the deal was off. Within the next few days, Mr. Wallace offered tangible assurances to address the Allens' concerns, but they had lost faith in him. Ironically, as the trial judge observed, all the evidence showed that the contract terms were fair and that the worrisome issues could have been easily resolved. With a little papering and patience, the Allens could have sold their business for the expected price, Mr. Wallace would have acquired the business he wanted, and they would all still have their friendship rather than the disaster of the lawsuit.

Mr. Wallace contended that there was a binding agreement on all essential terms that was reflected in the December 22 share purchase agreement. Although he was not ready, willing, and able to close on December 29, the Allens had not made time of the essence in the contract. Consequently, the Allens had the obligation to set a reasonable fixed closing date with respect to which time would be of the essence, and Mr. Wallace had the right to get his affairs in order so that he could close on that date.

The Allens disagreed, maintaining that there was no binding agreement. The letter of intent, on its face, was not meant to be binding. It anticipated further negotiations leading to an agreement that was to be signed and closed simultaneously. Because Mr. Wallace was not present to sign, and because there were outstanding issues that their respective lawyers could not decide on their behalf, no agreement was reached and the Allens were entitled to put an end to the negotiations.

The trial judge ultimately, and sadly, agreed with the Allens that there was no binding agreement: "Both parties were prepared to risk [the litigation], but I am left with the impression that if they had been prepared to be sensible rather than risk takers, both parties could have won." Scathing in his criticism of the Allens' conduct, the judge observed that Mr. Wallace "bore no fault except a crucial, uncharacteristic, unexplained failure to get his act together."

The conduct of the parties throughout the due diligence period clearly showed that both parties wanted the deal to happen. Their conduct was consistent with a shared intention to be bound. However, when Mr. Wallace included in the letter of intent the clause calling for a formal agreement, he demonstrated that he did not intend to commit to be legally bound until all the details had been negotiated to conclusion. If he had wanted to terminate negotiations, he would have relied on this clause. He wanted it all—the deal and the right to cancel it. He ended up with nothing.

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Provincial Residence: Recent Cases

Few cases have dealt with provincial residence; however, the Supreme Court of British Columbia recently addressed this issue in the context of the British Columbia Income Tax Act (BCITA), in *Waring v. The Queen* (December 15, 2006, court file no. S98635) and *Mandrusiak v. The Queen* (May 31, 2007, court file nos. L051824, L051825, and L051826).

Generally, an individual who is resident in a province on the last day of the taxation year must pay income tax under the relevant taxation law of the province. As in the case of the federal Income Tax Act (ITA), the term "resident" is not a defined term under provincial tax legislation; therefore, reference must be made to the case law.

It is possible for an individual to be resident in more than one province at the end of a year. Regulation 2607 of the federal Income Tax Regulations provides that where an individual was resident in more than one province on the last day of the taxation year, the individual is deemed to have resided on that day only in that province which may reasonably be regarded as his or her principal place of residence. By virtue of sections 1(4) and 1(5) of the BCITA, regulation 2607 is made applicable to the BCITA.

In *Waring*, the taxpayer and his wife had lived in Victoria, BC for many years. They moved to Calgary in October 2002 into a home they had acquired. They resided there at the end of 2002 but retained their home in Victoria and, owing to a change in circumstances, moved back to Victoria in March 2003. Josephson J examined a variety of factors, including the motivation for the move to Calgary (the intention of which was found to be permanent); time spent in each jurisdiction after the move by the taxpayer (none in British Columbia during 2002) and by his wife (some visits to British Columbia, but only for medical appointments); continued ties to British Columbia, which included retention of the home, a telephone number, and a vehicle in Victoria and continuing relationships with British Columbia financial institutions; and ties to Alberta, which included a property interest, relationships with financial institutions in Calgary, and the obtaining of an Alberta driver's licence.

Josephson J, relying on *Thompson v. Minister of National Revenue* ((1946), 2 DTC 812 (SCC)), in which Estey J stated that "one is 'ordinarily resident' in the place where in the settled routine of life he regularly, normally or customarily lives," held that on the last day of 2002 the taxpayer was ordinarily resident in Alberta and that Victoria was his occasional residence, and allowed the appeal.

In *Mandrusiak*, the taxpayer had been assessed on the basis that he was resident in both Alberta and British Columbia but was principally resident in British Columbia on the last day of the relevant years. The taxpayer had been born and raised in Alberta. He and his wife raised their two sons there, and they owned a home and operated a farm there. In 1987, after being employed for 25 years with his employer, the taxpayer moved to Vancouver to work in the BC office and acquired a home there. After his retirement in 1997, the taxpayer continued to work as a consultant for his former employer, which required him to work in British Columbia and elsewhere. Since 1987, the appellant maintained homes in British Columbia and Alberta and, during the years under appeal, had lived in both houses; however, the trial judge concluded that the taxpayer spent slightly more time in British Columbia than in Alberta. The taxpayer's two sons and extended family members resided in Alberta. The taxpayer, his wife, and their extended family spent Christmas and New Year's Eve at the Alberta home.

On the basis of the foregoing facts and a review of other factors (including motor vehicle access and registration in each jurisdiction, driver's licence registration, health-care coverage, and connections with religious and financial institutions in each jurisdiction), Sigurdson J, also relying on the decision in *Thompson*, concluded that the taxpayer resided in both British Columbia and Alberta.

The judge went on to conclude that the taxpayer's principal place of residence was Alberta on the basis that "principal" meant "chief, primary, most important," and placed particular importance on the residence of family members and social contacts.

These two cases show that, as in the case of a taxpayer who wishes to cease to be resident in Canada, an individual who wishes to take up residence in another province must, to the maximum extent possible, establish new ties in that province and sever his or her ties with the province of current residence.

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Limitation of an Executor's Liability Under Subsection 159(3)

Subsection 159(3) of the Income Tax Act provides that an executor who fails to obtain a clearance certificate from the CRA before distributing the property of the estate is personally liable for any tax owing by the estate, up to the value of the property distributed. Under subsection 159(3) as it now reads (and as it is proposed to be amended under Bill C-33), the minister "may at any time" assess the executor for any amounts payable by the estate. Does this mean that the CRA may reassess the executor beyond the three-year normal reassessment period otherwise applicable to the estate? Subsection 152(4) limits the CRA's authority to assess the estate (assuming no misrepresentation amounting to neglect, carelessness, or wilful default by the executor), but it does not cross-reference the potential liability of an executor under subsection 159(3). This leaves open the possibility that there is no time limit on an executor's liability under subsection 159(3).

Technical Interpretation 1999-0014955 deals with a somewhat analogous situation, and it provides some comfort to the executor who chooses to distribute without obtaining a certificate. The TI cites the technical notes accompanying an earlier amendment to paragraph 159(1)(b), effective June 18, 1998. The technical notes state that under the amended legislation, it is intended that the minister may assess a legal representative during the normal reassessment period of the person primarily liable. The comments in the TI are made with respect to an issue involving the liability of a legal representative of a dissolved corporate taxpayer. However, the analysis seems to apply equally to an executor of an estate. In essence, the power to assess under subsection 159(3) is subject to the rules in subsection 152(4). In the case of an estate, subsection 152(4) limits the minister's right to reassess to the normal reassessment period of the estate. Any liability of the executor under subsection 159(3) is contingent on the minister's right to first assess the estate. If the minister is out of time to do so, he may not rely on the "at any time" language in subsection 159(3) to assess the executor.

This result is consistent with the scheme of the Act relating to reassessments. If paragraph 159(3)(b) was intended to extend the normal reassessment period beyond that provided for in subsection 152(4), appropriate language should have been included to make this clear. Since this was not done, it is fair to conclude that the addition of the words "at any time" in 1998 is not to be read as overriding the protections in subsection 152(4). The technical notes and the TI are consistent with this interpretation.

Nonetheless, the language of subsection 159(3) could be misleading. It is hoped that the technical notes to the subsection will be amended to clarify the matter.

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Hedge Accounting: Mind the GAAP

In *Saskferco Products Inc.* (2007 TCC 462), Woods J considered the treatment of foreign exchange gains and losses for income tax purposes. She held that the taxpayer, Saskferco Products Inc., could not use hedge accounting in connection with foreign currency transactions when determining its business profit for the purposes of subsection 9(1) of the Income Tax Act. The decision is of interest for two reasons: (1) it is an example of the court deciding that generally accepted accounting principles (GAAP) are not an acceptable method for calculating business profit for income tax purposes; and (2) it is an example of the court finding merit in the taxpayer's arguments but ultimately rejecting them in favour of following judicial precedent and thereby providing certainty in the law.

Saskferco was a corporation formed by Cargill Limited and a Crown corporation owned by the province of Saskatchewan. It was formed for the purpose of building a plant in Saskatchewan that would produce nitrogen-based fertilizer. In order to finance construction of the plant, project debt was issued in July 1990 in the form of a series of notes denominated in US currency having a principal amount of $231 million.

The decision to denominate the debt in US currency was made because Saskferco expected that it would eventually have sufficient US currency revenue to make the principal repayments on the debt, and that using such revenue to make debt payments would provide a natural hedge against future fluctuations in the value of the Canadian dollar relative to the US dollar.

After Saskferco issued the debt, the Canadian dollar weakened significantly relative to the US dollar. Accordingly, Saskferco experienced large foreign exchange losses on each repayment of principal on its debt. By adopting hedge accounting, however, Saskferco was able to offset each such loss against its US currency revenue from the sale of fertilizer.

According to the principles of hedge accounting, the principal payments on the notes and the US dollar revenue stream from which they were paid were both translated into Canadian dollars at the exchange rate in effect in July 1990, when the debt was issued. By translating the US dollar revenue used to make principal payments at the historical exchange rate, rather than at the exchange rates actually in effect at the time of each sale of fertilizer, Saskferco ensured that foreign exchange losses incurred on the repayment of the debt were eliminated, and US dollar revenues were reduced by an equivalent amount.

Hedge accounting was adopted by Saskferco for its financial statements and for income tax purposes. The CRA challenged the use of hedge accounting for income tax purposes, and the matter went to the Tax Court of Canada.

The taxpayer raised two arguments before the court. First, it argued that hedge accounting fell within GAAP and accurately reflected revenue and income. Hedge accounting, therefore, was an acceptable method for calculating business profit for the purposes of subsection 9(1). Woods J rejected this argument for two reasons. First, she decided that hedge accounting severely distorted the revenue earned by the taxpayer and was not an appropriate method for calculating business profit for the purposes of subsection 9(1). In addition, she stated that the jurisprudence clearly sets out the requirement that taxpayers must (1) calculate revenue using exchange rates in effect at the particular time that a transaction occurs, and (2) make the calculation without reference to any other transaction. Consequently, the taxpayer's use of hedge accounting must be rejected because the taxpayer determined revenue by relying on the historical exchange rate in effect at the time that the debt was issued. Although Woods J did not expressly refer to the Supreme Court of Canada's decision in *Canderel Ltd.* ([1998] 1 SCR 147)), she essentially applied that court's decision: even though hedge accounting falls within GAAP, it is not an acceptable method for calculating business profit for the purposes of subsection 9(1) because it does not create an accurate picture of the taxpayer's profit for a given year and because it is inconsistent with established case law principles.

The second argument raised by Saskferco focused on the character of the foreign exchange losses that were realized when debt principal was repaid. Saskferco challenged the principle that a foreign exchange gain or loss on debt takes its character as income or capital from the character of the underlying debt (see *Shell Canada Ltd.* ([1999] 3 SCR 622) and *CCLI (1994) Inc.* (2007 FCA 185)). Its challenge was based on the assertion that the currency of the debt was selected in order to create a hedge that would protect against foreign currency losses on a portion of its US dollar revenue stream. The character of a hedging contract should be determined by the character of the item being hedged, which in this case was future revenue from the sale of fertilizer (see *Shell*).

Woods J rejected this argument as well. She acknowledged that the principles established in *Shell* and *CCLI* might not be entirely justified, but she said that they have been developed over a long period of time and should be respected in the interests of promoting certainty. It is interesting to note, however, that Woods J also stated that she was not persuaded that foreign currency exposure on revenues was the only factor taken into account when the currency of the debt was selected. Perhaps if she had been so persuaded, Woods J would have been more willing to reconsider the principles established in *Shell* and *CCLI*.

In any event, the decision in *Saskferco* highlights the dangers of relying on GAAP when calculating business profit, and it is authority for the proposition that established legal tests should be respected in the interests of providing certainty for taxpayers.

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Partnerships and Joint Ventures: Who Is Entitled to the Profits?

Under most partnership law, three basic elements must be present for a partnership to exist: (1) a business (2) must be carried on in common (3) with a view to profit. (See, for example, the statement to this effect in *Continental Bank Leasing Corporation*, 98 DTC 6505, at 6514 (paragraph 142) (SCC)).

Generally speaking, the major Canadian tax cases dealing with partnerships have focused on whether or not a valid partnership exists. The courts have usually been concerned with whether the arrangement under consideration is a sham and whether a business was carried on by the entity in question with a view to profit. (See, for example, *Continental Bank Leasing Corporation*; *Backman*, 2001 DTC 5149 (SCC); and *Spire Freezers*, 2001 DTC 5158 (SCC).) One case dealing with partnerships, however, has not received the attention it deserves. In *McEwen* (99 DTC 5326 (FCA)), the focus was on determining the identity of the real partners of two partnerships. The essential facts were as follows.

The shareholders of McEwen Brothers Limited ("the corporation") were a number of corporations and individuals who had transferred their shares to personal holding corporations. All of the individuals were contractually bound through their holding companies to render their services to the corporation. The shareholders of the corporation ("the shareholder-partners") purported to enter into two partnerships with the same arm's-length party. The shareholder-partners were, collectively, entitled to 50 percent of the profits of such partnerships. All of the capital required by the partnerships was borrowed from the corporation and the arm's-length partner, at interest; the shareholder-partners did not contribute any capital. The partnerships rented equipment from the corporation and the arm's-length partner. Control and management of the projects of both partnerships were vested in the founder of the corporation and in two of its key employees who were also shareholder-partners.

The court found that the two partnerships were not shams; a business was indeed carried on with a view to profit in both cases. The issue was the identity of the persons who carried on those businesses in common. The court said that it is necessary to determine "who is contributing capital, property, effort, knowledge, skill and assets to the undertaking." The court also said that it is necessary to determine who controls and manages the partnership and who shares profits and losses.

As indicated above, the corporation and two contractually bound employees controlled the partnerships, and none of the shareholder-partners had contributed capital. Therefore, in the eyes of the court, the shareholder-partners, qua partners, contributed nothing to the partnerships. The court said that none of the shareholder-partners was in a position to share losses incurred by the partnerships; therefore, the partnership agreements were legally ineffective and the real partners were the corporation and the arm's-length partner.

A structure similar to that in *McEwen* is often used by family groups involved in real estate development. It is not unusual for the patriarch or matriarch to fund joint venture interests held by corporations owned by their children. It is not inconceivable that the *McEwen* decision could be applied in such circumstances to attribute all of the joint venture profits to the patriarch, the matriarch, or their corporations where the children do not contribute capital or skill to the joint ventures. The following comment in *McEwen* suggests at least a partial solution. "It was certainly open to the taxpayer to make documented loans to the other partners, and for those partners to pay interest to the taxpayer out of the profits they received." In other words, rather than contributing capital on everyone's behalf, the patriarch, the matriarch, or their corporations should, where necessary, lend funds to the children's corporations to enable those corporations to contribute capital to the joint ventures. Over time, the children's corporations can repay the loans out of after-tax earnings. In the meantime, their contributions to the joint ventures will justify an allocation of profit to them.

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Failure To Purify Can Be Costly

A recent Tax Court of Canada decision, *Estate of Edward Reilly* (2007 TCC 404), serves as a reminder not to lose sight of the importance of purifying a qualifying small business on an ongoing basis. In *Reilly*, the taxpayer's estate was denied the capital gains exemption (CGE) on shares of an operating company because the company failed to meet the "90 percent active asset" test at the time of a deemed disposition (on the taxpayer's death). The loss of access to the CGE, which otherwise shelters up to $500,000 of capital gains, could have been prevented through some simple planning.

For the taxpayer to access the CGE, shares must meet the definition of "qualified small business corporation share" (QSBC) in subsection 110.6(1). This definition sets out three tests that must be met in order for the shares to qualify:

1) the "small business corporation" test,
2) the "holding period ownership" test, and
3) the "holding period 50 percent active asset" test.

The last two tests are generally not onerous. Essentially, the "holding period ownership" test requires that no one other than the individual claiming the exemption, or a person related to that individual, have owned the share at any time in the preceding 24-month period. The "holding period 50 percent active asset" test requires that during the 24-month period preceding disposition, more than 50 percent of the fair market value of the corporation's assets be made up of assets used principally in an active business carried on in Canada.

It is the first of the QSBC tests that causes taxpayers and their practitioners the most difficulty in accessing the CGE. In order to be a "small business corporation" as defined in subsection 248(1), the company must be a Canadian-controlled private corporation of which "all or substantially all" of the fair market value of its assets must be either (1) used principally in an active business carried on primarily in Canada, or (2) shares or debt of another small business corporation with which the particular corporation is connected. The term "all or substantially all" is generally understood to mean 90 percent. Successful small businesses that retain their profits can quickly accumulate cash and investments that may be considered inactive assets, causing the corporation to be offside this 90 percent test, as was the case in *Reilly*.

Ridding a corporation of its inactive or redundant assets in order to meet the QSBC definition is commonly referred to as purifying a corporation to make it eligible for the CGE. Most operating companies need a certain level of cash for operations, and it is sometimes difficult to ascertain how much cash or how many near-cash assets are required in the business and are therefore considered to be active assets. In *Reilly*, 38 percent of the fair market value of the assets of the company consisted of cash and marketable securities. The court concluded that there was no evidence that the cash and marketable securities held by the company were necessary or even important for the carrying on of its small active business. Mogan J cited the decision in *Ensite* ([1986] 2 SCR 509), wherein the Supreme Court noted that "[a] business purpose for the use of the property is not enough. The threshold of the test is met when the withdrawal of the property would 'have . . . a decidedly destabilizing effect on the corporate operations themselves.' . . . This would distinguish the investment of profits from trade in order to achieve some collateral purpose such as the replacement of a capital asset in the long term . . . from an investment made in order to fulfill a mandatory condition precedent to trade. . . . Only in the latter case would the withdrawal of the property from that use significantly affect the operation of the business."

Mogan J also relied on the decision in *Skidmore* (2000 DTC 6186 (FCA)). In that case, the Tax Court judge found that the appellants had failed to prove that the cash reserves which the company kept were reasonably required as backup assets or that the company relied on the term deposits as an integral aspect of its business operation. Further, he was unable to conclude that there was a relationship of substantial financial dependence between the amounts in issue and the active business. These findings were confirmed by the Federal Court of Appeal.

In addition to ascertaining whether cash or near-cash assets are "good assets" or "bad assets" for QSBC purposes, one must also consider what constitutes "all or substantially all" of the fair market value of the assets. The phrase has generally come to be understood as meaning 90 percent; however, the Tax Court in *Wood* (87 DTC 312) suggested that the 90 percent threshold was only an arbitrary assessing practice, and that "substantially all" could be as little as 80 percent.

Purification structures or strategies typically require the business owner to incur professional fees, which may deter some owners from undertaking purification planning. In *Reilly*, the cost to the taxpayer's estate of failing to purify was much greater than the cost would have been to purify the company and establish a plan for ongoing purification. The potential tax savings, especially where multiple capital gains exemptions can be accessed, is significant. The March 19, 2007 federal budget proposed to increase the lifetime capital gains exemption to $750,000; practitioners and small business owners now have even more reason to ensure that proper planning is done to access the exemption at all times. Not all dispositions can be anticipated, and therefore pre-disposition purification cannot always be accomplished.

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CDA Tax Scheme Voided—Sham Doctrine Expanded?

In tax matters, "sham" is generally understood to mean a transaction conducted with an element of deceit so as to create an illusion calculated to lead the tax collector away either from the taxpayer or from the true nature of the transaction. The Supreme Court has held that a transaction that lacks any business purpose is not, ipso facto, a sham, and that "deceit . . . is the heart and core of a sham" (*Stubart Investments Ltd.*, 84 DTC 6305, at 6321 (SCC)). In a very recent judgment, *Faraggi and Langlois, et al. v. The Queen* (2007 TCC 286), the Tax Court seems to have extended the sham concept to include transactions that the court finds abusive having regard for the object and spirit of the applicable provisions of the Act.

The facts giving rise to the appeal are extremely complicated and do not admit of a simplified summary. For the purposes of this article it is sufficient to identify the overall purpose of the arrangements and indicate in a general way how the objective was to be achieved. All of the transactions in question were completed in 1987 and thus were not subject to the general anti-avoidance rule (GAAR).

The basic objective of the arrangements was to create a positive balance in a corporation's capital dividend account (CDA) and then sell that benefit to an arm's-length person. There is no provision in the Act that permits a corporation to sell a positive CDA balance to another party, whether at arm's length or not. However, a corporation with a positive balance might issue a separate class of shares to a third party on the understanding that capital dividends equal to the positive CDA balance would be declared and paid on those shares. In 1987, when the transactions in this case were conceived, subsection 83(2.1) had not been enacted, and no other provision of the Act expressly prohibited such a transaction.

The arrangers of the scheme formed a Holdco, which created a chain of wholly owned subsidiaries—Sub 1, Sub 2, Sub 3, etc., down to Sub 13. None of Holdco and the subsidiaries had assets other than a nominal amount of initial capital subscribed by the arrangers. Sub 1 arranged with a chartered bank for access to $10 million on a short-term basis to finance successive subscriptions for newly created preference shares of each subsidiary by its parent company. Sub 1 subscribed for $10 million of preference shares of Sub 2 (the initial preference shares). Sub 2 invested in Sub 3, which invested in Sub 4, and so on down to Sub 13. Sub 2, following the issue of its initial preference shares to Sub 1, declared a stock dividend to Sub 1 payable in a separate class of shares with a high redemption amount and low paid-up capital. Sub 3 did the same vis-à-vis Sub 2, again declaring a stock dividend to Sub 2 in a separate class of its high-low shares, and so on down the line. At the end of the chain, steps were taken to have Sub 13 pay a cash dividend to Sub 1, which Sub 1 returned to the bank on the same day as part of the overall series of transactions. Sub 2 then sold its stock dividend shares in Sub 3 to Sub 1 for full value ($10 million) in exchange for Sub 1's promissory note in that amount. Similar steps were taken by the underlying subsidiaries.

At this point in the scheme, the $10 million of cash provided on a temporary basis by the bank had funded the issuance of $110 million of shares in the chain of corporations, and had been returned to the bank. On paper, each of Subs 2 through 12 had realized capital gains on the sale of the stock dividend shares, thereby creating a credit to their CDAs. Sub 2 (and in turn each of the corporations under it) increased the paid-up capital of the initial preference shares held by its parent, thereby creating deemed dividends. Each corporation elected to have the dividends paid out of its CDA, with the result that Sub 1 wound up with a credit balance of $55 million in its CDA.

Following the payment of the capital dividends, Sub 2 (and each of the underlying companies in turn) sold its initial preference shares to one of the arrangers for $1, thereby triggering a capital loss equal to the capital gain realized on the prior sale of shares to its parent. Sub 1 then issued a new class of its preference shares (the CDA shares) to a third party for a price that exceeded the redemption amount of the shares by $8 million. The CDA shares were then redeemed, triggering a deemed dividend equal in amount to Sub 1's CDA. A subsection 83(2) election was made in respect of the dividend, thereby transferring the CDA to the third party. The excess of $8 million remained with Sub 1 and was distributed among the arrangers, purportedly as capital dividends.

The CRA assessed on the basis that the purported additions to the CDAs were shams and that the dividends paid to the arrangers were taxable, not capital, dividends. It imposed penalties on the arrangers under subsection 162(3) for failure to report the dividends as taxable. The CRA assessed Sub 1 on the basis that the $8 million of excess amount was profit from carrying on a business. It also assessed penalties against the corporation for failure to report the profit. The Tax Court upheld the assessments, essentially on the basis that the transactions were ineffective to create the CDA credits, and that the excess amounts were income

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from a business. It agreed that penalties should be imposed in the circumstances.

The main basis for the decision was a finding that the arrangements designed to create the CDA credits were shams. The corporate steps were deceitful in that they were intended to lead the CRA to believe that the CDAs existed when, in the court's view, they never came into existence. In its reasons, the court lumps together the ineffective transactions doctrine, the concept of abusive tax planning, and the rules for interpreting statutory provisions in accordance with their object and spirit. The reasons can be read as saying that using statutory provisions in a way that is contrary to their object and spirit is abusive and that the result of the abuse may be a sham where the arrangers knew that there was no underlying economic substance to their series of transactions. In such a case, filing tax returns on a basis that relies on the form instead of the (lack of) substance involves deceit, and this supports a finding of sham.

This is perilously close to saying that a transaction that purports to create a specific result (here, the creation of a CDA) is a sham if the court concludes that the transaction does not have that result in law. While the court did not say so in so many words, it seemed to think that no tax adviser would have reasonably believed that the transactions would create the CDA credits, so that the filing of returns on the basis of a CDA was knowingly deceitful. In view of the fact that the transactions in question were implemented in the 1980s before the introduction of GAAR, I find it difficult to support such a finding. As the case reports for that decade illustrate, many advisers were prepared to support very aggressive schemes based on a literal application of the tax rules.

The sham doctrine, as previously understood, required a dishonest act on the part of the arranger in order to support a finding of sham. In my view, it is not deceitful to engage in a series of transactions based on an aggressive interpretation of the law, provided that there is a reasonable basis for the interpretation relied on. The fact that a court subsequently disagrees with that interpretation does not render the steps deceitful so as to justify a finding of sham. The impugned arrangements may be "abusive" as that term has come to be defined in the context of a GAAR analysis. As noted, all of the transactions here were implemented before the enactment of GAAR, and it is arguable that the abuse concept ought not to have been invoked in this case. In any event, while it may be correct to say that all shams are abusive, it does not follow that all abuses are shams. In this regard, the court's decision to uphold the penalties is particularly harsh.

I understand that the decision has been appealed. It will be instructive to see how the Court of Appeal regards the matter.

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