TAX FOR THE Owner-Manager

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Aborted Purchase: Vendor's Tax Issues

Dubois (2007 TCC 461) deals with the deductibility of expenses incurred by the taxpayer in connection with an aborted purchase of an income-producing real property. While the appeal was heard under the informal procedure and the decision has no precedential value, the case raises several interesting issues that are worth discussing.

The taxpayer already owned two rental buildings from which she derived income. In 2001, the taxpayer signed an offer to purchase another rental property; the offer was conditional on the taxpayer receiving financing. The taxpayer wanted to mortgage the building to finance the purchase, but the financial institution would provide the financing only if she mortgaged her residence, which she co-owned with her husband. She declined to borrow on this basis.

The taxpayer thought that the offer to purchase had become null and void; however, the vendors commenced a civil action against her. The taxpayer settled the action out of court by paying the vendors $6,500. She spent a net total of $23,285.78 for a full and final release, including legal fees. The CRA disallowed the deduction of these expenses.

The case raised two questions. First, did the taxpayer have a source of income to which the expenses were related? Second, if there was a source of income, were the expenses capital in nature and therefore non-deductible by virtue of paragraph 18(1)(b) of the Income Tax Act?

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Paris J found that the expenses incurred by the taxpayer on the aborted transaction could not be deducted from the income from the two existing rental properties, because each of these properties was a separate source of income. The operation of property normally commences with the purchase of the property, just as the operation of a business begins with the implementation of the structures with which the business is started up. In Paris J's view, the principle governing when a business commences is properly set out in paragraph 2 of *Interpretation Bulletin* IT-364: generally speaking, "a business commences whenever some significant activity is undertaken that is a regular part of the income-earning process in that type of business or is an essential preliminary to normal operations."

Paris J held that the principle set out in paragraph 2 of the IT applied to the commencement of the operation of property—that is, when a preliminary activity that is essential to the operation of a specific property is undertaken, the operation of that property has commenced. He found that the taxpayer's entering into an enforceable contract to purchase the building was an essential preliminary to the operation of the property. Accordingly, the expenses in question were attributable to a source of income.

With respect to the character of the expense, Paris J stated that if the purchase had been completed, the purchase price would have been a capital expenditure. Thus, the amount that the taxpayer paid to be released from the obligation to purchase the property was closely tied to what would have been a capital asset, and its character was the same. Consequently, the expenses were capital in nature and not deductible in computing income.

By way of obiter dicta, Paris J stated that the taxpayer's expenses may have been incurred as a part of a disposition of her right to purchase the building, and that the disposition of that right might constitute a disposition of property within the meaning of section 38 and the definition of "property" as set out in subsection 248(1). Thus, the taxpayer may have incurred a capital loss that could be claimed in the future.

This case raises interesting issues which tax advisers should consider in circumstances where the initial thought is that the taxpayer may not have a source of income or that no disposition has occurred.

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Contingent Liabilities Revisited

In a previous issue of this newsletter, I discussed the interpretation by the Tax Court of Canada of the phrase "contingent liabilities" in *General Motors of Canada Limited* (2003 TCC 815). (See "Contingent Liabilities," *Tax for the Owner-Manager*, January 2004.) Briefly, the facts of that case were as follows.

Pursuant to a formula in an agreement with its union (CAW), GM was required to accrue an amount to a particular fund (the SCCF) but was not required to segregate and pay the amount accrued to a trustee, custodian, etc. The amounts accrued were based on overtime hours worked by members of the union. Apart from the terms of the agreement, the liability was evidenced only by a bookkeeping entry. The agreement specified that the amounts accrued were to be paid, at undetermined future times, to support certain programs for the auto workers.

The TCC held that GM could not deduct the amounts accrued in 1995 because the accrual represented a contingent liability which, by virtue of paragraph 18(1)(e), could not be deducted. (The FCA ultimately denied GM's appeal, and the SCC refused to hear its further appeal.)

In 2005, GM and the CAW union modified certain aspects of the agreement. The modifications were intended to have retroactive effect. GM felt that as a result of such retroactive modifications, the amounts accrued in the SCCF account were no longer contingent but absolute. GM therefore deducted the amounts accrued in 1996. When the deduction was disallowed, again on the basis that the liability was contingent, the issue was once more put before the TCC (2007 DTC 272). This time, the TCC ruled in favour of GM. The court reviewed evidence that was extrinsic to the agreement because, in its view, the modified agreement was ambiguous in certain respects. In 2008, the FCA overturned the TCC decision (2008 FCA 142) for the reasons outlined below.

The first aspect of the FCA decision is of great interest to tax litigation lawyers but less so to other tax planners. The FCA held that evidence extrinsic to the agreement was inadmissible unless the agreement was ambiguous, which, in the eyes of the FCA, it was not. The FCA went further: it cited jurisprudence to the effect that the particular extrinsic evidence introduced would have been inadmissible even if the agreement had been ambiguous.

Having rejected the use of the extrinsic evidence, which had demonstrated to the trial judge that the intention of the agreement was to create an absolute liability, the FCA indicated that the agreement itself did no such thing; the original and revised agreements merely created an obligation to add amounts in connection with overtime worked to the SCCF but still left the payment of those amounts conditional on the occurrence of certain future events. The FCA did not even address the issue of whether a creditor with a legally enforceable obligation had to be identified in order to establish that a liability was not contingent.

In my 2004 article, I explained why I disagreed with the original TCC decision. Notwithstanding all of the subsequent jurisprudence that has held that GM's liability was contingent, I am still of the opinion that the liability was absolute. The only thing contingent about the liability was the time at which it would have to be satisfied. There was no suggestion that there was any possibility that GM would ever be entitled to reverse the accrual. In my view, the trial judge in the second instance got it right. It should also be noted that the second trial judge identified the CAW as a creditor with a legally enforceable claim in certain circumstances, which to my mind was the only reasonable conclusion to be drawn from the terms of the agreement. In light of that finding, I continue to find it surprising that the court held that the only liability here was to calculate an amount and add it to the SCCF. When all of the facts are considered, it seems inescapable that the parties intended that the amount so calculated and added was payable by GM. I would only add that for accounting purposes it was accepted that GM had a liability that was to be recorded in its financial statements for 1996 under GAAP.

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Meaning of "Contingent Amount": Paragraph 18(1)(e)

In *General Motors* (2008 FCA 142), discussed above, the FCA decided on the facts before it that an obligation to calculate and add amounts to a memorandum account did not create an absolute obligation to pay an amount. As a consequence, it held that there was uncertainty about the coming into existence of the liability linked to the memorandum account, and it applied paragraph 18(1)(e) to deny the deduction of the amount added to the account in the year under appeal. Very shortly after the FCA judgment, the Supreme Court published its decision in *McLarty* (2008 SCC 26), one aspect of which deals with the meaning of "contingent amount" in paragraph 18(1)(e). In holding that an amount due under a limited-recourse promissory note was not contingent, the court provided several examples of the types of uncertainty that may exist with respect to a debt without making it contingent.

McLarty and others acquired interests in proprietary seismic data from a company controlled by the promoter of a tax shelter arrangement. McLarty paid $100,000 for his interest, which he satisfied with $15,000 in cash and the delivery of a promissory note for $85,000. The note was payable on or before its seventh anniversary and was secured by an assignment of a portion of McLarty's interest in the expected cash flow from the exploitation of the seismic data. Any part of the debt not payable by the maturity date was to be forgiven. McLarty was not otherwise liable on the note—that is, recourse was limited to the security he pledged when he delivered the note. McLarty deducted a significant portion of his acquisition cost as a Canadian exploration expense in 1992, the year in which he purchased his interest; he deducted the balance in the following year. The minister disallowed the deduction on a number of grounds, one of which was paragraph 18(1)(e). In the minister's view, the obligation evidenced by the note was conditional, having regard to the repayment arrangements.

McLarty was successful both at trial and on appeal on the contingency issue. However, he lost his case in the FCA on a separate question—whether section 69 applied to reduce the purchase price for the seismic data on the basis that the purchase transaction was between parties deemed not to be dealing at arm's length. McLarty appealed the arm's-length finding, and the minister cross-appealed on the contingent amount point. The Supreme Court held for McLarty on the arm's-length point and dismissed the minister's cross-appeal on the other point.

Before the Supreme Court, the minister conceded that the limited-recourse nature of the note did not by itself make McLarty's obligation on the note contingent. However, the minister argued that because the value of the security pledged as collateral was suspect (in his view, the purchase price for the seismic data was greatly overvalued), the obligation was contingent. In effect, the minister argued that the quantum payable under the note was uncertain, and therefore contingent. In a split decision (7-2), the court held that the liability on the note was absolute, not contingent.

Rothstein J gave the reasons for judgment of the majority. He confirmed that a liability is absolute when its existence does not depend on the occurrence of some event that may or may not happen in the future. A liability may be absolute notwithstanding that there may be uncertainty regarding it. He gave several examples, citing with approval the decision of the FCA in *Wawang Forest Products Ltd.* (2001 FCA 80). There may be uncertainty about whether the payment will be made—for example, when the debtor is in financial difficulty. This does not mean that no obligation was incurred. Similarly, there may be uncertainty about the amount that will be repaid, in the sense that there is never certainty that the debtor will be able to pay the full amount that becomes due on maturity. Finally, there may be uncertainty about the time by which payment is to be made. An obligation is not contingent because payment may be postponed if certain events occur. In Rothstein J's words, "The test is simply whether a legal obligation comes into existence at a point in time or whether it will not come into existence until the occurrence of an event which may never occur."

The dissenting justices (Bastarache and Abella JJ) felt that the obligation on the note was contingent because the liability to pay ultimately depended on the terms of the limited-recourse security. Since it was uncertain whether McLarty's share of the proceeds of exploiting the seismic data would be sufficient to pay the note, no liability to pay arose until those proceeds were realized. The majority justices disagreed on the basic point of when the liability to pay, as opposed to the timing and amount of payment, arose. In the majority's view, the liability on the note was unconditional, notwithstanding that the time and quantum of payment might be uncertain. Rothstein J pointed out that the minister's real concern was that McLarty was claiming deductions on the basis of an overvalued purchase price. He said that the minister had other remedies to deal with this concern (section 67 was noted), but the case was not argued on that basis.

This decision and that in *General Motors* underscore the importance of the language of the document evidencing the obligation in a paragraph 18(1)(e) case. McLarty succeeded because his note created an absolute obligation to pay an amount when it was delivered, even though the timing and quantum of payment were uncertain at that time. GM lost because the FCA found that, properly construed, its obligation under the agreement to pay an amount came into existence only if certain events occurred in the future. It is perhaps ironic that in *General Motors*, both parties clearly intended that the obligation be absolute on the signing of the agreement. As it turned out, the court held that this was irrelevant in interpreting the language they actually used. Brevity, it has been said, is the soul of wit (as far as literature is concerned); clarity, it appears, is the basis of winning (at least in tax cases).

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TOLHOEK: LIMITED RECOURSE FOR TAXPAYERS

The recent FCA decision in *Tolhoek* (2008 FCA 128) sets a strict standard for tax shelter promoters and participants seeking deductions based on leveraged investments. Upholding the TCC decision, the FCA has moved the bar upward for designers of tax shelter investments.

Three critical (but hardly remarkable) lessons should be drawn from this decision:

1) The activities of the tax shelter must reflect the legal relationships in the documents creating it.
2) If necessary tax reporting information is left offshore, don't expect a court to be sympathetic to a claim for relief.
3) The possibility that a debt will be a "limited recourse amount" survives until the principal amount of that debt is finally repaid.

Like many other investors, Tolhoek paid for part of his tax shelter investment in cash; he paid for the balance by the assumption of his pro rata share of the debt under which the limited partnership acquired the software. As happens in many other similar deals, Tolhoek signed a document authorizing the limited partnership to pay his share of the "gross receipts" to the vendor of the software to ensure that the interest on the note and the principal amount of the debt were paid. The term "gross receipts" was defined to mean all revenues received from the operation of the limited partnership's business and all investment income earned on its funds.

The promoter provided warranties as to the volume of transactions (and hence the revenues) that the limited partnership would earn. The promoters testified at the TCC that the warranty was intended to be a mechanism to ensure that the limited partnership derived enough revenues to enable the limited partners to pay the interest on the acquisition debt they had assumed. As it turned out, because the partnership did not generate the warranted level of sales, the promoters paid amounts to the partnership pursuant to the warranty sufficient to enable the partnership to pay the interest accruing on the limited partner notes.

Since all the business activities were offshore, as were the main players, the CRA issued requirements for information to verify the limited partnership's financial statements, and in particular to verify that the full amount of the interest had been paid on a timely basis. The general partner responded to the requirements, but the vendor refused to provide any banking records relating to the payment of interest or the business revenues of the limited partnership.

The CRA noted that the software did not generate the sales volumes that had been anticipated by the investors and represented by the promoters. The promoters' response was that the payments under the warranty represented revenues of the limited partnership; they further argued that the source of funds for the payment of the interest was not relevant, so long as the interest was timely paid.

Both court decisions outline "the circular flow of money and the inconsistencies in the evidence," particularly the inability to determine to whom, when, why, and in what amounts payments were made. Although the TCC found that there were "payment-like events," it was unable to conclude that interest had been paid pursuant to a bona fide arrangement. Consequently, the portion of the acquisition debt assumed by Tolhoek was found to be a limited-recourse amount, and the ACB of his limited partnership interest (and his deductions) was reduced.

It seems clear from the decision that the lack of offshore evidence and the apparent failure of the parties to make payments under the terms of the various governing legal documents were fatal to the taxpayer's claim. One particular flaw was that the warranty payments did not fall within the definition of "gross receipts," so the limited partnership could never have distributed enough revenues to investors to allow them to pay the interest expense. But two more troubling issues loom.

First, could GAAR apply? The warranty payments were intended to provide a basis on which the limited partnership would receive sufficient revenue to notionally make distributions to the limited partners and allow them to direct payments on account of interest, thereby escaping the anti-avoidance provisions of section 143.2. Ryer J said,

> This intention, in and of itself, may not offend any of the specific provisions of section 143.2 and it is noted that the Minister did not seek to challenge this intended avoidance of the limited-recourse provisions in section 143.2 under the general anti-avoidance rule. However, a mere intention to comply with the provisions of section 143.2 will not, in and of itself, be sufficient to bring about the desired result. The arrangements by which such compliance is to be brought about must be legally effective and must withstand careful scrutiny to determine whether they actually produce the intended compliance, having regard to their specific terms and conditions.

Second, the operation of section 143.2 continues until the debt is finally repaid. Since interest on the outstanding debt must be paid annually within 60 days of the end of the year, a failure to make such a payment in any year will make the underlying debt a limited-recourse amount. Until the debt is finally repaid, there is always the risk that the interest will not be timely paid. Until that risk is eliminated, the possible application of section 143.2 must be considered.

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Section 216: Rents Paid to Non-Residents— A Continuing Liability

Subsection 216(1) of the Income Tax Act allows a non-resident to pay part I tax on the net rental income from real property in Canada (or timber royalty) rather than paying part XIII tax. In *Wright v. the Queen* (2001 TCC 2000989), the court held that once a non-resident taxpayer files a valid income tax return under part I of the Act, the non-resident taxpayer is no longer liable to pay part XIII tax on gross rental income. It followed, the court held, that pursuant to subsection 216(1), a non-resident taxpayer is not liable for interest accrued on an amount that was not required to be withheld and remitted by a resident payer under subsection 215(1).

The recent Tax Court decision in *Pechet* (2008 TCC 208) suggests that non-residents cannot rely on the *Wright* analysis. In *Pechet*, the non-resident taxpayer received rental income, but no amounts were withheld and remitted by the payer as required by part XIII of the Act. The taxpayer made a voluntary disclosure and filed a Canadian income tax return under part I in accordance with subsection 216(1). No part I tax was payable based on the return as filed. The CRA initially assessed Pechet for part XIII withholding tax and arrears interest on the amount that would have been payable absent the subsection 216(1) returns. The CRA then reversed the withholding tax, but not the arrears interest.

The issue was whether the taxpayer was liable to pay interest on amounts assessed under part XIII notwithstanding that her ultimate tax liability was nil. Pechet relied on *Wright* in arguing that she was absolved from paying tax under part XIII by virtue of subsection 216(1), so there was no obligation on the part of the Canadian-resident payers to withhold and remit any amount under subsection 215(1). Since there was no obligation on the part of the Canadian resident to withhold and remit any part XIII tax, there was no interest payable by the resident pursuant to subsection 227(8.3), or by the taxpayer pursuant to subsection 227(8.1).

The judgment turned on the relationship between subsections 215(1) and 216(1) of the Act. The relevant portion of subsection 216(1) reads as follows:

> Where an amount has been paid during a taxation year to a non-resident person . . . on account of . . . rent on real property in Canada . . . that person may . . . file a return of income under Part I . . . and the non-resident person shall . . . thereupon be liable, *in lieu of* paying tax under this Part on that amount, to pay tax under Part I for the year as though (a) the non-resident person were a person resident in Canada. (Emphasis added.)

Campbell J contrasted the effect of subsections 216(1) and 216.1(1) (in respect of acting services) to analyze the meaning of "in lieu of." She found that subsection 216.1(1) negated the part XIII tax, while "the words 'in lieu of' [in subsection 216(1)] connote the continued existence of, but substitution for, Part XIII tax." She stated that permitting a non-resident to pay tax under part I "in substitution for" paying tax under part XIII does not affect a resident payer's obligation to withhold and remit under subsection 215(1), nor does it extinguish any liability of the non-resident to pay part XIII tax. In this case, the interest in question related to the resident payer's failure to remit—the non-resident was jointly and severally liable for that interest under subsections 227(8.1) and (8.3). The non-resident taxpayer's payment under part I in lieu of part XIII did not eliminate the interest for late remittance.

In applying a textual, contextual, and purposive interpretation, Campbell J found that

> the textual (ordinary meaning of "in lieu of") and contextual (subsection 215(1) reference to subsection 216.1(1)) interpretations also accord with the purposive interpretation. If the occurrence of a subsequent event, such as the filing of a section 216 return, could retroactively eliminate the obligation to withhold and remit pursuant to subsection 215(1), this could encourage non-compliance and introduce a measure of unintended risk and uncertainty within the system.

Counsel for the taxpayer argued that the interest calculation in subsection 227(8.3) leads to an absurd result: it never stops unless "the amount" due under section 215 is paid. Campbell J agreed, but dismissed the argument on the basis that "expediency is not a canon of statutory interpretation."

This interpretation leads to a serious lacuna in the Act: unless part XIII tax is remitted, the interest liability cannot be stopped. Campbell J's response to this result was as follows:

> To stop interest from accruing indefinitely, the Appellant would have to pay the subsection 215(1) amounts on behalf of the Canadian resident, then apply these amounts to the Appellant's Part I tax owing, by way of subsection 216(2) and finally, obtain a refund (also through subsection 216(2)). *However, to avoid such an onerous system, it is more practical and reasonable to view the whole process as contemporaneous so that the interest on the subsection 215(1) amounts would not continue to accrue beyond the point where the ultimate tax debt was settled.* Obviously this would not eliminate the interest arrears owing to this point nor would it stop interest from accruing on those arrears. *The wording of subsection 216(2) contemplates that amounts withheld pursuant to subsection 215(1) will be applied to the non-resident's substituted Part I tax liabilities with any excess to be refunded.* It follows from this, that the *Act* contemplates situations where Canadian residents withhold and remit subsection 215(1) amounts and the non-residents subsequently file returns pursuant to subsection 216(1). (Emphasis added.)

However, while viewing the process as contemporaneous may be "practical and reasonable," there is no mechanism in the Act to stop the interest running, short of payment under section 215. While the Act may contemplate situations where funds paid under one rule are applied to another liability, it needs a rule to do so. This rule does not exist, and cannot be created by judicial analogy.

The decision is under appeal to the FCA. Pending the decision in that court, Canadian tax advisers should be aware of the consequences of non-resident clients receiving rents from Canadian tenants.

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The Unintended Consequences of Subsection 256(9)

Subsection 256(9) of the Income Tax Act provides that where control of a corporation is acquired at any time during a given day, for the purposes of the Act control of the corporation is deemed to have been acquired at the beginning of that day, unless the corporation elects otherwise. This corporate election is to be made with the corporation's tax return for its taxation year immediately preceding the change of control.

The rationale for this provision seems obvious. When control of a corporation is acquired, the corporation's fiscal year is deemed to end immediately before that time. This allows the corporation's books to be closed during the time when it is owned by the previous owners and reopened in respect of the time when it is owned by the new owners, so that a corporation's fiscal year does not end during the middle of a business day.

This provision was considered by the Federal Court of Appeal in *La Survivance* (2006 FCA 129). The case was discussed in a previous issue (see "Subsection 256(9): Deemed Change in Control," *Tax for the Owner-Manager*, July 2006) in the context of a claim for an ABIL by a public corporation on the sale of the shares of a subsidiary. The case may have ramifications in other circumstances. For example, it may deny the claim for the capital gains deduction otherwise available when shares of a qualifying small business corporation are sold to a public company, unless an appropriate election is made.

In *La Survivance*, the appellant, a publicly traded insurance company, sold all of its shares in a wholly owned subsidiary company (Subco), which also carried on an insurance business in Canada, to a private Canadian company. In respect of the sale, the appellant realized a $2,654,372 loss. Absent the operation of subsection 256(9), the appellant's loss would have been treated as a capital loss. This loss would not qualify as a business investment loss, because Subco, which was wholly owned by the appellant, was not a Canadian-controlled private corporation (CCPC).

Relying on the acquisition-of-control deeming provision in subsection 256(9), the appellant took the position that the purchaser acquired control of Subco at the beginning of the day on which the sale took place. Consequently, when the sale occurred later that day, Subco was deemed to be controlled by the purchaser. Therefore, Subco was a CCPC at the time of the sale, and the appellant's capital loss, which was realized on the disposition of its Subco shares, qualified as a business investment loss.

The court held that for the purposes of the Act, and subject to the exceptions provided, the purchaser was deemed to have acquired control of the target company and the taxpayer was deemed to have surrendered it at the first moment of July 5, 1994. As a consequence, the target was deemed to be a private corporation at the time the sale was completed, and the parent company was entitled to claim an ABIL in respect of the resulting loss.

While the result for the appellant in *La Survivance* was favourable, the reasoning of the court raises the possibility of unintended tax consequences in other circumstances. Specifically, the decision may put at risk the availability of the capital gains deduction in subsection 110.6(2.1) where a taxpayer sells qualified small business (QSB) shares to a non-resident or a public company.

For instance, if a taxpayer sells shares that would otherwise qualify as QSB shares to a non-resident, subsection 256(9) may operate to deem the non-resident to have acquired control of the target company at the beginning of the day on which the sale is completed. As a consequence, that company is no longer a CCPC when the shares are actually transferred to the non-resident. In this instance, and on the basis of *La Survivance*, the taxpayer's shares in the target company will no longer qualify as QSB shares and the capital gains deduction will not be available to shelter any resulting capital gain.

Similar results will occur if the target company is acquired by a public company, because the definition of a CCPC will not be met by the target company later in the day when the sale actually takes place.

In a recent technical opinion, CRA Views 2006-0214781E5, "Capital Gains Deduction: Interaction 256(9) and 110.6(2.1)" (February 22, 2008), the minister confirmed that as a result of *La Survivance*, if a taxpayer sells shares that would otherwise qualify as QSB shares to a public company, resulting in an acquisition of control of the target company by the public company, the taxpayer may not be entitled to the capital gains deduction unless the necessary election in subsection 256(9) is made. The minister stated:

> We agree with you that, in the situation you have presented, technically, Mr. A would not be entitled to the capital gains deduction, under subsection 110.6(2.1), in respect of the disposition of shares of the capital stock of Opco on the basis of the FCA's position on subsection 256(9) in *La Survivance*. Therefore, unless Opco elects not to apply subsection 256(9), Mr. A would not be entitled to claim the capital gains deduction in respect of the disposition of the Opco shares.
>
> In view of the above, we will bring this matter to the attention of the Department of Finance for consideration as to whether a legislative change is necessary.

To date, no legislative amendments have been proposed to deal with this issue. Accordingly, a taxpayer who intends to sell QSB shares to a public company (or a non-resident), resulting in the acquisition of control of the QSB company by the public company (or a non-resident), and who plans on using the capital gains deduction should elect out of the application of subsection 256(9) so that that the acquisition of control occurs at the time of sale, not at the beginning of the day of the sale.

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GST: Meaning of "Recipient of the Supply"

To claim an input tax credit (ITC) for GST purposes, a person must acquire property or a service on which GST is paid or payable (subsection 169(1) of the Excise Tax Act).

This requirement is meant to work hand in hand with the definition of "recipient" in ETA subsection 123(1), but a literal reading of the provisions does not make that intention entirely clear. The definition of "recipient" will be relevant where the ETA refers to a "person to whom a supply is made," and which implicitly (we suppose) is meant to include a person "acquiring" property or services. Either way, the "recipient" definition has caused conceptual difficulties. The recent *Telus Communications (Edmonton) Inc.* case (2008 TCC 5) explores how the provision works, and whether there can be more than one "recipient" of a particular supply in the context of a purchase and sale of a business.

Telus, the appellant, had bought out the property, assets, and rights of a smaller Edmonton company, EdTel. The buyout was in the form of an arrangement under the Canada Business Corporations Act. Before the arrangement, EdTel had contracted for a number of business supplies in the normal course of its business, and most of those supplies had been made but not paid for at the time of the arrangement. The purchase price under the arrangement included "an assumption of liabilities" of EdTel, including the obligations to pay for the supplies.

Notably, the arrangement (unlike a bankruptcy) did not release EdTel from its liabilities, and after the arrangement EdTel was still obligated to pay for the supplies. The effect of the arrangement, therefore, was that EdTel unilaterally arranged for a third party (Telus) to make the payments on its behalf. Under the arrangement, there was no contractual relationship between the suppliers of the supplies and Telus.

Telus later paid the suppliers for the supplies, including the GST invoiced, and claimed the ITCs. The CRA denied the ITC claim, and Telus appealed to the TCC. While there were other minor issues, the main issue before the court was whether Telus was the "recipient" of the supplies and thus able to claim ITCs pursuant to subsection 169(1).

In the TCC, Telus argued essentially that it was liable to pay for the supplies, and thus by virtue of the definition of "recipient" it met all the necessary requirements of the subsection 123(1) definition:

> "recipient" of a supply of property or a service means
>
> (a) where consideration for the supply is payable under an agreement for the supply, the person who is liable under the agreement to pay that consideration,

> (b) where paragraph (a) does not apply and consideration is payable for the supply, the person who is liable to pay that consideration, and
>
> (c) where no consideration is payable for the supply,
>
> (i) in the case of a supply of property by way of sale, the person to whom the property is delivered or made available,
>
> (ii) in the case of a supply of property otherwise than by way of sale, the person to whom possession or use of the property is given or made available, and
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> (iii) in the case of a supply of a service, the person to whom the service is rendered,
>
> and any reference to a person to whom a supply is made shall be read as a reference to the recipient of the supply.

The CRA took the position that although Telus paid for the GST as a party liable to pay for the supplies under the arrangement, Telus was not the recipient of supplies as defined under the ETA, because it did not pay for the supplies under any contractual agreement with the suppliers: Telus's liability was to pay EdTel the purchase price of the business acquired, and this included the payment for the supplies. In the CRA's view, liability to the supplier was a requirement under the ETA.

In the result, the TCC concluded that only EdTel met the ITC requirements of subsection 169(1), being the only person to whom the supplies were made. EdTel, not Telus, was the "recipient of supplies," and only EdTel could claim the ITCs. The TCC observed that Telus only acquired the supplies from EdTel pursuant to a second, non-taxable transaction (the conveyance provided for in the arrangement), which was not relevant in determining who was eligible to claim the ITCs.

In considering Telus's arguments that (1) there could be more than one "recipient" of a supply, and (2) the assumption and payment of a liability substituted one recipient for another, the TCC expressed a concern that such a construction might have the effect of blurring or transferring the liability to pay GST under section 165 and affecting the Crown's right to collect GST under section 296.

The court also found that the definition of "recipient" referred to the person liable for the consideration payable "under an agreement for the supply," which was fatal to Telus's position. (The "agreement" that Telus was relying on was the agreement between Telus and EdTel, and not the agreement between EdTel and the suppliers for the supplies.)

While the decision appears to be technically correct, it demonstrates the real legal difficulties that arise when one applies these rules. The case is a reminder that advisers in purchase and sale transactions should carefully consider the GST consequences when structuring the transaction.

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GAAR: No Abuse of the Stop-Loss Rules in Landrus

In *Landrus* (2008 TCC 274), the taxpayer successfully appealed an assessment under the general anti-avoidance rule (GAAR). The facts can be summarized as follows. The individual taxpayer was a limited partner of a partnership (partnership 1) formed in 1989 to acquire and operate a residential condominium building. Adjacent to this building was a similar building that had previously been acquired by a different limited partnership (partnership 2). The values of both buildings decreased significantly. In December 1994, the assets of partnership 1 and partnership 2 were transferred to a third limited partnership (the new partnership) in a series of transactions, and the limited partners of partnership 1 and partnership 2 ultimately received partnership interests in the new partnership. As a consequence of those transactions, partnership 1 and partnership 2 realized terminal losses pursuant to subsection 20(16) of the Income Tax Act. The taxpayer deducted his allocated share of partnership 1's terminal loss. The minister denied the claim, relying on subsection 85(5.1) and GAAR.

At trial, the taxpayer conceded that the terminal loss was a tax benefit, but took the position that there was no avoidance transaction on the basis that the primary purposes of the asset sales were to save costs and to eliminate competition between the buildings. However, Paris J, after reviewing several items of evidence, concluded that the disposition of partnership assets to the new partnership could not reasonably be considered to have a primary bona fide purpose other than to obtain a tax benefit (the terminal loss). In particular, Paris J observed, inter alia, that (1) a letter sent to the partners proposing the transaction only contemplated the income tax advantages of the restructuring; (2) the organizers of the restructuring had prior experience with the tax advantages of similar transactions; (3) no analysis was conducted to determine whether there would be any cost savings upon consolidation; and (4) the terminal loss tax benefit was much greater than any potential economies resulting from the consolidation. Therefore, the TCC had no difficulty concluding that the disposition of assets by

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partnership 1 to the new partnership was an avoidance transaction.

With respect to a determination of whether the avoidance transaction was abusive, the minister rightly conceded that under a textual interpretation of the Act, the taxpayer was permitted to deduct his share of the terminal loss. It is worth noting that the stop-loss rules in the Act did not apply. Indeed, those rules would not have applied if partnership 1 had simply been wound up, even if its former assets were then contributed to the new partnership, an alternative that apparently was not desirable because, among other non-federal income tax considerations, it gave rise to adverse Ontario land transfer tax implications. While the perceived gap in the stop-loss rules may have troubled the minister, viewed from this perspective, it is difficult to see how the transactions could be considered abusive. Nevertheless, the minister argued that the stop-loss rules should be considered evidence of a general policy in the Act to disregard dispositions of property to related persons or persons within the same economic unit as the taxpayer, or until there has been an arm's-length sale.

Paris J was not persuaded, noting that each stop-loss rule was drafted to apply to a different set of specific circumstances. None of those circumstances extended to all related persons or supported the minister's vague "economic unit" test. Paris J held as follows:

> In my view, the particularity with which Parliament has specified the relationship that must exist between the transferor and transferee for the purpose of each stop-loss rule referred to by the Respondent is more indicative that these rules are exceptions to a general policy of allowing losses on all dispositions.

Therefore, the TCC did not find a general policy in the Act to prohibit losses on all transfers between related parties, or between those forming an economic unit. To the contrary, the general policy of the Act was found to be to allow losses, subject to the specific stop-loss rules. Thus, GAAR did not apply. Moreover, the TCC found the minister's attempt to apply GAAR to be "inappropriate," citing the following passage from *Geransky* (2001 DTC 243) in support:

> The *Income Tax Act* is a statute that is remarkable for its specificity and replete with anti-avoidance provisions designed to counteract specific perceived abuses. Where a taxpayer applies those provisions and manages to avoid the pitfalls the Minister cannot say "Because you have avoided the shoals and traps of the *Act* and have not carried out your commercial transaction in a manner that maximizes your tax, I will use GAAR to fill in any gaps not covered by the multitude of specific anti-avoidance provisions."

While at first blush *Landrus* might seem inconsistent with certain other jurisprudence where GAAR was applied to deny loss trading (for example, *Mathew* (2005 SCC 55) and *OSFC Holdings Ltd*. (2001 FCA 260)), the TCC noted in *Landrus* that the taxpayer had "underlined the fact that this case does not involve a scheme whereby the [taxpayer] is trying to claim a loss incurred by some other taxpayer" and, further, that the taxpayer had "suffered a real economic loss."

It is notable that the taxpayer ultimately disposed of his interest in the partnership property in a straightforward sale, such that the transactions at issue resulted in an acceleration of the tax benefit (the terminal loss deduction) that they taxpayer ultimately realized. Had GAAR been applied to disallow the taxpayer's loss altogether, the result would have been more severe than the result that generally occurs under the stop-loss rules, where they apply.

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