TAX FOR THE Owner-Manager

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The Subsection 185.1(2) Election: A Solution Fraught with Problems

Subsection 185.1(2) is part of the scheme for taxing eligible dividends. Generally, the subsection is intended to relieve against the penalty tax otherwise incurred under subsection 185.1(1) when a corporation designates an excessive amount as an eligible dividend. ("Excessive eligible dividend designation" is defined in subsection 89(1).) The following example demonstrates some of the practical difficulties likely to be encountered in working with subsection 185.1(2).

Opco is a CCPC whose issued common shares are owned 51 percent by Holdco and 49 percent by Mr. X. Holdco and Opco are part of a larger corporate group of CCPCs that is commonly owned by the same persons. Holdco, Opco, and Mr. X are all residents of Canada and Ontario. Holdco and Opco have an April 30, 2008 taxation year-end. The opening GRIP of both Opco and Holdco is nil. A dividend of approximately $100 was paid to both Mr. X and Holdco. The controller of Opco assumed that by April 30, 2008 there would be significant active business income exceeding the small business limit of the corporate group and that there would be GRIP in Opco. As a result, in February 2008, he issued a T5 slip to Mr. X and Opco designated as an eligible dividend a $100 dividend paid by the corporation to Mr. X at the time of payment.

The controller's assumption was wrong. There was no active business income exceeding the small business limit for the corporate group as of April 30, 2008, as the tax adviser discovered when finalizing the corporate year-end in October 2008. As a result, Opco is subject to part III.1 tax of 20 percent on the excessive eligible dividend designation (in this case, $40). Looking for a solution, the tax adviser turns to the subsection 185.1(2) election, which deems an eligible dividend to be an ineligible dividend and in theory avoids the part III.1 corporate distribution tax for Opco.

What steps might Opco take to deal with this situation?

1) *Take the filing position that Opco paid an eligible dividend to Mr. X of $100 and an ineligible dividend to Holdco of $100 on the same class of shares*. This step would reduce the part III.1 tax exposure from $40 to $20 in the example. Unfortunately, paragraph 185.1(2)(c) deems each shareholder to receive a proportionate amount of the eligible and ineligible dividends, as the case may be, elected by the dividend payer corporation. This provision supports the CRA's administrative position that a corporation cannot pay a dividend on the same class of shares to two different shareholders while designating only one part of the dividend as eligible and treating the other part as ineligible.
2) *Have Opco make the subsection 185.1(2) election*. The outcome of this step is not exactly what might be expected. The preamble to subsection 185.1(2) states that the election can only be made on or before the day that is 90 days after the date of mailing of the notice of assessment. In order to avoid any interest and penalties in respect of unpaid part III.1 tax, Opco needs to pay its tax liability on or before its balance-due day pursuant to subsection 185.1(1). Then Opco must wait until it receives its notice of assessment to make the election. The minister must then reassess Opco in order to accept the election and consequently refund to Opco its part III.1 tax already paid. As is the case with any contestation of an assessment, there is uncertainty about the length of time it will take the minister to reassess accordingly. (Interestingly, the language in subsection 184(3) is similar with respect to an

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election to treat a capital dividend that exceeds a corporation's CDA as a taxable dividend.)

3) This election cements Finance's policy that an accurate determination of GRIP must be made by the dividend payer *at the time of the dividend payment*, or else the corporation may be subject to the punitive part III.1 tax. On one hand, the election is relieving because it allows Opco to eventually receive a refund of the corporate distributions tax that it would otherwise not be entitled to. On the other hand, the election does not permit a complete avoidance of the part III.1 tax, since it forces Opco to prepay the tax in any case. Given the relative complexity and ambiguity of the legislation surrounding GRIP, it would make sense to have the election more relieving in nature than it really is. For instance, the legislation could be amended to allow the election to be filed on or before Opco's corporate tax filing deadline.

   Finance has indicated in informal discussions that the intention of the filing timeline of subsection 185.1(2) is parallel to that of subsection 184(3). Finance's position is that the intent of both provisions is to allow an election to be filed any time before 90 days after the date of mailing the notice of assessment. There is some uncertainty with respect to the CRA's published rulings on subsection 184(3). However, the CRA's administrative practice in respect of the timing of the filing of the subsection 184(3) election follows Finance's aforementioned intention. It is hoped that the CRA will administer the timing of the subsection 185.1(2) election in a manner similar to that of subsection 184(3).

4) *Create GRIP in Opco equal to the shortfall causing the part III.1 tax liability*. GRIP will be created in Opco if the active business income of the corporate group exceeds the federal small business limit of $400,000. If this step is taken, the small business limit cannot be used, wholly or in part, to reduce the corporate tax rate on active business income in Opco.

If the right fact pattern exists, part III.1 tax could be completely avoided by deferring the utilization of discretionary deductions in the corporate group (such as CCA, ECE, SR & ED expenditures, unexpired losses, and reserves), which in turn would increase Opco's active business income.

It can be seen that subsection 185.1(2) is not as helpful as one would expect. In the example given above, barring any changes in the legislation, Opco's controller should have consulted a tax adviser prior to making an assumption about the GRIP balance at the end of the corporation's April 30, 2008 taxation year.

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The Constructive Trust Defence in Section 160 and Section 325 Cases

Section 160 of the Income Tax Act permits the CRA to assess a taxpayer who receives property for inadequate consideration from a non-arm's-length person (for example, a spouse or common-law partner) who is liable for tax. An identical provision is found in section 325 of the Excise Tax Act, which imposes joint and several liability on a transferor's spouse or common-law partner for GST payable by the transferor when the transferee received the property for no consideration, or for less than FMV consideration. Taken together, the provisions give the CRA broad powers to assess a transferee for the transferor's outstanding tax and GST liabilities and thereby realize on the value of the transferred assets (money, property, cars, etc.) to satisfy the tax debt. To the extent that a transferee has acquired an interest in the transferred property prior to the transfer, the recent decision of the Tax Court in *Darte* (2008 TCC 66) may provide him or her with some relief.

The appellant was the common-law partner of D, had lived with him for 20 years, and had two children with him. D owned a five-unit property, which was registered in his name only. The property required substantial renovations and the appellant, not D, took care of that. She used her salary, family allowance payments, and rental payments from the units to do so. The appellant also did most of the renovation work; D had minimal involvement with it. After the renovations, D and the appellant lived in one unit and rented out the others. Over time, the outstanding mortgages on the property were paid off with the rent received from the units.

D was also involved in a car business and was having problems paying income tax instalments and GST remittances as they fell due. He was ultimately assessed for unremitted GST and unpaid income taxes. During this time, D transferred the property to the appellant for natural love and affection (that is, for no money), despite the fact that the property was then worth $140,000. D's outstanding tax liabilities at the time of the transfer were about $138,000 ($59,000 in GST and $79,000 in payroll taxes). In view of the transfer, the CRA assessed the appellant for those amounts, and attempted to realize on the property to satisfy the tax debts.

The issue in the Tax Court was the applicability of section 160 of the ITA and section 325 of the ETA. The appellant argued that the sections did not apply because she had right, title, and interest in the property at the time it was transferred to her, based on her common-law relationship with D and the principle of constructive trust. In law, the principle of constructive trust applies when three conditions are met: (1) one person is enriched as a result of work done by another; (2) the other person has suffered a deprivation as a consequence; and (3) there was no other legitimate reason for the enrichment. (See *Peter v. Beblow* ([1993] 1 SCR 980).) The court said that it was not a court of equity and thus could not make a declaration that a constructive trust had come into existence in this case. However, the court went on to consider whether its interpretation of section 160 of the ITA and section 325 of the ETA ought to be based on the fact that the appellant had made out a case for a constructive trust notwithstanding that the Tax Court itself could not make that declaration.

Looking at the underlying purposes of the two provisions, the court concluded that "[i]t would be unfair to not recognize her rights to an interest in the Property" when dealing with these assessments, adding the following:

> As a result, I find that for the purposes of section 160 of the *Income Tax Act* and section 325 of the *Excise Tax Act*, the Appellant had a right to apply to a court of equity for a declaration that she had an interest in the Property at the time that the Property was transferred to her in 2001 and this right was surrendered when the Property was transferred to her and hence the surrender of this right was consideration that the Appellant gave for the transfer of this Property to her. The Appellant has established, on a balance of probabilities, that the elements of unjust enrichment, as set out above, are present in this case and that there is a direct link to the Property as the Property was the one on which the Appellant worked for no consideration. Therefore the Appellant had a right to apply to a court of equity for a declaration that she had an interest in the Property.

On the basis of this reasoning, the court found that the appellant had given consideration of $70,000 (which was one-half of the fair market value of the property) for the transfer of the property to her. The court referred the section 160 matter back to the minister for reconsideration and reassessment, and vacated completely the GST assessment under section 325 of the ETA.

It seems that the court in *Darte* arrived at an equitable result on the facts of the case, since the appellant established that she had a beneficial interest in the property at the time of the transfer. With respect, however, the court's reasoning may be suspect, especially its conclusion that the appellant had given "consideration" to D for the property at the time of the transfer.

Perhaps a more appropriate analysis is that the appellant already had an equitable ownership in 50 percent of the property at the time of the transfer, and that all D could have transferred to her was his 50 percent of the property and his 100 percent legal title to it. Generally, the equity in the property represents its value; the legal title is usually worth little. Thus, the court could have concluded that the fair value of what the appellant received was $70,000—the value of D's half-interest in the property—and that the CRA's assessment against the appellant should be limited to $70,000 on that basis.

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Par for the Course in Rachfalowski

The taxpayer in *Rachfalowski* (2008 TCC 258) scored a hole in one when the Tax Court of Canada recently revisited the issue of the taxation of employee benefits. The taxpayer joined Canada Life as a vice-president in 1998. He was offered a membership in a local golf club of his choice, provided that the club membership included year-round dining privileges. The taxpayer tried to decline the offer because he "hated golf, could not golf and did not golf." Instead, he asked for the cash equivalent of the golf club membership or a membership in a curling club. Canada Life, however, strongly encouraged the taxpayer to accept the golf membership, stating that he would look like a "rebel" if he did not. The taxpayer reluctantly accepted the membership; Canada Life paid the initiation and yearly membership fees. The taxpayer used the club occasionally to entertain clients and, on a few occasions, to take his wife to dinner (paying for the meals himself). He did not include any amounts in respect of the golf club membership in calculating his income for the purposes of the Income Tax Act. He was reassessed for the 2002 taxation year to include the amount of the 2002 golf club membership fees in calculating his income. The court, however, held that the golf membership did not constitute a taxable employee benefit for the purposes of paragraph 6(1)(a) of the Act.

Paragraph 6(1)(a) requires that the value of "benefits of any kind whatever received or enjoyed by the taxpayer . . . in respect of, in the course of, or by virtue of . . . employment" be included in a taxpayer's employment income each taxation year. Thus, the taxpayer must receive a quantifiable benefit, and the benefit must be received or enjoyed in the taxpayer's capacity as an employee. Moreover, the courts (and the CRA) have recognized in certain circumstances that when something has been provided to an employee primarily for the benefit of the employer, it will not be a taxable benefit if any personal enjoyment is merely incidental to the business purpose. (See, inter alia, *Lowe* (96 DTC 6226) at paragraph 16 (FCA).)

In *Rachfalowski*, the court navigated the water hazards and sand traps commonly associated with the taxation of employee benefits and crafted a decision that advocates a practical, commonsense approach to the "primary benefit" test. Specifically, Bowman CJ applied the primary benefit test with reference to the subjective views of both the employer and the employee. Although Bowman CJ stated that such subjective views are not determinative and that "by and large [the analysis] requires an objective determination," the reasoning of the court may potentially expand the scope of what should not constitute a taxable employee benefit. In determining that the golf membership in *Rachfalowski* was primarily for the benefit of Canada Life and therefore was not taxable to the taxpayer, Bowman CJ stated:

> From the appellant's point of view the membership was clearly not an advantage to him. He did not even want it. It is a fair inference that the employer wanted its senior executives to belong to a golf club. It enhanced the company's image and prestige and provided a place for its executives to entertain clients of the company. . . .
>
> In the first place the membership in the golf club was clearly primarily for the benefit of the employer. Even if I am wrong in that conclusion, the benefit, if any, to the appellant of the membership in the golf club was minimal at most and did not constitute a taxable benefit under paragraph 6(1)(a) of the *Income Tax Act*.

Bowman CJ also provided his view, in obiter, on the taxation of other benefits commonly received by taxpayers. For example, he stated that contrary to the general administrative position of the CRA, he had "serious doubts whether providing an employee with a parking space is ever a taxable benefit." For those employees who are provided a benefit of a questionable nature by an employer, *Rachfalowski* is a basis for arguing that such benefits should not be taxable under paragraph 6(1)(a) of the Act.

It is interesting to note that in *Rachfalowski* the taxpayer's aversion to golf resulted in a lack of use of his golf club membership, a benefit (if any) that was quantified by the court as "minimal." This result is consistent with Bowman CJ's statement that the value to a particular taxpayer of an employee benefit "should be determined on an individual basis of actual use as opposed to availability." Indeed, *Rachfalowski* is the latest in a line of cases wherein the courts have quantified an employee benefit on a pro rata basis with reference to the employee's actual use of a benefit. In *McGoldrick* (2003 DTC 1375), for example, the Tax Court determined that the taxpayer in the case at bar had consumed the free meals provided by the employer only 50 percent of the time, and it held that the taxable benefit derived by the taxpayer therefrom should be reduced accordingly. Thus, to the extent that a benefit is primarily for the benefit of the employee, not the employer, there may be scope to reduce the quantum of the paragraph 6(1)(a) employee benefit to an amount that reflects only those benefits used by the employee in his or her personal capacity during the taxation year.

Although *Rachfalowski* is a decision rendered under the court's informal procedure and technically has no precedential value, it is important because it may be indicative of an increasingly practical judicial approach to the taxation of employee benefits. Thus, *Rachfalowski* provides assistance to both employers and employees with respect to how the paragraph 6(1)(a) employment income inclusion in respect of employee benefits may be minimized.

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"More Than Five" Does Not Mean "At Least Six"

A corporation is not considered to be carrying on a "personal services business" as defined in subsection 125(7) of the Income Tax Act if it employs in the business throughout the year "more than five full-time employees." In *489599 BC Ltd.* (2008 TCC 332), the sole issue was whether one could satisfy this requirement by employing five full-time employees and at least one part-time employee rather than "at least six full-time employees."

The taxpayer ("489") was a Canadian-resident corporation whose 50-50 shareholders were two spouses, Mr. and Ms. Clark. During 489's 2003 and 2004 taxation years, 489 provided management consulting, purchasing, and administrative services to another corporation, which was not "associated" with 489 under the Act and which employed in its business five full-time employees and at least one part-time employee throughout the relevant years.

The CRA disallowed all of 489's business expenses for those years except those that were deductible pursuant to paragraph 18(1)(p) on the basis that 489 carried on a personal services business.

The Crown relied on the decision of Muldoon J in *Hughes & Co. Holdings Limited* (94 DTC 6511 (FCTD)), in which it was held that the phrase "more than five" in the definition of "specified investment business" meant "at least six." In the *489599 BC Ltd.* case, Campbell J rejected Muldoon J's conclusion in *Hughes* for four reasons: (1) his approach to statutory interpretation was incorrect, (2) a particular criminal-law case on which reliance was placed was misinterpreted, (3) the conclusion with respect to parliamentary intent was incorrect, and (4) the comments on the issue were obiter. In her analysis, Campbell J noted that in *Burton* (2005 TCC 762) the words "more than two years" as used in subsection 227.1(4) were not interpreted to mean "at least three years," and that the CRA took the position in paragraph 9 of *Interpretation Bulletin* IT-497R4 that the phrase "more than 6 consecutive months" in subsection 122.3(1) meant six consecutive months "plus one day."

Campbell J dealt with several cases that referenced *Hughes*. She disagreed with the comments of Margeson J in *Ben Raedarc Holdings Limited et al.* (98 DTC 1218 (TCC)) approving the comments of Muldoon J in *Hughes* and found that the comments were obiter because the court did not have to conclude on that issue. She rejected Beaubier J's decision in *Woessner* (99 DTC 1039 (TCC)), which also quoted *Hughes* on the basis that it did not deal with the part-time employee issue. Campbell J also referred to the decision of Rothstein J, as he then was, in *Lerric Investments Corp.* (2001 DTC 5169 (FCA)), in which the correctness of the view expressed in *Hughes* was questioned. She concluded that Rothstein J's comments in *Lerric* suggested that there was no uniform consensus on the approach to be taken, and that ambiguity existed regarding the meaning assigned to the expression "more than five full-time employees."

Campbell J also examined the decision in *Baker et al.* (2005 DTC 5266 (FCA)), in which the court had to decide whether six individuals were part-time or full-time employees. In that case, the court suggested that only full-time employment qualified. She concluded that the court in *Baker* was not commenting on what constituted "more than five full-time employees," made no statement on whether the requirement for the additional employee should be full-time or part-time, and stated only that the five employees referenced in the provision must be full-time employees.

Campbell J concluded that the term "more than five" did not require a sixth full-time employee. In reaching this conclusion, she also relied on the decision of Bowman J, as he then was, in *Lerric* (99 DTC 755 (TCC)), in which he rejected the view that the phrase "more than five" means "at least six."

In her decision, Campbell J noted that the term "at least" was used in other provisions of the Act, applied the presumption of consistent expression, and concluded that the legislative intention was to clearly distinguish between the phrases "more than" and "at least." She concluded that it was not the legislative intention that the terms be used interchangeably in the definition of "personal services business." In her view, if the legislature had intended to require a corporation to employ "at least six full-time employees," it would have said so. That wording was not used because it was intended that employment of part-time employees throughout the year could enable a corporation to meet the "more than five full-time employee" test. Campbell J also held that while the case law contained ambiguity with respect to the meaning of those words, the provision was capable of only one interpretation. The appeal was allowed on the basis that by employing part-timers, 489 fulfilled the requirement of employing throughout the relevant years more than five full-time employees. The Tax Court did not speak to what constitutes part-time employment.

This case decides an important issue and allows corporations to satisfy the "more than five full-time employees" requirement in the definitions of "personal services business" and "specified investment business" in subsection 125(7) by employing part-time employees. At the time of writing, it was not known whether the Crown would appeal this decision to the Federal Court of Appeal.

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QSBC Planning Upheld

The decision of the Tax Court of Canada in *Chartier and Nadeau* (2007 TCC 37) raises an interesting point of interpretation regarding the capital gains exemption for qualified small business corporation (QSBC) shares. Specifically, it examines whether an option to purchase or sell shares pursuant to an option agreement made concurrently with a purchase and sale agreement constitutes a right under a purchase and sale agreement for the purposes of the capital gains deduction.

In *Chartier*, a series of shareholders entered into a purchase and sale agreement with a purchaser, pursuant to which 100 percent of the corporation's non-voting class A shares and 49 percent of its voting class B shares were sold. Because the corporation's class B shares were all of its voting shares, the transaction contemplated by the purchase and sale agreement represented a sale of 49 percent of the total voting interest in the corporation. The agreement was entered into on October 17, 1997. The purchaser was a corporation controlled by a US corporation.

Pursuant to an option agreement (entered into simultaneously with the purchase and sale agreement), the purchaser was entitled to purchase the remaining class B shares and all of the class D shares in the capital stock of the corporation at any time after January 1, 1999. The purchaser also granted the class D shareholders the option to sell all of their D shares to the purchaser at any time after January 1, 1999 at a set price. The purchaser exercised the options on January 31, 1999.

The appellant, a class D shareholder, reported a taxable capital gain in respect of the disposition of his class D shares, and he claimed a capital gains deduction under subsection 110.6(2.1) of the Act. The minister disallowed the deduction on the basis that the corporation was not a Canadian-controlled private corporation (CCPC) (as defined in subsection 125(7)) by virtue of paragraph 251(5)(b). If the corporation was not a CCPC, it would not be a small business corporation (SBC) (as defined in subsection 248(1)); the shares disposed of would not fall within the definition of a QSBC share (in section 110.6); and the deduction would not be available to the appellant. The appellant argued that paragraph 251(5)(b) was inapplicable and that the corporation was therefore a CCPC. He argued that his class D shares were in fact QSBC shares, and that the deduction ought to be available to him.

The central issue in the case was whether the option to purchase and/or sell the class D shares was a "right under a purchase and sale agreement." Paragraph 251(5)(b) states (broadly) that for the purposes of the definition of a CCPC, a person that has a right under a contract to acquire shares of the capital stock of a corporation will be deemed to be in the same position in relation to the control of the corporation as if the person actually owned the shares at that time. The option agreement provided for the sale to the purchaser of the remaining 51 percent of the class B shares in the capital stock of the corporation; therefore, paragraph 251(5)(b), if applicable, would deem the purchaser to control the corporation at the time at which the appellant disposed of his class D shares. Because the purchaser was controlled by a non-resident, the corporation could not be classed as a CCPC, and the appellant would be denied the capital gains deduction set out in section 110.6.

However, paragraph 110.6(14)(b) explicitly states that in determining whether a corporation is an SBC or a CCPC for the purposes of the definition of a QSBC share, "a right referred to in paragraph 251(5)(b) shall not include a right under a purchase and sale agreement relating to a share of the capital stock of a corporation." The question, then, is whether the rights granted under the option agreement constitute rights under a purchase and sale agreement.

The court held that the mere fact that the option was contemplated or envisaged in the purchase and sale agreement suffices to create a "right under a purchase or sale agreement." The court found sufficient evidence of such an intention in a clause of the purchase and sale agreement relating to the execution of collateral instruments and agreements. It was noted that parties are able to contract in one agreement that they will comply with another agreement that will be signed at a later date. Here, the shareholders had simply intended to sell all of their interests in the corporation, but they wished to do so while preserving the capital gains deduction (probably as a result of concerns about the deemed change-of-control rule in subsection 259(9)). The court held that while the option agreement itself was not a purchase and sale agreement, the clause in the option agreement that granted the purchaser and vendor the option to sell or purchase their remaining shares could, in fact, be a right under a purchase and sale agreement.

This case is of interest for several reasons. First, the trial judge noted in his reasons that the shareholders had engaged in this sort of planning in order to preserve the capital gains deduction; nonetheless, he allowed the paragraph 110.6(14)(b) exception to be applied. Second, the case reinforces jurisprudence suggesting that a series of steps taken to complete a transaction involving two separate agreements to be signed at separate times and potentially involving separate taxpayers could be taken together in applying provisions such as paragraph 110.6(14)(b). An agreement to comply with an agreement that may be signed at a later date resulted in the provisions of the second agreement being classified as "rights" under the first agreement. Finally, whereas the CRA had commented in document no. 2002-01567450 that it takes the view that options to purchase or sell shares do not constitute purchase and sale agreements for the purposes of the paragraph 110.6(14)(b) exception, the court noted in *Chartier* that such option agreements, while not themselves constituting purchase and sale agreements, could constitute *rights* under purchase and sale agreements. Such was the case in *Chartier*.

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Valuation of a Service Business's Work in Progress

CDSL Canada Limited (2008 TCC 106) deals with a question that is quite common in today's high-tech world: how does one value a consultant's work in progress (WIP) for income tax purposes? The taxpayer carried on the business of computer consulting. Its financial statements, which complied with GAAP, recorded its WIP at FMV and computed its profit under the percentage-of-completion method. In computing its income for tax purposes on the basis that its WIP constituted inventory, the taxpayer relied on subsection 10(1) of the Act to allow it to value its year-end WIP at cost, which was less than FMV. The CRA agreed that the WIP was inventory but reassessed on the basis that the subsection 10(1) valuation at cost was not applicable in the taxpayer's circumstances.

While agreeing that subsection 10(1) was applicable, the court nevertheless ruled that the financial statements presented an "accurate picture" of profit by valuing the WIP at FMV and that subsection 10(1) could not be used to value it at cost for tax purposes. The court characterized the taxpayer's reduction in the value of WIP to cost, for tax purposes, as a reserve that was not authorized by the Act. (In fact, the corporation had itself characterized the reduction, on its income tax return, as a reserve—an incorrect characterization and obviously a bad idea.)

Subsection 9(1) provides that a taxpayer's income from a business is the taxpayer's "profit" from the business. It is clear that, as stated in *Canderel* (98 DTC 6100 (SCC)) and as repeated in the reasons for judgment in this case, "profit" is not defined in the Act. The method used to determine profit, the Supreme Court said, must give an accurate picture of the financial situation of the business. Subsection 9(1) is "subject to this Part" (that is, part I of the Act). Subsection 10(1) is in part I and is therefore applicable. All of this was acknowledged by the court.

If the taxpayer had been carrying on the professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian, or chiropractor, section 34 of the Act would have allowed it to elect to exclude any amount in respect of its year-end WIP. In fact, as will be seen below, the court used section 34—wrongly, in my opinion—to justify its reasoning that the taxpayer could not write its WIP down to cost pursuant to subsection 10(1). On a basis that I find questionable, it also effectively read subsection 10(1) out of the Act in the circumstances of a service business.

The court quoted comments from *Friesen* (95 DTC 5551 (SCC)) to the effect that the valuation of inventory at the beginning and end of the fiscal period is an anachronism in an age when computer technology allows businesses to track the cost and sale price of each item of inventory. Whether or not one believes that that statement is too general, it was not made in the context of a service business; the inventory of the business in question was land, and in that context the observation was valid.

The court also stated that section 34 of the Act would be rendered meaningless if subsection 10(1) had the same effect—namely, to exclude profits from WIP. With respect, this statement is incorrect. Section 34 allows the professional businesses in question to elect to exclude WIP *in its entirety* in computing income. Conversely, subsection 10(1) requires the cost of WIP (or its FMV if lower) to be included in computing income. (Regulation 1801, in conjunction with subsection 10(1), also allows, by election, the valuation of inventory at FMV.)

It is too early to tell whether the taxpayer intends to appeal. One hopes that it does, because the resolution of the issue in this case affects the many companies that are in the business of providing services.

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The Gap in Dow Chemical

The Federal Court of Appeal recently released its decision in *Dow Chemical* (2008 FCA 231), setting aside the decision of the Tax Court. The Tax Court had held, in part, that subsection 78(1) of the Income Tax Act contains a gap: it does not anticipate the amalgamation of a corporate taxpayer. The Federal Court of Appeal disagreed.

The facts in *Dow Chemical* are relatively simple. A Canadian subsidiary (UCCI) of a US corporation (UCC) incurred interest expenses on a loan held by a Canadian financing subsidiary of UCC (UCCFI). UCCI deducted $30,990,628 in interest expenses for the 2000 calendar year that had accrued but were not actually paid by UCCI. Subsection 78(1) would have applied to include the unpaid interest expenses in UCCI's income for its third taxation year after 2000.

UCC was acquired by another US corporation (Dow) on February 6, 2001, after which UCCI amalgamated with a Canadian subsidiary of Dow on October 1, 2001 to form a new corporation (Amalco). The acquisition of control and the subsequent amalgamation each triggered a deemed year-end for UCCI. Consequently, UCCI's interest expenses remained unpaid for two taxation years after the year in which they were incurred. Amalco was subsequently reassessed for its first taxation year (October 1, 2001 to December 31, 2001) in order to include in its income the interest expenses incurred but not paid by UCCI in 2000.

The Tax Court held that the interest expenses incurred by UCCI could not be included in Amalco's income pursuant to subsection 78(1) because Amalco did not satisfy the non-arm's-length requirement in subsection 78(1) at the time that the interest expenses were incurred by UCCI. Three reasons were provided in support of this finding, the most interesting of which was that subsection 78(1) does not anticipate the amalgamation of a corporate taxpayer. The Federal Court of Appeal reached the opposite conclusion on the basis of its interpretation of paragraph 87(7)(d):

> There can be no doubt about the object and purpose of section 87. A common thread throughout this provision is the continuation of the rights and obligations of the predecessor corporations to the "new corporation." With respect to any debt or other obligation incurred or issued by a predecessor, paragraph 87(7)(d) provides that the Act is to be applied "as if" the obligation had been incurred or issued by the "new corporation."

The Federal Court of Appeal's interpretation of the phrase "as if" is particularly interesting. The court accepted that Amalco was a new corporation (in other words, it was distinct from UCCI) but found that Amalco "[stood] in the shoes" of UCCI for the purposes of subsection 78(1). Indeed, the court applied subsection 78(1) as though UCCI's historical relationships and taxation years belonged to Amalco. The effect of this interpretation was essentially to treat Amalco as a continuation of UCCI.

It is fair to ask whether the text of paragraph 87(7)(d) supports the Federal Court of Appeal's analysis. Notwithstanding the court's statement to the contrary, its interpretation of paragraph 87(7)(d) appears to go well beyond the plain text of that provision, which simply states that the Act is to be applied as if Amalco had borrowed the funds that were in fact borrowed by UCCI. The provision does not deem Amalco to have inherited UCCI's history (including its two deemed year-ends) and other tax characteristics (such as its non-arm's-length relationships). In contrast, Parliament used clear language where it intended an amalgamated corporation to be the same corporation as, and a continuation of, a predecessor corporation (see, for example, paragraph 87(2)(g.1)).

Courts have struggled to apply the rules relating to amalgamations, and this case is no exception. It is arguable that the Federal Court of Appeal reached a commonsense result in this case, but it is equally arguable that its extrapolation of paragraph 87(7)(d) went beyond the boundaries of acceptable statutory interpretation. Although the result in *Dow Chemical* may be consistent with what Parliament would have legislated had it considered the point, it is not open to a court to fill in a true gap in the legislation in the guise of an exercise in statutory interpretation.

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Remai Estate: Charitable Gifts Not Abusive Tax Avoidance

The recent decision of Rossiter J in *Remai Estate* (2008 TCC 344) illustrates the slipperiness of the notion of "abuse" in the context of tax avoidance. In a GAAR case, once the court finds that there is a tax benefit and an avoidance transaction, the question becomes whether the result of the avoidance transaction is a misuse of a provision of the Act or an abuse of the provisions of the Act read as a whole. There is no definition of "abuse" in the Act. In the *Canada Trustco* case (2005 SCC 54), the court said that the abuse analysis is a two-step procedure. The first step is to identify the object and spirit of the provisions of the Act giving rise to the tax benefit. The second is to inquire whether the result of the tax planning frustrates the object and spirit of those provisions. The analysis is therefore rooted in the provisions of the Act, not in some overarching policy regarding what constitutes appropriate tax planning.

In *Remai Estate*, the Crown argued that there was a policy underpinning the applicable provisions of the Act which, if accepted, supported the application of GAAR. However, the Crown was unable to source that policy in the actual words of those provisions. The lesson to be drawn from the decision is that it is not sufficient for the Crown to allege a general principle of tax policy in defence of a GAAR assessment. It must go further and show that the alleged policy is found in the words actually used.

The provisions at issue in *Remai Estate* were those relating to charitable gifts of securities to organizations with which the donor is not acting at arm's length. Generally, such gifts do not qualify as charitable gifts for the purposes of section 118.1. Consequently, where a donor who is not at arm's length with a charitable

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foundation makes a gift of securities to it, the donor may not claim a charitable credit in respect of the gift. However, the scheme of section 118.1 contemplates that a non-qualifying gift may be regularized if, among other things, the charity disposes of the non-qualifying securities to a third party acting at arm's length. In that event (and subject to the conditions set out in the section), the sale to the third party regularizes the gift for donation purposes in the year of the sale.

Subsections 118.1(13) and following deal with "non-qualified securities." Added by the federal budget of 1997 to respond to situations in which an individual claimed a charitable deduction in respect of a promissory note gifted to a controlled foundation, the subsections set out a code for determining when such gifts are recognized for charitable donation purposes. In a typical case targeted by the new rules, an individual is owed a salary or bonus by a controlled corporation. Instead of cash, the corporation delivers its promissory note to the individual in the requisite amount. The individual then gifts the note to a controlled charitable foundation and claims a donation credit. In tax policy terms, allowing a deduction in these circumstances was thought to be inappropriate because the amount of the deduction never left the corporation, which retained the use of the cash that otherwise would have gone to the foundation.

This is essentially what happened in the *Remai Estate* case. Notes of a controlled corporation totalling some $10.5 million were gifted to a family foundation in 1998 and 1999. The donor claimed a charitable credit for those years. When the family's tax adviser realized that the credits were not available because of the new rules, steps were taken to regularize the gifts. The foundation sold the notes to an arm's-length third party in exchange for a new note that bore interest at the same rate as the old notes. The third party was a nephew of the donor but was not related to him under the rules in section 251. Consequently, the nephew acted at arm's length unless as a matter of fact he did not act at arm's length as provided in subsection 251(5). The court concluded that the nephew was at arm's length as a matter of fact. This aspect of the judgment is interesting in its own right, but will not be commented on in this note.

Because the nephew was an arm's-length purchaser from the foundation, the provisions of subsection 118.1(13) applied to regularize the gift in the year he purchased the notes (2001). Nonetheless, the Crown argued that GAAR should apply to deny the charitable credit in 2001, on the basis that no funds actually passed from the operating business to the foundation. In the Crown's view, the purpose of the non-qualifying securities rules in section 118.1 is to prevent persons from claiming a credit when they have not lost the use of the gifted funds. The sale to the nephew did not involve the transfer of any cash to the foundation; the nephew's note to the foundation was on the same terms as the donor's notes that he purchased. Accordingly, the arrangements frustrated the purpose of the new rules, and GAAR should apply.

The court refused to accept the argument. Rossiter J said that there was nothing in the wording of the new provisions that required an actual transfer of funds by the third-party purchaser. Subsection 118.1(13) regularizes a charitable gift if the non-qualifying security is acquired by a person dealing at arm's length. Nothing in the subsection or the accompanying provisions speaks to the use of funds by the foundation. Structuring a transaction to take advantage of a specific provision (non-avoidance interpretation of the Act), he said, is not a misuse or abuse.

This conclusion reflects the decision of the Supreme Court in the *Canada Trustco* case. To succeed with a GAAR challenge, the minister must satisfy the court that the arrangements in question frustrate the object and spirit of the provisions of the Act relied on to achieve the tax benefit. General statements of policy are not sufficient for this purpose. The Crown must point to a policy that is reflected in the language of the applicable provisions when read in a textual, contextual, and purposive way. It may be the case that the "use of funds" factor was the driving force for the non-qualifying securities rules. If so, it is ironic that the first reported case dealing with the new rules is one in which there was no change in the use of funds, but the Crown was unsuccessful because of the very specific wording of the provisions. However, it has long been understood that there is no taxation by intendment. Every provision of the Act, GAAR included, stands only for what it says, not for what the drafter may have intended it to say.

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