TAX FOR THE Owner-Manager

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Intercompany Fees: Loss Planning

Loss utilization is an issue that arises frequently in tax planning. In closely held corporate groups, it is not uncommon for one corporation in a group (Profitco) to be profitable while another (Lossco) is expected to suffer losses. In such circumstances, the need to preserve cash necessitates searching for ways to offset the losses against the profits to reduce or eliminate the tax liabilities that would otherwise arise. Where the tried and true approach of combining corporations by way of amalgamation or the windup of a subsidiary into a parent is not practicable, tax planners generally consider the possibility of paying management fees from Profitco to Lossco. This approach is workable, provided that proper arrangements are made.

Safety Boss (2000 DTC 1767 (TCC)) is probably the most instructive Canadian case to examine the issue of intercompany management fees paid to a closely held corporation. In that case, the TCC sanctioned the deduction by a Canadian corporation (Canco) of significant fees paid to a Bermuda corporation (Bermudaco) owned by the same individual. The facts and the reasoning of the court are essential reading. The sole shareholder of Canco (Miller) was initially a Canadian resident. He moved to Bermuda and incorporated Bermudaco. He resigned as president and director of Canco and signed an exclusive employment contract with Bermudaco. Canco and Bermudaco then entered into a contract pursuant to which Bermudaco was to render services to Canco and Bermudaco was to make the services of Miller available to Canco.

The channelling of fees to Lossco is likely to be examined closely by the CRA if, in the past, Profitco was in the habit of reducing its profits to the small business level by paying bonuses to individual shareholder-managers. If those fees are redirected to Lossco, it is advisable to be even more prudent than one would ordinarily be in structuring a tax plan. Contracts similar to those described in *Safety Boss* should be put in place in order to bring the arrangements squarely within the parameters set out therein.

It is also essential that the fees be reasonable in the circumstances. In this regard, reference should be made not only to the discussion of this issue in *Safety Boss*, but to the comments in a number of other cases such as *Laidlaw Transport* (77 DTC 5091 (FCTD)), *Pazner* (91 DTC 1153 (TCC)), *Halifax Grain Elevator* (96 DTC 1178 (TCC)), and *Bertomeu* (2008 DTC 4673 (TCC)).

Where Lossco earns fees from a non-associated corporation, or where Lossco does not employ more than five full-time employees in the business of providing the services, consideration must be given to the possible impact of the personal services business rules in subsection 125(7) of the Act. The general concern that the service income will not be eligible for the small business deduction is not an issue, because the income will be sheltered by losses. However, careful attention should be paid to the restricted list of expenses deductible to a personal services business set out in paragraph 18(1)(p). For example, remuneration paid to persons other than the "incorporated employee" (possibly the shareholder-manager) in the course of rendering services to Profitco will not be deductible to Lossco if the service business is found to be a personal services business.

The final tax issue to be considered is GST. If the fees are received by a "closely related corporation" as defined in subsection 128(1) of the Excise Tax Act, GST need not be collected because of the election provided by subsection 156(2). It is important to note that parent and subsidiary corporations are defined to be closely related, as are sister corporations that are subsidiaries

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of the same parent corporation. However, sister corporations owned by one or more individuals are not defined to be closely related.

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GAAR: Cinderella's Slipper and the Search for Purpose

Everyone is looking for the perfect slipper to fit the perfect foot. In tax terms, that means finding a clear provision in the tax legislation that undeniably applies to the particular facts. Once upon a time, in *Friesen* (95 DTC 5551), the Supreme Court concluded that

> [w]hen a provision is couched in specific language that admits of no doubt or ambiguity in its application to the facts, then the provision must be applied regardless of its object and purpose [the perfect fit]. Only when the statutory language admits of some doubt or ambiguity in its application to the facts is it useful to resort to the object and purpose of the provision [reshaping the perfect foot?].

A decade later, in *Canada Trustco* (2005 DTC 5523), the Supreme Court seemed to reiterate this conclusion:

> The interpretation of a statutory provision must be made according to a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole. When the words of a provision are precise and unequivocal, the ordinary meaning of the words plays a dominant role in the interpretive process. On the other hand, where the words can support more than one reasonable meaning, the ordinary meaning of the words plays a lesser role. The relative effects of ordinary meaning, context and purpose on the interpretive process may vary, but in all cases the court must seek to read the provisions of an Act as a harmonious whole.

The taxpayer seeking to design the slipper that fits perfectly must always question whether the words in the statute are "precise and unequivocal" or "admit of some doubt or ambiguity" in their application to the facts. The Supreme Court has reassured taxpayers that Parliament intends to promote predictability, certainty, and fairness in tax law and that it expects that taxpayers will take full advantage of provisions that confer tax benefits. Further, it is not the role of the courts to second-guess Parliament's intention. The court said in *Canada Trustco*,

> The *Income Tax Act* is a compendium of highly detailed and often complex provisions. To send the courts on the search for some overarching policy and then to use such a policy to override the wording of the provisions of the *Income Tax Act* would inappropriately place the formulation of taxation policy in the hands of the judiciary, requiring judges to perform a task to which they are unaccustomed and for which they are not equipped.

What happened in *Lehigh Cement* (2009 TCC 237)? At issue was whether GAAR could apply to override what appeared to be a clear exemption from withholding tax under subparagraph 212(1)(b)(vii) for interest paid by a Canadian-resident corporation to an arm's-length non-resident corporation on a qualifying "obligation." Both the taxpayer and the Crown counsel agreed that the necessary conditions to invoke this exception had been satisfied. Absent GAAR, we would have had the perfect slipper to fit the perfect foot. However, the Tax Court's decision has reshaped the foot so that the slipper no longer fits.

The Tax Court found that the exception applies only to an arm's-length borrowing by a Canadian resident from a non-resident lender. There are at least two problems with this finding. First, the court relied on three published articles or reports written by tax professionals, none of whom would likely appreciate being considered a spokesperson for government fiscal policy. There was no reference to original government documents, parliamentary debates, committee hearings, or submissions—only outright reliance on secondary analysis and materials. In its search for the purpose of the exception, the court made two findings—first, that the purpose of the exception "is to help Canadian corporations needing to borrow money by increasing their access to international capital markets," and, second, that the exception "applies only to the arm's length borrowing of capital from a non-resident lender." While one may quibble with the first finding on the basis that there are ways of accessing foreign capital markets other than direct lender-borrower transactions, the second finding seems to fly in the face of direct guidance from the Supreme Court in *65302 British Columbia Ltd.* (99 DTC 5799): "It would introduce intolerable uncertainty into the *Income Tax Act* if clear language in a detailed provision of the Act were to be qualified by unexpressed exceptions derived from a court's view of the object and purpose of the provision." After all, the exception is available in respect of any "obligation," a term used throughout the Act to include debts arising from many different commercial relationships, including lender-borrower, debtor-creditor, unpaid vendor, and other covenants to pay amounts. In reaching its restrictive interpretation, the court undertook no analysis of this key word in its context: where was the "textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole"?

The decision has been appealed. One hopes that Cinderella will ultimately be able to wear her slipper again.

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Trusts, Treaties, and Section 116: "It's a Fine Mess, Ollie"

The current rules for taxing trusts are a mess worthy of a Stan Laurel and Oliver Hardy comedy, especially when the rules are applied to a trust that is established in a foreign jurisdiction but has ties of some sort to Canada. The Department of Finance is rightly concerned that the rules be sufficiently robust to ensure that persons resident in Canada do not escape liability for tax on passive income earned offshore. This has proved to be no easy task; witness the continuing inability to finalize the NRT and FIE rules. The resulting legislative uncertainty has led to administrative headaches for the CRA, and the courts that have attempted to make sense of the mess have not been able to shed much light on the subject either.

In the recent Federal Court decision in *Morris et al. v. MNR* (2009 FC 434), Morris and two others were the trustees of the RCI trust. The trust was established in Barbados in 2002 to acquire shares in two Canadian-resident companies. The sole beneficiary of the trust was a trust established in the Cayman Islands in 1995. The beneficiaries of the Cayman trust included persons resident in Canada. The settlor of both trusts is described in the reasons for judgment as "North West Investments." The case gives no particulars of its status as an entity, its controlling persons, or the source of the funds it used to settle the trusts. The RCI trust acquired shares in the two Canadian companies for $200 in 2002. The companies amalgamated in 2006. Shortly thereafter, the RCI trust agreed to sell the shares to a Canadian corporation for $145 million. Because the shares were taxable Canadian property, the vendor trust applied for a section 116 certificate in respect of the sale. In the application, the trust took the position that it was a resident of Barbados, that the gain on the sale was exempt from Canadian tax under the Canada-Barbados tax treaty, and that the minister should therefore issue a section 116 certificate.

The case came before the court after the minister declined to issue the certificate. The minister claimed that certain relevant information regarding the trust, its cost base in the shares, and the adequacy of the sale price was not provided. The applicants disputed these claims. Of more immediate interest, though, are the legal arguments advanced by the parties in support of their positions.

The trustees of the RCI trust argued that the trust was resident in Barbados under article IV of the treaty, and for treaty purposes was not to be regarded as resident in Canada under the domestic deemed residence rules. The trustees argued that the gain was therefore exempt from Canadian tax and that they were entitled to a notification from the CRA to this effect. It appears that they viewed the issuing of a section 116 certificate as one way in which this notification should be effected. In the Crown's view, the trust was resident in Canada as well as in Barbados by reason of the extended concept of residence of a trust in section 94 of the Act. If the trust was a dual resident, then article IV.3 of the treaty was engaged, and the matter of jurisdiction to tax was to be settled by the competent authorities. This application to the court was therefore inappropriate.

The court found in favour of the trust. It held that the trust was a resident of Barbados and that the question of residence was to be decided solely under the treaty, ignoring Canada's deemed residence rules. As the judge read article IV, residence in Barbados was established on the basis of "the physical criteria associated with actual residence." She interpreted the language of paragraph IV.1 as describing actual, not deemed, residence. Since the alleged residence in Canada was based on the deeming rules in section 94 and not on actual presence evidenced by physical criteria, the trust was not a dual resident. As a consequence, Barbados, not Canada, had the sole jurisdiction to tax the gain on sale. (At the time, no tax was imposed on capital gains in Barbados.)

Given that Canada was not entitled to tax the gain, what remedy should be awarded to the trust? The court held that where no tax is owing by reason of a treaty, as was the case here, "the respondent should not use section 116 of the Act to accomplish enforcement and collection objectives, however worthy. . . . In my view, the Applicants are entitled to a binding ruling from the Respondent about whether the RCI shares are treaty exempt property, accepting that the Barbados Trust is a resident only of Barbados."

This judgment is significant for a number of reasons. If it stands, it will severely limit Canada's right to enforce its deemed residence rules for trusts where the trust is resident in a treaty jurisdiction on the basis of its "physical attributes." This is likely to be the most important result of the judgment. However, the case also raises an important question regarding the sort of order that may be made against the minister when he declines to take an administrative step under the Act. Here, the order requires the minister to make a "binding ruling." There is no legislative provision authorizing such a ruling, although it may be that the court's general power to require agencies of government to perform their statutory duties could be extended to the sort of ruling requested here. The specific circumstances that should guide the court in making such an order are not set out in the reasons.

Where does all this leave us? Somewhat deeper in the mess than was the case before the judgment, one suspects. *Julien* (2008 FCA 260) illustrates the impossible situation facing both the CRA and the non-resident trustees when the question of dual residence has to be settled under the competent authority provisions of a treaty. *Morris* compounds the uncertainty by raising new questions about the dual residence provisions of our treaties. On the legislative front, the proposed rules for NRTs and FIEs introduced in 1999 (and revised on several occasions since) are still unenacted. In the meantime, though, Finance says that we should view the latest version as stating the law. Administratively, the CRA is squarely in the middle as the time limits for reassessing prior year's returns run out. It's indeed a fine mess, Ollie.

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Provincial Residence: A 2009 Saskatchewan Case

In 2007, the British Columbia Supreme Court handed down two decisions that dealt with the residence of individuals under the British Columbia Income Tax Act. (See "Provincial Residence: Recent Cases," *Tax for the Owner-Manager*, October 2007.) The recent decision of Popescul J in *Smale v. The Queen* (2009 SKQB 114) deals with the issue of residence of an individual, but in this case under the Saskatchewan Income Tax Act.

Under the Saskatchewan ITA (and under the Alberta tax legislation), an individual who is resident in the province on the last day of the year must pay income tax on his or her income. As was the case with the British Columbia ITA, the term "resident" is not defined in the Saskatchewan ITA; thus, reference must be made to case law for its meaning.

Regulation 2607 of the federal income tax regulations, which is adopted by and is applicable under the Saskatchewan ITA, provides that where an individual was resident in more than one province on the last day of the year, the individual is deemed to have resided on that day only in the province that may reasonably be regarded as the individual's principal place of residence.

The appellant filed his 2005 income tax return on the basis that he was a resident of Alberta. The CRA reassessed the appellant on the basis that he was a resident of Saskatchewan. The Crown's position at trial was that the appellant was a resident of both Saskatchewan and Alberta; however, he was principally resident in Saskatchewan on the last day of the 2005 taxation year.

The first issue for the court to decide was whether the appellant was a resident of Saskatchewan or of Alberta on the last day of December 2005. Popescul J relied on the decision in *Thomson v. Minister of National Revenue* ((1945) 2 DTC 812 (SCC)). In particular, he relied on the comment of Rand J that "[w]hether a person 'resides' or is 'resident' in a particular place . . . is chiefly a matter of the degree to which a person in mind and fact settles into or maintains or centralizes his ordinary mode of living with its accessories in social relations, interests and conveniences at or in the place in question."

The appellant, a 56-year-old chartered accountant, was born, raised, and educated in Saskatchewan. As of December 31, 2005, he had two children who attended school in Saskatchewan, and his wife worked full time in Saskatoon. Prior to November 22, 2005, the appellant lived with his wife and children in a jointly owned house in which they had resided since 1982. The appellant was employed as a CFO by an organization in Saskatchewan from 1999 until February 2005, when his employment was terminated. He was unable to find employment in Saskatchewan, so by August 2005 he had expanded his job search to Alberta. On November 21, 2005, he signed an employment agreement with an organization based in Calgary and became its vice-president and CFO. Initially, the appellant had planned to move to Alberta immediately; his wife and children were to remain in Saskatoon until June 2006, when the younger child completed grade 11. At that time, the house in Saskatoon would be sold and they would move to Calgary. That plan was amended so that his wife and children would move in June 2007, to enable the younger child to remain in Saskatoon until she graduated from grade 12. The family operated under this plan until March 2007, when the appellant and his wife separated. The appellant continued to live and work in Calgary, and his wife planned to remain and reside in Saskatoon.

The appellant left for Calgary on November 22, 2005. Initially, he stayed in a hotel, but he moved into an apartment on December 1, 2005. The appellant took a carload of personal items to Calgary and, in addition, purchased furniture for the apartment. On or about February 1, 2006, he obtained an Alberta driver's licence and arranged for his car to be registered in his name in Alberta. In November 2005, he applied for Alberta health-care benefits; however, the benefits were initially denied because the Saskatchewan health-care plan covered him for 12 months from the time he left the province. The appellant became covered under the Alberta plan after the Saskatchewan benefits expired. Upon his move in November 2005, the appellant changed his address for all his credit cards, bank accounts, and professional mailings from Saskatchewan to Alberta.

Popescul J concluded that on November 22, 2005, the appellant moved from Saskatchewan to Alberta; that the move was unconditional and permanent; that the appellant had in "mind and fact" left Saskatchewan for good to take up a new career in Alberta; and that the move was not a temporary placement. He rejected the Crown's contention that because the appellant continued to own his home in Saskatoon, had friends and family who continued to reside in Saskatoon, did not immediately change utility and mortgage payments from his name to his wife's name on his move, and returned to Saskatoon once every four to six weeks to visit his family, he was still therefore resident in Saskatchewan. Further, he concluded that the appellant's occasional trips to Saskatchewan to visit family and friends were as or more consistent with Alberta residence. The appellant became resident in Alberta on November 22, 2005, and as of December 31, 2005 the appellant had unequivocally relinquished his Saskatchewan residence and had taken up a new residence in Alberta.

The *Smale* case illustrates that a taxpayer who wishes to cease to be resident in one province and take up residence in another province must establish sufficient new ties in the province where he or she wishes to take up residence and must sever his or her ties with the province of current residence to the maximum extent possible. The case also shows that a taxpayer seeking to change his or her provincial residence can retain some ties with the province of current residence and still become resident in another province. It will be a question of fact in each case whether any ties are such that the taxpayer will be regarded as having retained residence in the other province.

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GST and Commissioned Salespersons

The Tax Court of Canada recently dismissed the appeal in *Chambers* (2009 TCC 186), which serves as a useful reminder of the pitfalls that can affect commissioned salespeople. At the same time, the court refused to be drawn into a debate about whether the appellant's accountants had provided correct advice on the application of the GST.

The appellant was a commissioned salesperson who acted for a non-resident who was registered under the Excise Tax Act. The appellant earned commissions from the sale of advertising in western Canada. Upon making a sale, he would prepare an invoice on his client's letterhead showing the price of the advertising and the GST payable on the sale, collect a cheque or credit card slip for the total amount payable to the client, and send all the documentation to his client.

The appellant earned a commission of 30 percent on each sale, but he did not collect GST from his client. He did, however, file GST returns and claim input tax credits for the GST he had paid during the relevant period. He was assessed for the period ended December 31, 2005 for failure to collect GST on his commission earnings. The appellant testified that he had been assured by both his client and by his accountant that "he need not worry about remitting GST in respect of his commissioned sales."

The key fact appears to have been that the non-resident was registered for GST during the period in question. The Excise Tax Act provides relief from the normal requirement to collect GST where commissioned salespeople act for non-residents who are not registered for GST. Specifically, section 5 of part V of schedule VI to the ETA zero-rates a supply made to a non-resident person of a service of acting as an agent of the person or of arranging for, procuring, or soliciting orders for supplies by or to the person where the service is (1) in respect of a zero-rated supply or (2) in respect of a supply made outside Canada by or to the person. ETA subsection 143(1) deems every supply by an unregistered non-resident to be made outside Canada; thus, point 2 would apply.

In this case, section 5 was not applicable because the appellant's client was registered for GST. The appellant was therefore required to collect GST on his commission earnings, a fact that he appeared ultimately to accept at trial.

The court correctly acknowledged that there are two supplies in a commission arrangement: the supply by the principal and a supply of services to the principal by the commissioned salesperson. Commissioned salespeople can be dangerously reliant on their clients for GST advice, particularly when it is the clients who prepare the commission statement and the de facto invoice for their sales representatives. The case is a useful reminder that despite such arrangements, commissioned salespeople are independent contractors who are required to make their own determinations about their GST obligations.

Although the point is not addressed in the decision, some protection from assessment might have been afforded if the appellant had obtained a signed statement from the client attesting to its status in the form recommended by the CRA (*GST/HST Memoranda Series* 4.5.1). If the non-resident had erroneously certified that it was not registered for GST, the appellant might have been spared an assessment for interest and penalty and perhaps the GST altogether. However, the usefulness of such statements has yet to be fully tested in court.

Finally, the appellant apparently took full advantage of his day in court to express his feelings on the advice he had allegedly received from his accountant and his client. The court reserved judgment but stated that the court does not have jurisdiction to look into allegations of misconduct by the accounting profession. In any event, as the court stated, the appellant cannot avoid liability for his obligations under the ETA by claiming reliance on bad advice. Presumably, had the appellant brought forward more compelling evidence of such reliance, it might have been possible to mitigate any penalties included with the assessment on the basis of due diligence, consistent with the court's decision in *Consolidated Cdn. Contractors* ([1998] GSTC 91 (FCA)).

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Transit Provider's Internal Communication System Not Taxable

In recent years, the Ministry of Finance has raised a number of aggressive, and perhaps surprising, assessments against taxpayers based on the use of internal communication systems. *Toronto Transit Commission v. Ministry of Finance* (2009 CanLII 28407 (Ont. Sup. Ct. 2009)), clarifies the extent to which taxpayers are required to self-assess and pay Ontario retail sales tax (RST) on internal telecommunications.

The taxpayer operated a large public transit system. In order to provide transit services in a safe and efficient manner, the taxpayer acquired and operated various types of communication equipment that allowed its vehicles to communicate with a control centre. The equipment was acquired tax-paid and included various radiocommunication devices, electrical cabinets and consoles, microwave transmitters, antennas, and specialized units built into the vehicles. The equipment allowed voice communication between vehicle operators and the control centre and allowed the control centre to monitor vehicle location and operational status.

The ministry assessed the taxpayer on the basis of the "own use" concept—that is, the use of this internal communication system was taxable as a "telecommunication service" produced for the taxpayer's "own use."

The taxpayer appealed the assessment to the Ontario Superior Court. The court reviewed the relevant provisions of the Ontario Retail Sales Tax Act, section 2(3) of which requires that purchasers of taxable services pay RST. The definition of "purchaser" includes a person who acquires or receives a taxable service at a sale in Ontario; a "sale" includes the production of a taxable service for one's own use. Taxable services include telecommunication services. The court noted that if there is no purchase or sale of a taxable service, which includes a telecommunication service, no RST is payable.

The main issue for the court to decide, therefore, was whether the taxpayer's communication system was a telecommunication service that it produced for its own use. While "telecommunication service" and "service" are not defined, "telecommunication" is broadly defined to mean any transmission, emission, or reception of signs, signals, or intelligence by wire, radio, visual, or electromagnetic/laser-based system. In the court's view, the plain meaning of the word "service" connotes assisting or involving another person. Here, while the public benefited peripherally from the taxpayer's communication system, there was no real element of provision of telecommunication services to a third party. Rather, the communication system was used to assist the taxpayer in providing transit services to the public. In the court's view, therefore, the taxpayer had not created any telecommunication *service* that it used itself.

The court then reviewed the legislative background and ministry bulletins and memoranda to determine the underlying purpose of the legislation. In the court's view, these background materials were relevant and indicated that the purpose was only to tax commercially marketable services that could be sold to the public and were diverted for the taxpayer's own consumption. The legislation would also apply to, for example, typical sellers and resellers of telecommunications services (such as telephone companies and large organizations that sell excess capacity in their communication networks). The legislative intent was to impose tax on persons that created a taxable telecommunication service for others and also used that service themselves or sold their excess capacity. Here, the parties agreed that the taxpayer did not sell any telecommunication services, and the evidence showed that the taxpayer was the exclusive user of its communication system, which could not be used and was not used by anyone else.

Notably, the court also found that the ministry had not interpreted the relevant legislative provisions with consistency, fairness, and predictability. The evidence showed that no other public transit provider, police department, fire department, or ambulance service had been assessed, even though such organizations would have used communication equipment for similar purposes.

Finally, the court agreed with the taxpayer that the ministry's interpretation is tantamount to imposing tax on any internal telecommunication for a taxpayer's own use, and could include an intranet within a corporation or business, an intercom system, and even the operation of remote controls, since they all involve "telecommunication" as defined. This was an "overbroad, and absurd" interpretation that could not stand.

In the result, the court concluded that the taxpayer's communication system was not a telecommunication service, and thus could not be a taxable service under the Act. The court rejected the taxpayer's alternative arguments challenging the ministry's calculation of the assessment based on an administrative formula and the inclusion of labour costs in that calculation, although this finding had no impact on the disposition of the case.

The court's decision on what constitutes a taxable telecommunication service has important implications for many businesses with internal communication systems, such as large entities with intranets, transportation companies, and security-monitoring businesses. Significantly, the court recognized that mere telecommunication in the course of a business is not taxable. Rather, the taxpayer must produce and use a commercially marketable telecommunication service, which, on the evidence presented to the court, did not exist in this case.

The court's decision is consistent with the legislative purpose of preventing tax leakage by imposing RST on persons that produce and use services that would be taxable if they were acquired from or sold to others. Further, in this case the taxpayer acquired the communication equipment tax-paid, which means that it had already paid tax in respect of the use of that equipment under section 2(1) of the Retail Sales Tax Act. Taxing the use of that equipment again on the basis that it somehow gives rise to a taxable service for the taxpayer's own use arguably amounts to double taxation.

It remains to be seen how the ministry will react. As of the date of writing, it is unclear whether the ministry will appeal the decision.

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GST Input Tax Credits for Allowances Paid to Employees

Can an employer claim an input tax credit in respect of an amount paid to an employee as a moving allowance? The recent Tax Court decision in *Exxonmobil Canada* (2009 TCC 25) holds that it cannot, although this finding is directly contrary to the earlier decision of the court in *3859681 Canada Inc.* (2003 TCC 501). This conflict in the jurisprudence creates another level of uncertainty for taxpayers attempting to comply with the Excise Tax Act provisions relating to the goods and services tax.

Under section 174 of the ETA, an employer paying an allowance to an employee can claim an input tax credit (ITC) for goods and services acquired with the allowance if the following requirements are met:

- the goods and services are acquired in Canada,
- the goods and services are subject to GST,
- the goods and services are in relation to activities of the employer, and
- the allowance is deductible in computing the employer's income under the ITA.

Section 169 of the ETA provides generally that a registrant may claim ITCs on inputs acquired exclusively for consumption, use, or supply in the course of its commercial activities. Through a number of deeming rules, section 174 extends the general rule to permit an employer to claim ITCs for purchases made by its employees with amounts received as allowances. Section 174 deems the employer, not the employee, to have received the goods and services purchased with the allowance; to have consumed the goods and services; and to have paid the GST on the purchases. However, paragraph 170(1)(b) provides that no ITCs are available if goods or services are acquired exclusively for the personal consumption, use, or enjoyment of an employee unless the allowance is not treated as a taxable benefit to the employee under the ITA. Finally, ETA subsection 170(2) denies the deduction of ITCs if the amount on which the ITCs are calculated is unreasonable.

Exxonmobil paid a moving allowance to employees that it relocated. The moving allowance was equal to 15 percent of the employee's annual salary, and was paid in addition to the reimbursement of the employee's direct moving expenses. The allowance was intended to cover any moving-related expense (other than direct moving charges), including penalties for early cancellation of cellular phone contracts and replacement of items that could not be shipped.

A relocated employee was only required to show receipts to receive reimbursement of the direct moving expenses. The employee did not have to provide receipts or account for the expenses in order to receive the moving allowance. The portion of the allowance in excess of $650 was included in the employee's T4 income statement as a taxable benefit under the Act. Exxonmobil claimed ITCs in respect of the reimbursement expenses and the moving allowances. The CRA allowed the ITCs for the reimbursement expenses but denied the ITCs in relation to the moving allowances. Exxonmobil argued that it met all of the requirements of section 174 and was therefore entitled to claim the related ITCs. Little J of the Tax Court disagreed on the basis that section 174 does not operate in isolation but rather is subject to the general restriction on ITCs set out in ETA section 170.

Little J was of the view that ETA paragraph 170(1)(b) applied to Exxonmobil because the allowance was used to make purchases that were exclusively for the personal consumption of the relocated employee. The exception in paragraph 170(1)(b) did not apply because the portion of the allowance paid by Exxonmobil in excess of $650 was reported as a taxable benefit to the relocated employee. Accordingly, Little J reasoned that no ITCs were available under ETA paragraph 170(1)(b). Alternatively, he found that an allowance equal to 15 percent of the employee's salary was unreasonable, which also disentitled Exxonmobil from claiming ITCs under ETA subsection 170(2).

The decision in *Exxonmobil* is directly contrary to the earlier Tax Court decision in *3859681 Canada Inc.* In that case, the employer reimbursed direct moving expenses and paid a moving allowance equal to 10 percent of the moved employee's salary. The allowance was taxable to the relocated employee for income tax purposes. The minister denied the ITCs on the basis that the requirements of section 174 were not met because the purchases were personal in nature and not in relation to the commercial activities of the employer. Campbell J adopted a broad interpretation of the requirement that ITCs be limited to purchases "in relation to activities engaged in" by the employer. She observed that relocating employees was integral to the success of the employer's business operations, and therefore the purchases made with the allowances were incurred in the course of its commercial activities. The employer won its appeal.

The Crown in *3859681* raised the same argument presented in *Exxonmobil*—namely, that paragraph 170(1)(b) prevents the claiming of ITCs under section 174 when the allowances are used to make purchases that have a largely personal element to them. Campbell J dismissed this argument on the basis that once the requirements of section 174 are met and the deeming rules are engaged, "that is the end of the matter." She went so far to say that the minister's interpretation was "dead wrong." The difference between the Tax Court's views in the two cases is that Campbell J in *3859681* found that the deeming rules in section 174 conclusively determine the employer's entitlement to claim ITCs, whereas Little J in *Exxonmobil* held that section 174 is subject to section 170.

The court in *Exxonmobil* declined to follow *3859681*, which was an appeal heard under the informal procedure and consequently was not a precedent for subsequent decisions. *Exxonmobil* has been appealed to the Federal Court of Appeal. Practically speaking, the decision is relevant to owners and managers in determining whether ITCs can be claimed on moving allowances paid to employees. From both a legal and a practical perspective, it will be interesting to see how the Federal Court of Appeal reconciles these conflicting interpretations of the relevant provisions.

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Crystallization of Losses: Recent Developments

During difficult economic times, taxpayers may want to crystallize inherent losses in their investments to recover taxes paid on previously realized gains. *Cascades Inc.* (2009 CAF 135 (FCA)) reminds taxpayers and practitioners of the potential impact of the suspended loss provisions in subsections 40(3.3) and 40(3.4) of the Income Tax Act when engaging in a related-company loss-planning transaction. The decision is also important for its affirmation of the modern approach to statutory interpretation, which demands a contextual analysis of the relevant provisions having regard for the general spirit of the Act.

In *Cascades*, the taxpayer held 71.1 percent of the common shares of Les Industries Paperboard International Inc. (PII) in May 2000. The PII shares had an accrued loss of $15,941,608. On December 5, 2000, the taxpayer sold its PII shares to a wholly owned subsidiary, 3715965 Canada Inc., for fair market value consideration consisting of common shares, thereby creating a capital loss of $15,941,608. On December 31, 2000, less than 30 days after the disposition, PII and 3715965 Canada Inc. merged.

The taxpayer had realized a capital loss as a consequence of the sale. However, subsection 40(3.4), if it applied, would suspend the loss until the resale of the shares to a non-affiliated party. Subsection 40(3.4) applied if the conditions in paragraph 40(3.3)(c) were met. Those conditions required the shares to be owned by an affiliated person at the end of the 30-day period commencing with the sale to PII. The taxpayer took the position that the property was not owned by the transferor or an affiliated person at the end of the 30-day period specified in paragraph 40(3.3)(b). As a result, the "property"—the shares of PII—no longer existed. It is important to note that paragraph 40(3.5)(c) specifically contemplates the situation where the transferred property consists of shares of a corporation that is merged with another corporation after the disposition.

At trial, the Tax Court based its decision on the clear wording of subsection 40(3.5) and found in favour of the taxpayer on the basis that the three criteria in subsection 40(3.3) must be met before paragraph 40(3.5)(c) can apply. It held that the shares of PII no longer existed as of the date of the merger. Further, paragraph 40(3.5)(c) did not apply unless it was first established that the loss suspension rules in subsections 40(3.3) and 40(3.4) otherwise applied. In the court's view, the property sold (here, the PII shares) ceased to exist on the merger, so those rules were inapplicable and subsection 40(3.5) was inapplicable. This approach to statutory interpretation was rejected by the Federal Court of Appeal.

In overturning the Tax Court's decision, the FCA applied the modern approach to statutory interpretation. The FCA cited the Supreme Court's decision in *Canada Trustco Mortgage Co.* (2005 SCC 54), which stated that "the provisions of the *Income Tax Act* must be interpreted in order to achieve consistency, predictability and fairness so that taxpayers may manage their affairs intelligently." The FCA also analyzed the principles guiding the interpretation of the Act and cited the decisions of the Supreme Court in *Imperial Oil Ltd. and Inco Ltd.* (2006 SCC 46). Those cases, while supporting the continuing relevance of textual interpretation, emphasized the importance of applying the modern approach—that is, a contextual analysis of the relevant provisions having regard for the general spirit of the Act.

The FCA's view was that the words "where subsections (3.3) and (3.4) apply" used in paragraphs 40(3.5)(c) and (d) of the Act only add more precision to the words used in subsection 40(3.3). In other words, when interpreting subsections 40(3.4) and 40(3.3) in a situation where a transferor disposes of shares of the capital stock of a corporation which then merges with another corporation, paragraph 40(3.5)(c) deems the corporation existing after the merger to be the owner of those shares as long as it is affiliated with the transferor. The FCA confirmed its interpretation by noting that the wording of paragraphs 40(3.5)(a) and (b) clearly contemplates that these provisions should be used in the interpretation of subsections 40(3.3) and (3.4), and not the opposite.

While this decision goes against the taxpayer on the facts, the result appears to be in harmony with the current approach to the interpretation of the Act directed by the Supreme Court. It is another example of the recent trend away from a literal reading of the Act in favour of a purposive analysis of the relevant provisions.

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The Attribution Rules and Living Separate and Apart

The rules in subsection 74.1(1) and section 74.2, which attribute income and capital gains to a person who transfers property to a spouse, cease to apply when the spouses are divorced. This fact is intuitively embedded in the legislation and is a longstanding CRA position (see paragraph 16 of *Interpretation Bulletin* IT-325R2, "Property Transfers After Separation, Divorce and Annulment"). However, it is not unusual for the spouses to live apart for a long period before they are divorced. A recent TI (2008-030283) discusses the subtle yet important differences in the planning required to avoid the attribution of income or loss and capital gains or losses on property transferred between spouses during such a period of separation.

Paragraph 74.5(3)(a) of the Act provides that any income or loss is not attributed back to the transferor

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while the spouses are living separate and apart due to marital breakdown. This rule operates automatically. This means that no special election is required to be filed by the transferor spouse to avoid the subsection 74.1(1) attribution rules during the period of separation. The rule relieves the transferor spouse from tax on the income received by the transferee spouse during the period of separation—a period when they are not really, from a social and economic perspective, a single family unit.

Paragraph 74.5(3)(b) provides that a capital gain or capital loss is not to be attributed back to the transferor when two spouses are separated, provided that a joint election is filed with the transferor's return of income. The TI states explicitly that the election can be filed after the actual disposition of capital property is made by the transferee in the transferor's return of income for the taxation year that includes the time of disposition.

The attribution of capital gains or losses between spouses ceases to apply for the year in which the joint election is filed and thereafter. The election can therefore be filed for any taxation year after the time of separation. For the election to be valid, however, it must be filed no later than the year in which the transferee spouse or common-law partner disposes of the property.

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