UTILIZATION OF TAX LOSSES AND DEBT RESTRUCTURING

GERALD D. COURAGE
MILLER THOMSON LLP
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UTILIZATION OF TAX LOSSES AND DEBT RESTRUCTURING*

I. INTRODUCTION

The effective preservation and use of tax losses is an important element of corporate tax planning. While generally a taxpayer would not seek to generate a loss from its activities, nevertheless, accrued and realized tax losses constitute an important asset of a corporation, which, if properly harnessed, can be of significant value. Unfortunately, the incurring of losses often leads to some degree of financial difficulty. As a consequence, loss corporations are frequently forced to seek some of form of debt restructuring with their creditors. While the commercial benefits of debt restructuring are obviously compelling, debt restructuring can seriously jeopardize the loss corporation's ability to access its losses as a consequence of the debt forgiveness rules in the *Income Tax Act* (Canada) (the "Act").

This paper will examine the utilization of tax losses from a corporate perspective, dealing firstly with the utilization of accrued but unrealized losses within a corporate group with particular reference to the stop-loss rules and the "affiliated persons" concept. The paper will then deal with various techniques to utilize realized losses within an affiliated corporate group. Next, the paper will examine the impact of an acquisition of control of a corporation on the utilization of its tax losses. Finally the paper will briefly describe the debt forgiveness rules and consider various debt restructuring and planning techniques, with particular reference to debt restructuring which may occur in the context of a takeover of the loss corporation, to avoid or minimize the application of the debt forgiveness rules and hence preserve, to the maximum extent possible, tax losses available to the loss corporation.

II. TRIGGERING ACCRUED LOSSES – THE STOP-LOSS RULES

An underlying principle of Canadian income tax law is that income, gain or loss is not to be recognized until there has been a sufficient realization. Hence the requirement for a disposition[1] before a gain or loss in respect of capital property is recognized for tax purposes. As well, the Act contains a series of rollover provisions which defer the recognition of income or gain where there has been a disposition but an insufficient realization in monetary terms (e.g. rollovers of property under subsection 85(1) of the Act where the consideration received in exchange is in the form of shares).

In a similar vein, the Act contains a number of so called "stop-loss rules" where there has been a transfer of property with an accrued loss within a statutorily defined closely held group. While the transfer might otherwise be treated as a sufficient realization so as to permit recognition of the loss, nevertheless the loss is denied until the property (or, in some cases, property received in exchange on the transfer) is transferred out of the group, at which point there is effectively a "true" realization by the group of the loss for tax purposes. Obviously, the definition of the group is a critical issue from a tax design point of view.

The Act has for some considerable period of time contained a variety of stop-loss rules, but as a result of perceived or potential abuses of the rules as then formulated, major changes in the stop-loss rules were proposed, initially in draft legislation published on April 26, 1995. These proposals, with a variety of amendments, were subsequently enacted in 1998 but remain generally applicable after April 26, 1995 (the "1995 amendments"). One important feature of these rules is the "affiliated persons" concept contained in section 251.1, which defines the group to which the stop-loss rules apply. This term is consistently used throughout virtually all of the stop-loss rules. In general terms, the former stop-loss rules denied recognition of the accrued loss to the transferor and transferred the accrued loss to the transferee. Thus, upon an arm's length disposition of the subject asset, it was the transferee who recognized the loss for tax purposes. This offered a variety of tax planning possibilities.[2, 3] In contrast, the present rules, while still denying the loss to the transferor, leave the accrued loss with the transferor to be recognized and reported by the transferor at an appropriate later date (e.g. upon a disposition out of the group of affiliated persons of the subject asset). Generally speaking, these rules are, as one might expect, more restrictive than the former rules and generally exercise an inhibiting effect on the utilization of accrued losses without an arm's length sale and on the transfer of the benefit of accrued losses to unaffiliated persons.

A. THE AFFILIATED PERSONS CONCEPT – SECTION 251.1

As mentioned above, a key feature of the present stop-loss rules is the consistent use of the term "affiliated persons" to define the affected group.[4]

Under this definition, an individual and the spouse or common-law partner of the individual are affiliated persons. It is noteworthy that children, siblings, in-laws and various other human relatives are not affiliated persons, although they would be "related" persons pursuant to section 251 of the Act.

A corporation will be affiliated with a person or each member of an affiliated group of persons by whom or which the corporation is controlled and the spouses or common-law partners of each of the foregoing persons. For purposes of the affiliated persons definition, control is defined to mean *de facto* control.[5] An "affiliated group of persons" is defined to mean a group of persons each member of which is affiliated with every other member. Persons are deemed to be affiliated with themselves and a person is defined to include a partnership.

Two corporations will be affiliated if each corporation is controlled by a person and those two persons are affiliated (or are the same person). Two corporations will also be affiliated if one is controlled by a person and the other is controlled by a group of persons each member of which is affiliated with the person controlling the first corporation. Two corporations will also be affiliated if each is controlled by a group of persons and each member of each group is affiliated with at least one member of the other group. Thus, if a husband controlled corporation A and his wife controlled corporation B, the two corporations would be affiliated. If the husband controlled corporation A and husband and wife together controlled corporation B, the two corporations would be affiliated. If two husbands controlled corporation A and their two wives controlled corporation B, the two corporations would be affiliated.[6]

The affiliated corporation rules also deal with partnerships. A partnership and a majority interest partner will be affiliated. A corporation and a partnership will be affiliated if the corporation is controlled by a particular group of persons each of whom is affiliated with at least one member of a "majority interest group of partners" of the partnership and each member of that majority interest group is affiliated with at least one member of the particular group. A "majority interest group of partners" is defined to mean a group of persons each of whom has an interest in the partnership such that if one person held the interest of all members of the group, that person would be a majority interest partner and if any member of the group were not a member, the foregoing test would not be met. Two partnerships will be affiliated if the same

person is a majority interest partner of both partnerships, if a majority interest partner of one partnership is affiliated with each member of a majority interest group of partners of the other partnership or if each member of a majority interest group of partners of each partnership is affiliated with at least one member of a majority interest group of partners of the other partnership.

An example of the affiliated person rules involving partnerships that was considered by the CRA in a technical interpretation[7] is as follows. Two limited partnerships, Partnership No. 1 and Partnership No. 2, control Aco and Bco respectively. The general partner of each of the limited partners is Zco, which is controlled by the controlling shareholder of Xco. Under paragraph 251.1(1)(b), a corporation and the person who controls the corporation are affiliated persons. For purposes of section 251.1, control means *de facto* control. The CRA referred to the Supreme Court of Canada decision in *Vineland Quarries*[8], where the Supreme Court held that the word controlled "contemplates and includes such a relationship as, in fact, brings about control by virtue of majority voting power, no matter how that result is effected, that is, either directly or indirectly". The CRA therefore commented that where a partnership owns more than 50% of the issued voting shares of a corporation and where a particular partner is entitled, without restriction, to exercise more than 50% of the votes that may be cast a meeting of the partnership (e.g. a general partner), it is the CRA's view that that partner controls the corporation. Thus, Zco, the general partner of each of the two limited partnerships, its controlling shareholder, Xco, Aco and Bco are affiliated persons for purposes of section 251.1.

Three specific points should be noted regarding the affiliated persons definition. Two corporations must be affiliated directly with each other; unlike the "related person" rules, there is no rule which imputes affiliation where two corporations are otherwise unaffiliated to each other but affiliated with a common third corporation.[9] Secondly, the existence of rights to acquire shares described in paragraph 251(5)(b) of the Act is not expressly dealt with in the affiliated persons definition. However, subsection 256(8) provides that for purposes of determining whether, for the purpose of section 251.1, a corporation is controlled by any person or group of persons, where a taxpayer acquires such a right and it can reasonably be considered that one of the main purposes of the acquisition is to avoid the application of the affiliated person rules, the taxpayer is deemed to be in the same position in relation to control of the corporation as if the

right were immediate and absolute and as if the taxpayer had exercised the right at that time. Moreover, the existence of such rights might lead to a finding of *de facto* control.[10] Thirdly, unlike certain other rules in the Act[11], until the 2004 Federal Budget proposals were enacted in 2005, there were no specific rules for trusts that look through to the beneficiaries of the trust. A trust itself could, however, be an affiliated person under these rules (if, for instance, the trust controlled a corporation).[12] The situation regarding trusts under the former rules was somewhat unsatisfactory. As one commentator put it:

> "Clarity that would otherwise be established if the relationship of a trust for the purposes of an affiliated person were legislated has been left to a series of interpretations that has created a degree of uncertainty."[13]

The 2004 Federal Budget proposed amendments which were enacted in 2005 (the "2004 Budget Amendments") to the affiliated persons rules to deal specifically with trusts. In general terms, whereas the focus under the former rules was on the trustees, the new rules shift the focus to the beneficiaries of and the contributors to the trust. A number of new definitions were added to section 251.1. A "beneficiary" includes a person beneficially interested in the trust.[14] A "contributor" to a trust means a person who has at any time made a loan or transfer of property either directly or indirectly, in any manner whatever, to or for the benefit of the trust other than, if the person deals at arm's length with the trust at that time and is not immediately after that time a "majority-interest beneficiary" (see below) of the trust, (a) a loan made at a reasonable rate of interest; or (b) a transfer made for fair market value consideration. (The term contributor is also used in the rules relating to foreign trusts in proposed amendments to section 94 of the Act. Mercifully, the extensive rules relating to arm's length transfers in the proposed foreign trust rules are not replicated in the trust affiliation rules.) There is also a rule contained in subparagraph 251.1(4)(d)(ii) which provides that for purposes of determining whether a person is affiliated with a trust, the interest of a person in a trust as a beneficiary is disregarded in determining whether the person deals at arm's length with the trust if the person would, in the absence of the interest as a beneficiary, be considered to deal at arm's length with the trust.

A person is considered to be a "majority-interest beneficiary" if the fair market value of the person's interest, if any, in the income or capital of the trust together with the interest of all persons affiliated with that person exceeds 50% of the fair market value of all the interests as a

beneficiary in the income or capital of the trust. A "majority-interest group of beneficiaries" is defined to mean a group of beneficiaries such that if one person held the interests as a beneficiary of all the members of the group, that person would be a majority-interest beneficiary of the trust and if any member of the group were not a member, the foregoing test would not be met.

Paragraphs 251.1(4)(c) and (d) contain a number of subsidiary rules to support the foregoing definitions. Paragraph 251.1(4)(c) provides that for purposes of the rules and notwithstanding subsection 104(1), a reference to a trust does not include a reference to the trustee or other persons who own or control the trust property. This is the major departure from the former affiliated person rules. For purposes of determining whether a person is affiliated with the trust, paragraph 251.1(4)(d) also provides that:

(i) If the amount of income or capital that a person may receive as a beneficiary under a trust depends on the exercise of or failure to exercise a discretionary power, that discretionary power is deemed to have been fully exercised or not to have been exercised, as the case may be. According to the Technical Notes published with the draft legislation preceding the 2004 Budget Amendments, the effect of this rule is to maximize, for the purpose of determining whether a person is affiliated with a trust, the amount of income or capital a person may receive as a result of a discretionary power.

(ii) A trust is not considered to be a majority-interest beneficiary of another trust unless the trust has an interest as a beneficiary in the income or capital of the other trust. For instance, if the trust is affiliated with one or more persons who together have majority interests in either the income or capital of the other trust, the first trust will not be considered to be a majority interest beneficiary in the other trust unless it is itself a beneficiary of the other trust.

(iii) In determining whether a contributor to a trust is affiliated with a contributor to another trust, individuals connected by blood, marriage, common-law partnership

or adoption are deemed to be affiliated with one another. This is a significant expansion of the normal rules for affiliation of individuals as described above.

Taking the foregoing definitions and rules into account, a trust will be considered affiliated with a majority-interest beneficiary of the trust and persons who would otherwise be affiliated with such majority-interest beneficiary. Further, two trusts will be considered to be affiliated if a contributor to one of the trusts is affiliated with a contributor to the other trust and:

(i) a majority-interest beneficiary of one of the trusts is affiliated with a majority-interest beneficiary of the other trust,

(ii) a majority-interest beneficiary of one of the trusts is affiliated with each member of a majority-interest group of beneficiaries of the other trust, or

(iii) each member of a majority-interest group of beneficiaries of each of the trusts is affiliated with at least one member of a majority-interest group of beneficiaries of the other trust.

The December 6, 2004 Technical Notes point out that the trust affiliation rules are intended to compliment, rather than supplant, the general affiliation rules as they apply to trusts. A trust may therefore be affiliated with another person otherwise than under the new rules. For example, a trust will continue to be affiliated with a corporation that it controls.

B. DEPRECIABLE PROPERTY – SUBSECTION 13(21.2)

The stop loss rule for depreciable property is set forth in subsection 13(21.2) (which replaces the former subsection 85(5.1)). Subsection 13(21.2) applies where a person or partnership[15] disposes, subject to certain limited exceptions[16], of depreciable property of a prescribed class where both the capital cost of the transferred property and the proportionate amount of UCC (based on relative fair market value, as was the case with former subsection 85(5.1)) exceeds what would otherwise be the transferor's proceeds of disposition and on the 30th day after the disposition, the transferor or an affiliated person owns or has a right to acquire the transferred property (other than as security only). Thus, the transfer need not be directly to

the affiliated person, but an affiliated person must own the property on the 30th day after the disposition or have a right to acquire such property. If the foregoing circumstances obtain, for purposes of section 20 and the capital cost allowance rules, the transferor is deemed to have disposed of the property for proceeds equal to the lesser of its capital cost and the proportionate UCC. Where two or more properties of the same class are involved, ordering is permitted. The transferee is deemed for recapture purposes to have acquired the property at the transferor's capital cost but to have previously taken capital cost allowance equal to the excess of such capital cost over the fair market value of the property. Thus, implicitly the transferee is only entitled to claim capital cost allowance on the fair market value of the transferred property. This is a fundamental difference compared to former subsection 85(5.1) since no element of the accrued loss is transferred to the transferee.

A further and key difference from former subsection 85(5.1) is that the transferor is deemed to have acquired a notional property of the same prescribed class before the beginning of the taxation year (so as to avoid the half year rule on capital cost allowance) at a capital cost equal to the excess of the deemed proceeds of disposition over the fair market value of the transferred property. Thus, the transferor is entitled to claim capital cost allowance on this excess amount. The transferor is considered to continue to own this notional property until one of the events described below occurs, at which time the transferor would be entitled to claim a terminal loss if there are no other assets in the class.[17] The transferor will be deemed to continue to own the property until immediately before the earliest of the following:

(a) the commencement of a 30-day period throughout which neither the transferor nor an affiliate owns or has a right (other than as security) to the transferred property;

(b) the property is no longer used by the transferor or an affiliate for the purpose of earning income;

(c) a change of residence of the transferor (section 128.1) or the transferor becoming exempt from tax (subsection 149(10));

(d) the time immediately before an acquisition of control of the transferor (if it is a corporation); or

(e) the winding up of the transferor begins (other than a wind up under subsection 88(1) of the Act) where the transferor is a corporation.

Where a partnership would otherwise cease to exist, there is a rule deeming the partnership to continue to exist and all members to remain members until the earliest of the events described above.[18]

It is the CRA's view that the test in (a) above would be met where a transferor and transferee cease to be affiliated persons and are not affiliated for a period of 30 days. The transferor could then realize a terminal loss in a taxation year in which the transferor is no longer deemed to own the notional property by virtue of the transferor and transferee ceasing to be affiliated.[19, 20]

The CRA has expressed the view that subsection 13(21.2) would not apply with the disposition of property by a trust to a majority interest beneficiary, an affiliated person, where the trust is wound up within 30 days of the transfer. As a result of the wind-up, the majority interest beneficiary in the trust that would no longer be affiliated persons.[21]

Of particular note for the discussion of the acquisition of control rules and debt restructuring consideration which follow, the notional property will be considered by virtue of (d) above to have been disposed of immediately before an acquisition of control. Thus, any terminal loss on such disposition will be taken into account in the corporation's taxation year immediately before the acquisition of control, hence possibly increasing its non-capital loss for that year, which will then be subject to the streaming rules contained in subsection 111(5) discussed later.

Paragraphs 87(2)(g.3) and 88(1)(e.2) provide for carryover rules where the transferor is amalgamated or wound up pursuant to subsection 88(1). The rules in paragraph 87(2)(g.3) or

88(1)(e.2) as the case may be, provide for retention of the characteristics of the notional property on the reorganization and hence permit claims for capital cost allowance in respect thereof.[22]

A simple illustration of these rules would be helpful at this stage. Assume that the transferor corporation has an asset with a capital cost of $100,000, which is the only asset in a prescribed class with a UCC of $60,000 and which has a fair market value of $40,000. Under this rule, if the asset is transferred to a wholly-owned subsidiary (i.e. an affiliated person), the affiliate would have a deemed capital cost of $100,000, be deemed to have previously claimed capital cost allowance of $60,000 and would have a UCC of $40,000. The transferor would not realize a loss on the transfer since its deemed proceeds of disposition would equal the UCC of $60,000 and would have a notional depreciable property with a capital cost of $20,000 (being the excess of the lesser of the capital cost of $100,000 and the UCC of $60,000 over the fair market value of $40,000) which would then be added to the UCC of the same class. This $20,000 of UCC could be depreciated until, for instance, the subsidiary sells the asset to an unaffiliated person, at which point the transferor may claim a terminal loss and the subsidiary will report its disposition in the usual fashion. In this example, if the shares of the subsidiary were sold to an unaffiliated person, again the terminal loss would be triggered in the hands of the transferor and not the transferee. Thus, these rules prevent the selling of the accrued loss which would have been possible under former subsection 85(5.1).[23]

As one writer[24] points out, subsection 13(21.2) is particularly harsh where a non-resident corporation incorporates a Canadian branch. Since the accrued loss stays with the non-resident transferor, the loss will be effectively useless unless the subsidiary disposes of the property to an unaffiliated person (or otherwise generates a triggering event for purposes of subsection 13(21.2)) at a point where the non-resident parent has sufficient Canadian source income to utilize the loss or is able to carry the loss back, subject to the usual three year limitation, against income (if any) of the branch operation.

A recent technical interpretation considers the interaction of subsection 13(21.2) and Schedule III of the Regulations.[25] The example considered was one where a leasehold interest with a capital cost of $2,400, a lease term of 20 years and a fair market value at the beginning of year ten of $840 was transferred to an affiliated person. The technical interpretation indicates

that the annual CCA claim (based on the prorated portion of the capital cost of the property of $2,400) after the acquisition of the property by the affiliated person will be $218 (i.e. $2,400 divided by 11 years). As a result, the UCC of $840 to the affiliated person will be written off after four years, being the end of the 13th year of the lease. The reasoning for this is that subparagraph 13(21.2)(g)(i) of the Act deems the transferee to have a capital cost of the property that is equal to the amount that was the transferor's cost of the property. Pursuant to paragraph 1100(1)(b) of the Regulations and Schedule III, the capital cost of the property to the transferee is deemed to be incurred by the transferee at the time of the acquisition of the property since it is available for use at that time. The termination date of the lease is not changed for purposes of the Act, the Regulations or Schedule III. Subparagraph 13(21.2)(g)(ii) of the Act deems the difference between the capital cost of $2,400 and its fair market value of $840 to have been deducted by the transferee under paragraph 20(1)(a) and accordingly the transferee has a UCC equal to the purchase price of the property (assuming fair market value). Thus, it is possible that the remaining UCC of the leasehold interest may be claimed over a period that is less than the remaining lease term. From the point view of the transferor, the separate property which it is deemed to own will have a cost of $480, being the difference between the UCC at the end of year nine of $1,320 and the fair market value of $840. This separate property may be amortized over the remaining term of the lease at the rate of $44 per year (i.e. $480 divided by 11 years), unless one of the events described in paragraph 13(21.2)(e)(iii)(A) to (E) occurs before that time, in which the terminal loss will be available.

Subsection 13(21.2) does not totally preclude the transfer of accrued losses to unaffiliated parties, however, although the methodology differs somewhat from that utilized under former subsection 85(5.1). For instance, depreciable assets with an accrued loss could be transferred by sister corporation A to sister corporation B, triggering the application of subsection 13(21.2). The shares of corporation A could then be sold by the parent to an unaffiliated person, thereby potentially triggering a terminal loss in respect of the notional property that sister corporation A was deemed to have acquired pursuant to subsection 13(21.2). Assuming that the property in question constituted the only property of the prescribed class, this would generate a terminal loss which would generally increase the non-capital losses of corporation A prior to the acquisition of control by the unaffiliated person. Subject to the acquisition of control rules for non-capital losses in subsection 111(5) (see discussion below), these losses would be available for utilization

by corporation A after the acquisition of control.[26] As well, it would be possible to merge Corporation A with affiliated Corporation C such that the profits of the business of the former Corporation C are offset by the capital cost allowance taken on the notional asset sold by Corporation A.[27]

C. NON-DEPRECIABLE CAPITAL PROPERTY – SUBSECTIONS 40(3.3) TO (3.6)

The 1995 amendments repealed both paragraph 40(2)(e) and subsection 85(4) and in substitution, added subsections 40(3.3) to (3.6) to the Act. These rules are in many respects similar to those in subsection 13(21.2). Subsection 40(3.3) sets out the preconditions for subsection 40(3.4) to apply. Subsection 40(3.4) will apply where: (i) a corporation, trust or partnership disposes of a non-depreciable capital property (subject to certain limited exceptions[28]); (ii) during the 61-day period commencing 30 days before and ending 30 days after the disposition, the transferor or an affiliated person acquires the same or an identical property (the "substituted property"); and (iii) at the end of the period, the transferor or an affiliated person owns the substituted property. It will be noted that these rules differ somewhat from the depreciable property rules to take into account the potential for the non-depreciable capital property to be fungible (e.g. shares). Hence the reference to identical properties and the fact that the rules contemplate acquisition of the substituted property before the disposition of the loss property. As with subsection 13(21.2), the transfer need not be directly to the affiliated person; rather, the affiliated person must hold the substituted property at the end of the period.[29]

Where it applies, subsection 40(3.4) provides that the transferor's loss from the disposition is deemed to be nil and is held in suspense to be triggered immediately before the first of the following:

(i) the commencement of a 30 day period throughout which neither the transferor nor an affiliated person owns: (A) the substituted property, or (B) an identical property acquired in the 30 day period immediately prior to the commencement of the aforementioned 30 day period;

(ii) a change of residence of the transferor (section 128.1) or the transferor becoming tax exempt (subsection 149(10));

(iii) the time immediately before an acquisition of control of the transferor where the transferor is a corporation;

(iv) where the substituted property in question is a debt or share of a corporation, the bad debt rules in section 50 applying thereto so as to result in a deemed disposition of the property by the transferor or an affiliated person; or

(v) the beginning of the winding up of the transferor if the transferor is a corporation (other than a winding up under subsection 88(1)).

As with subsection 13(21.2), there is a deeming rule to keep partnerships in existence until the earliest of the events described above.

As with the rules for depreciable property, (i) above could be triggered either by a disposition of the transferred property or by a cessation of affiliation of the transferor and the affiliate holding the property. As well, on an acquisition of control of the transferor, the suspended capital loss will be deemed to be realized in the taxation year ending before the acquisition of control, thereby potentially being extinguished by virtue of subsection 111(4) of the Act discussed below, unless some steps are taken to utilize the loss in the year before the acquisition of control (such as an election under paragraph 111(4)(e)).

Since children are not affiliated with their parents, where a shareholder wholly owns Company A which owns shares of Company B which have declined in value and has Company A sell the Company B shares to a minor child of the shareholder, neither the stop loss rules nor the superficial loss rules (discussed below) would apply since the minor is not affiliated with Company A.[30]

Technically, subsections 40(3.3) and (3.4) apply to produce an anomalous result in the situation where a corporation purchases 100 shares of another corporation on January 1 and proceeds to sell 99 of such shares on January 25, incurring a capital loss of $1,000 on the sale. Since the corporation acquired the shares within the 30 day period preceding the sale and

continues to own one share, the stop-loss rule technically applies since subsection 40(3.3) only requires that the taxpayer acquire and continue to own an identical property. In this situation, the CRA is prepared to apply a formula in determining the loss that is denied as follows:

$$DL = \frac{\text{Least of S, P \& B}}{S} \times L$$

Where DL is the amount of the loss deemed to be nil;

S is the number of items disposed at that time;

P is the number of items bought in the 60 day period;

B is the number of items left at the end of the period; and

L is the loss on the disposition as otherwise determined.

Applying the formula, the denied loss would be 1/99 x $1,000 or $10.10, which is the same result that would occur if a taxpayer had bought and sold the 99 shares and then subsequently acquired a share. The CRA has the same administrative policy for superficial losses[31], but the policy does not apply for subsection 40(3.6) discussed below.[32]

One writer notes that the stop-loss rules may be advantageous in the context of capital dividend account planning for a private corporation[33] where a private corporation has capital assets with accrued gains and losses and is in the process of selling same to an arm's length party. The capital losses will be netted against capital gains for computation of the capital dividend account if the assets are sold at the same time. If, on the other hand, the loss assets are sold to an affiliated person, the losses would be suspended by the application of subsection 40(3.4) and would therefore be ignored in computation of the capital dividend account. A capital dividend could then be paid and the assets then sold to an arm's length party, thereby triggering the capital loss without reducing the amount of the capital dividend at the time the dividend is paid if the assets are held for more than 30 days. Apparently, the CRA objects to this sort of transaction.[34] The writer notes that a challenge of this provision under the general anti-avoidance rule ("GAAR") may be an issue to consider. However, if a commercial arrangement for such a deferral is present, this type of planning may be possible.[35]

Subsection 40(3.5) contains some further deeming rules for purposes of subsections 40(3.3) and (3.4) which again differ from the depreciable property rules in subsection 13(21.2) and which deal with changes to or the disappearance of the subject property. Subsection 40(3.5) provides that a right to acquire a property (e.g. an option) (other than as security) is deemed to be a property identical to the subject property. A share that is acquired in exchange for another share under certain rollover provisions (sections 51, 85.1, 86 or 87) is deemed under subsection 40(3.5) to be property identical to the exchanged share. Among the effects of this deeming rule is to ensure that a deferred loss is not inappropriately realized through a transaction under one of those sections. In this regard, the Explanatory Notes relating to the draft technical legislation issued by the Department of Finance on December 20, 2002 which was carried forward in revised draft legislation and Technical Notes issued by the Department of Finance on November 9, 2006 (the "November 9, 2006 Draft Legislation" and the "November 9, 2006 Technical Notes" respectively) gives the following example. Assume that a taxpayer who on Day 1 disposed of a share for proceeds that were less than the taxpayer's adjusted cost base of the share reacquired an identical share on Day 15. Under the stop-loss rules, the taxpayer's loss on the disposition will be deferred until, generally, neither the taxpayer nor an affiliated person owns such a share. If the taxpayer then exchanged that share for another, under for example an exchange under section 86 of the Act, it would be appropriate to continue to defer recognition of the deferred loss until that substituted share is disposed of. This is accomplished by treating the share acquired on the exchange as identical to the share given up.[36]

The November 9, 2006 Technical Notes point out, however, that paragraph 40(3.5)(b) can have an inappropriate effect where a taxpayer uses the share-for-share exchange rule in section 85.1 of the Act. Provided certain criteria are satisfied, that section permits a share-for-share exchange to take place on a tax-deferred basis, but it also allows the exchanging shareholder to realize a loss. A shareholder who chooses to do so may find that paragraph 40(3.5)(b) forces a deferral of that loss – even though the loss arises from the section 85.1 exchange itself, not from a previous disposition as in the above example. Accordingly paragraph 40(3.5)(b) is to be amended pursuant to Bill C-10 to deem a share that is acquired in exchange for another share under section 85.1 to be identical to that other share only if the loss in respect of the exchanged share is suspended at the time of the exchange by virtue of subsections 40(3.3)

and (3.4). This amendment will apply to dispositions occurring after April 26, 1995, subject to the original coming into force provisions relating to subsection 40(3.5).[37]

Where the transferred property is a share and after the disposition, the corporation that issued the share is merged (other than on a rollover as described above) or is wound up pursuant to subsection 88(1), the corporation formed on the merger or the parent (on a subsection 88(1) wind up) (the "transferee") is deemed by paragraph 40(3.5)(c) to own the share while it is affiliated with the transferor. Where the transferee is itself amalgamated pursuant to section 87 or wound up pursuant to subsection 88(1), the amalgamated corporation or the parent of the transferee, as the case may be, is deemed for this purpose to be the same corporation as, and a continuation of, the transferee by virtue of new paragraph 87(2)(g.4).

For instance, one CRA letter[38] deals with the situation where a public corporation ("Parentco") had a controlling interest in another public corporation ("Subco") with the remaining shares of Subco held by the public. The fair market value of the shares of Subco held by Parentco were less than the adjusted cost base. In order to take Subco private, Parentco incorporated a new corporation ("Newco") and transferred its Subco shares to Newco at fair market value thereby realizing a capital loss. Subco and Newco subsequently merged and on the merger, shares of the capital stock of Parentco were issued to the public (i.e. a triangular merger). The capital loss to Parentco on the disposition of the Subco shares was denied by subsection 40(3.4) of the Act on the basis that the merged corporation ("Mergeco") was deemed to continue to own the Subco shares by virtue of 40(3.5)(c) until such time as Parentco and Mergeco ceased to be affiliated.

The CRA has indicated that the deeming rule in paragraph 40(3.5)(c) must be taken into account in determining whether the transaction is one to which subsection 40(3.3) and (3.4) apply. Thus, a merger within 30 days after the transfer of the share would not result in subsections 40(3.3) and (3.4) not applying by virtue of the deeming rule in paragraph 40(3.5)(c).[39]

Similarly, paragraph 40(3.5)(d) provides that where the transferred property is a share and after the disposition it is redeemed, acquired or cancelled by the issuing corporation, the

transferor is deemed to own the share while the issuing corporation is affiliated with the transferor. Thus, in the typical scenario, there would have to be a cessation of affiliation in order for the loss to be realized. Paragraphs 87(2)(g.3) and 88(1)(e.2) provide for carryover rules where the transferor itself is amalgamated or wound up pursuant to subsection 88(1).

A more particular rule is contained in subsection 40(3.6) where a taxpayer disposes of a share (other than a distress preferred share) of an affiliated corporation to that corporation (e.g. a redemption, acquisition or cancellation of the share by the issuing corporation) which continues to be affiliated after the disposition. In this case, the loss is deemed to be nil and is added to the adjusted cost base of the transferor's remaining shares of the affiliated corporation. Therefore, not only is the loss denied, but it will not necessarily be completely triggered when the transferee corporation ceases to be affiliated with the transferor. For instance, if the transferor owned 100% of the shares of the acquiring corporation and certain of those shares were purchased for cancellation, any resulting loss would be added to the adjusted cost base of the remaining shares. If the transferor then sold 60% of the remaining shares to an arm's length party, only 60% of the loss would be realized even though the corporation would no longer be affiliated.

The situation can be even worse where after the disposition of the share to the corporation, the taxpayer remains affiliated but does not own any shares in the corporation. In this case, the loss is denied but there is no mechanism for the taxpayer to subsequently realize the loss. Apparently, the CRA and the Department of Finance are aware of this anomaly.[40]

The CRA has issued a number of interpretations dealing with subsection 40(3.6) in the context of estates having their shares purchased by a corporation. These interpretations are for the most part rendered irrelevant by the 2004 Budget Amendments relating to the affiliated persons rules dealing with trusts, but are still worth noting for situations prior to the effective date of the proposals regarding trusts. Where the executors of an estate are not affiliated with one another and the estate does not control the corporation, but the persons who are the executors constitute a related group controlling the corporation, the estate would not normally be affiliated with the corporation and subsection 40(3.6) would not apply.[41] If the estate did control the corporation, the estate and the corporation would be affiliated and subsection 40(3.6) would apply.[42] The CRA has also confirmed that where an estate has *de facto* control of a corporation,

it will be affiliated with the corporation for the purposes of subsection 40(3.6).[43] Where the estate has all of its shares redeemed and no single executor/trustee has *de facto* control over the corporation, the estate would ordinarily not be considered to be affiliated with the corporation after the redemption of all the corporation's shares held by the estate.[44]

Where an individual owns all of the voting common shares of the corporation and an *inter vivos* trust of which the individual is the sole trustee owns all of the non-voting preferred shares, if the corporation redeems some, but not all, of the preferred shares held by the trust, the loss will be denied under subsection 40(3.6), since the individual would be affiliated with the corporation by virtue of owning all of the voting shares and would be affiliated with himself as trustee of the trust. By virtue of being the trustee, the individual is the legal owner of the shares. Therefore, subsection 40(3.6) would apply.[45] Similarly, the CRA also considered the situation where an individual personally controlled a holding company which in turn controlled an operating company. An *inter vivos* trust held common and preferred shares of the operating company and the individual was the sole trustee of the trust. In the circumstance where the redemption of preferred shares held by the trust in the operating company would otherwise give rise to a deemed dividend and a capital loss, the capital loss will be denied since the individual will be affiliated with the holding company and the operating company by virtue of controlling the holding company. Further, the individual as sole trustee of the trust is the legal owner of the preferred and common shares of Opco held by the trust. Therefore, subsection 40(3.6) would apply to deny the capital loss to the trust.[46]

Prior to the 2004 Budget Amendments, the CRA also took the position that a corporation, all of the shares which are owned equally by four trusts with each trust having the same corporate trustee, would be affiliated with each trust for purposes of subsection 40(3.6) after the redemption of some or all of the shares held by only one trust.[47]

In a 1998 technical interpretation[48], the CRA expressed the view that paragraph 40(2)(g) and subsections 40(3.3) and (3.4) do not apply to a capital loss realized by a Canadian parent debtor on the repayment of a loan from a controlled foreign affiliate where the loss arose due to currency fluctuation. While the borrower and the controlled foreign affiliate would be affiliated for purposes of section 251.1, the loss would not arise from the disposition of a particular

property by the debtor since the loan is a liability and therefore not property of the debtor. Thus, the foreign exchange loss computed under subsection 39(2) is not caught by these stop-loss rules.

Where the capital loss is deemed to be nil by virtue of both subsection 40(3.6) and subsection 112(3), no amount is added to the cost base of the shares, since the capital loss otherwise determined without reference to paragraph 40(3.6) is still nil by virtue of subsection 112(3).[49]

D. ELIGIBLE CAPITAL PROPERTY

Normally, where a taxpayer ceases to carry on a business, paragraph 24(1)(a) permits the taxpayer to deduct the remaining balance in its cumulative eligible capital account in respect of that business. The stop-loss rules for eligible capital property are contained in subsections 14(12) and (13). These rules are very similar to subsections 40(3.3) and (3.4). Essentially, the terminal loss is denied to the transferor until a triggering event occurs (the triggering events being the same as for subsection 40(3.3)), whereupon the loss may be claimed by the transferor. As discussed above, paragraphs 87(2)(g.3) and 88(1)(e.2) provide for carryover rules where the transferor is amalgamated or wound up pursuant to subsection 88(1).

E. ACCRUED LOSS ON DEBT INSTRUMENTS

One stop-loss rule that remained untouched in the 1995 amendments was paragraph 40(2)(e.1), which provides that a transferor's loss from the disposition of an obligation of a debtor to a transferee is nil where the transferor, transferee and debtor are related to each other or would, if the rules in paragraph 80(2)(j) (which impute ownership by a partnership or trust to the members or beneficiaries thereof) applied, be related to each other. It is interesting that the proscribed group in this stop-loss rule continues to be based on the related persons concept rather than on the new affiliated persons concept. The loss is then added to the transferee's adjusted cost base of the obligation pursuant to paragraphs 53(1)(f.1) or (f.11). The CRA has indicated that paragraph 40(2)(e.1) would not apply to deny a loss in the context of a deemed disposition on death pursuant to subsection 70(5) of the Act.[50]

An interesting example of using a stop-loss rule to advantage is described in a CRA published advanced tax ruling, ATR-66, dated April 20, 1995. The Ruling describes a situation where Holdco owns all of the shares of Opco and holds a note receivable from Opco (the "Opco Note"). As a consequence of losses from its operations, Opco has non-capital loss carryforwards and the principal amount of the Opco Note held by Holdco is greater than its fair market value. Purchaseco wishes to acquire Opco so that it can access Opco's non-capital losses. It is therefore critical that in any dealing with the Opco Note, the debt forgiveness rules in section 80*ff* of the Act not apply so as to reduce Opco's non-capital losses.

The transactions were therefore structured in the following manner. Opco incorporated a new wholly-owned corporation, Subco. Holdco sold its Opco Note to Subco at fair market value in exchange for a note payable from Subco (the "Subco Note"). The loss realized by Holdco on this transaction is denied pursuant to paragraph 40(2)(e.1) and the amount of the denied loss is added to the adjusted cost base of the Opco Note in the hands of Subco pursuant to paragraph 53(1)(f.1) so that the adjusted cost base equals the principal amount of the Opco Note. Subco is then wound up into Opco under subsection 88(1) of the Act and Opco elects pursuant to subsection 80.01(4) of the Act so that the Opco Note is deemed to have been settled or extinguished for its cost amount (i.e. the principal amount) so no debt forgiveness occurs. As a consequence of the winding up, Opco now owes Holdco an amount equal to the principal amount of the Subco Note. Holdco then sells its shares and the new Opco Note to Purchaseco for fair market value and Purchaseco amalgamates with Opco.

The results of the transaction are that while Holdco is denied a capital loss on its Opco Note, no forgiveness of debt occurs in the hands of Opco and its non-capital losses will be available to Purchaseco post-acquisition, subject to the streaming rules in subsection 111(5) described in more detail later in this paper. The CRA confirmed that the general anti-avoidance rule would not apply in the circumstances since no doubling up of losses occurred. This is an example of the sort of debt restructuring which can be utilized to optimize the taxpayer's situation in terms of both the loss utilization rules and the debt forgiveness rules.

F. ADVENTURES IN THE NATURE OF TRADE

New stop-loss rules were introduced by the 1995 amendments in subsections 18(14) to (16) for accrued losses on inventory of a business that is an adventure or concern in the nature of trade which are similar to subsections 40(3.3) and (3.4). The rules apply where the transferor transfers such a property, the disposition is not one of certain deemed dispositions[51],[52] during the 61 day period commencing 30 days before the disposition, the transferor or an affiliate acquires a property that is or is identical to the transferred property (a "substituted property"), and at the end of the period, the transferor or an affiliate owns the substituted property. In such a case, the transferor's loss is deemed to be nil and held in suspense until the earliest of certain events, being the same events as described in subsection 40(3.4) (except the reference in subsection 40(3.4) to section 50 is deleted as it would be inapplicable to inventory property in any event). Again, a right to acquire a property (other than held for security only) is deemed to be an identical property.[53]

A similar rule, subsection 18(13), has been in the Act for property held in a money lending business for some time.

G. SUPERFICIAL LOSSES

Subparagraph 40(2)(g)(i) of the Act provides that a taxpayer's "superficial loss" is deemed to be nil. The definition of superficial loss was significantly reworked in the 1995 amendments. Firstly, the definition was conformed to the other stop-loss rules through the use of the "affiliated person" concept. Superficial loss is defined in section 54 of the Act to be a loss of a taxpayer from the disposition of property, subject to certain limited exceptions, where the same or identical property (the "substituted property") was acquired during the 61 day period commencing 30 days prior to the disposition by the taxpayer or an affiliated person and at the end of the period, the taxpayer, or an affiliated person owned or had a right to acquire the substituted property.

Secondly, the definition was changed by adding paragraphs (f) to (h) to the list of exceptions to the definition. The exceptions, as a result, are as follows:

"(c) a disposition deemed by paragraph 33.1(11)(a), subsection 45(1), section 48 as it read in its application before 1993, section 50 or 70, subsection 104(4), section 128.1, paragraph 132.2(1)(f), subsection 138(11.3) or 142.5(2), paragraph 142.6(1)(b) or subsection 144(4.1) or (4.2) or 149(10) to have been made,

(d) the expiry of an option,

(e) a disposition to which paragraph 40(2)(e.1) applies,

(f) a disposition by a corporation the control of which was acquired by a person or group of persons within 30 days after the disposition,

(g) a disposition by a person that, within 30 days after the disposition, became or ceased to be exempt from tax under this Part on its taxable income, or

(h) a disposition to which subsection 40(3.4) or 69(5) applies,"

Bill C-10 proposes to amend paragraph (c) of the definition of superficial loss to read as follows:

> "A disposition deemed by paragraph 33.1(11)(a), subsection 45(1), section 50 or 70, subsection 104(40), section 128.1, paragraph 132.2(3)(a) or (c), subsection 138(11.3) or 142.5(2), paragraph 142.6(1)(b) or subsection 144(4.1) or (4.2) or 149(10) to have been made,".

The revisions to the definition are significant in that dispositions of the types listed in (c) to (g) above would not trigger the application of the stop-loss rules in subsections 13(21.2) or 40.(3.4) described above. The definition now also provides that a right to acquire a property (other than as security only) is deemed to be an identical property. The November 9, 2006 Draft Legislation proposes that as a consequence of the proposed restructuring of section 132.2 of the Act, the reference in paragraph (c) of the definition to paragraph 132.2(1)(f) be replaced by references to paragraphs 132.2(3)(a) and (c) with respect to dispositions occurring after 1998.

The amount of the denied loss is added to the adjusted cost base of the substituted property. Thus, the accrued loss is in effect transferred to the transferee. This leads to a well publicized strategy whereby shares with accrued losses can be transferred to one's spouse at fair market value, with an election to have subsection 73(1) not apply. If the transferee spouse holds the property for 30 days, the denied loss is added to the transferee spouse's adjusted cost base. Thus, the transferee spouse may subsequently realize the loss, without the attribution rules applying, on a subsequent arm's length transfer of the share.[54] (Care must be taken that the

attribution rules in sections 74.1 and 74.2 of the Act do not apply; therefore, the transfer must be at fair market value and the spouse must use his or her own funds to acquire the property.) A further variation on this theme would be, for example, where a husband sells shares of a particular corporation in an arm's length transaction on the open market at a loss and immediately thereafter his wife purchases the same number of shares on the open market. If the wife then sells the shares a short period of time following the expiration of 30 days after the sale by the husband, the superficial loss denied to the husband would be realized by the wife.[55]

For an interesting example of a flawed attempt to exploit the superficial loss rules, see *Graphic Packaging Canada Corporation v. HMTQ*.[56]

H. DIVIDENDS

Subsections 112(3) and following contain a series of stop-loss rules reducing a taxpayer's loss on the disposition of a share in certain circumstances by the amount of dividends previously received on the share. These rules were extensively revised contemporaneously with the other stop-loss rules, but it is beyond the scope of this paper to discuss them.[57]

III. UTILIZATION AND PRESERVATION OF LOSSES WITH AN AFFILIATED CORPORATE GROUP

It is a frequent occurrence within a corporate group that some corporations in the group are in a taxable position while others are incurring or have incurred losses. Obviously, from an overall corporate treasury point of view, it is inefficient to have one or more corporations in a group paying taxes when there are loss carryforwards lying fallow within the group.

Prior to the 1995 amendments which introduced the current version of the stop loss rules and the definition of "affiliated persons", the CRA's administrative practice, based on its understanding of the scheme of the Act (including in particular subsection 69(11) and subsections 111(4) to (5.4)), permitted a variety of loss utilization techniques within a related group of corporations. With the passage of the 1995 amendments, including amendments to subsection 69(11) of the Act to deny rollover treatment on certain transfers to persons with whom the transferor is not affiliated, rather than not related as under the former law, the CRA announced in 1996 that it was altering its position on loss consolidation within a corporate group

so that only loss transfers amongst affiliated, rather than related, corporations would be permitted. Accordingly, a series of transactions that results in the transfer of the benefit of losses from one corporation to another corporation with which it is not affiliated would be considered to be subject to the general anti-avoidance rule.[58] The CRA noted that many loss transfers would be unaffected by the change since many corporations that are related will also be affiliated under section 251.1. As previously discussed, probably the most significant difference between the affiliated persons rules and the related persons rules is that children are related but not affiliated with their parents and siblings are related but not affiliated with each other. This must be borne in mind when effecting loss consolidation transactions within a closely held group of companies where estate freezing arrangements have been put in place to introduce children as shareholders.

The 1995 amendments to subsection 69(11) introduced a modified definition of "affiliated persons" in that the definition of control in subsection 251.1(3), which defines control to be *de facto* control, is excluded. Accordingly, the writer understands that the CRA uses the concept of *de jure* control in determining whether corporations are affiliated in applying this administrative position.[59]

A. DIVIDENDS

1. Amalgamations[60]

Amalgamations are an obvious and useful technique for loss utilization within an affiliated corporate group. Generally speaking, the Act provides for rollover treatment at both the corporate level and the shareholder level and an amalgamation is relatively straightforward from a corporate and commercial law point of view.

The rules regarding loss carryovers are set forth in subsection 87(2.1) of the Act. Subsection 87(2.1) provides that the amalgamated corporation is deemed to be the same corporation as, and a continuation of, each predecessor corporation for purposes of determining the amalgamated corporation's non-capital loss, net capital loss, restricted farm loss, farm loss and limited partnership loss and in determining the extent to which the acquisition of control rules in subsection 111(4) to (5.4) apply to restrict the deductibility by the amalgamated corporation of such losses. Subsection 87(2.1) does not, however, affect the determination of the

fiscal period or income of the amalgamated corporation or any of its predecessors or the taxable income or tax payable of any predecessor corporation. Thus, the amalgamated corporation succeeds to the position of the predecessors with respect to loss carryforwards and may therefore use the loss carryforwards of the predecessors, subject to the usual temporal and acquisition of control restrictions. On the other hand, subject to the discussion regarding subsection 87(2.11) below, losses of the amalgamated corporation may not be carried back to reduce the taxable income or tax payable of the predecessor corporations.

A significant and quite helpful exception to this latter rule is contained in subsection 87(2.11) of the Act, which provides that where there is an amalgamation of a corporation and one or more of its subsidiary wholly-owned corporations, the amalgamated corporation is deemed, for a variety of provisions, including the loss carryover rules, to be the same corporation as, and a continuation of, the parent corporation. The effect of this rule is that post-amalgamation losses, which prior to the enactment of subsection 87(2.11) could not be carried back against income of the predecessor corporations, may now be carried back against the taxable income of the parent corporation, subject to the usual three year carryback restriction. This rule was enacted to bring the rules on amalgamations more closely into line with those for the winding up of a wholly-owned subsidiary under subsection 88(1).[61]

As a planning point, therefore, if an amalgamation is contemplated, steps should be taken prior to the amalgamation to fit within the confines of subsection 87(2.11). For instance, where Corporation A has two wholly-owned subsidiary corporations, Profitco and Lossco, and wishes to amalgamate the two corporations, it would be prudent prior to amalgamation to transfer the shares of Lossco to Profitco on a section 85 rollover basis so that Lossco becomes a wholly-owned subsidiary of Profitco. Thereupon, the amalgamation would take place and subsection 87(2.11) should be applicable. While there may be some anti-avoidance concerns at first blush[62], this same result could be achieved by transferring the shares of Lossco to Profitco and then winding up Lossco under subsection 88(1). Therefore, the concern would not appear in the writer's estimation to be great.

On the other hand, while subsection 87(2.11) has effected a certain degree of liberalization, care must be taken in applying this provision to specific circumstances. In a 1998

technical interpretation[63], the CRA considered the application of subsection 87(2.11) in two particular fact situations. The first situation involved the amalgamation of three corporations: Aco, Bco and Cco where Bco was wholly-owned by Aco and Cco was wholly-owned by Bco. For the taxation year ending on the amalgamation, Aco and Bco had taxable incomes and in the first taxation year of the amalgamated corporation, a non-capital loss of $125 was incurred. The CRA expressed the view that the non-capital loss of Amalco was available to reduce the taxable income of Aco as the parent corporation of the group, but was not available to reduce the taxable income of Bco notwithstanding that it was in a sense the parent of Cco. The CRA's position was that under subsection 87(2.11), both Bco and Cco were subsidiary wholly-owned corporations of Aco and therefore the amalgamated corporation was deemed to be a continuation of Aco only for purposes of applying section 111.

The second example considered was one where two sister corporations, Xco and Yco, and their respective wholly-owned subsidiaries, Subco 1 and Subco 2, were amalgamated. The CRA's view was that subsection 87(2.11) would not apply as the amalgamation involved two sister corporations and their respective wholly-owned corporations.

In each of the above cases, the desired result could have been obtained through a multiplicity of amalgamations and possibly windings up, although the resulting number of deemed year ends might in certain cases defeat the scheme.[64]

One important issue which arises with respect to amalgamations is the choice of date of amalgamation. Generally, within an affiliated corporate group, all corporations tend to have the same taxation and financial year to facilitate financial statement consolidation. Paragraph 87(2)(a) provides that the fiscal years of the predecessor corporations are deemed to end immediately before the amalgamation. In paragraph 9 of *Interpretation Bulletin IT-474R*, the CRA takes the position that absent a specific time being specified in the certificate of amalgamation (which neither the *Canada Business Corporations Act* or the *Business Corporations Act* (Ontario) contemplate), an amalgamation is deemed to take place at the earliest point on the day on which the articles of amalgamation become effective. Accordingly, if two corporations having October 31 year ends are to be amalgamated and it is desired not to have a short fiscal year, the effective date of the amalgamation should be November 1.

Generally, it is preferable not to have a short fiscal year for the predecessor corporations because this will shorten the carryforward period for non-capital losses since the short year will still be treated as a full taxation year for those purposes. Nevertheless, there are some situations in which an immediate amalgamation may be considered useful notwithstanding that a short fiscal period may result.[65]

One other provision contained in the 1995 amendments deserves mention. Subsection 87(11), like subsection 87(2.11), represents an attempt to bring the amalgamation rules more closely into line with the rules on the wind up of a wholly-owned subsidiary under subsection 88(1) of the Act. Subsection 87(11) applies where there is an amalgamation of a parent and one or more subsidiary wholly-owned corporations of the parent. One effect of the provision is to allow a "bump" in the adjusted cost base of certain non-depreciable capital property of the subsidiary in the hands of the amalgamated corporation, similar to the bump available on the wind up of a subsidiary. Another significant aspect of the rule is that whereas generally amalgamations provide for a rollover at the shareholder level, the wind up rules contemplate that in certain cases[66], a capital gain could result to the parent on the disposition of shares of the subsidiary. Subsection 87(11) imports this rule as well and therefore if there is to be an amalgamation of a parent with a loss subsidiary, as a due diligence matter, an investigation should be made to ensure that no capital gain will result on the amalgamation.[67]

One further issue which must be considered on an amalgamation or a subsection 88(1) wind up is whether property, such as depreciable property, will retain its character on the merger, particularly property with an accrued loss. While the Supreme Court of Canada decisions in *Mara Properties* and *Hickman Motors*[68] were both decided in favour of the taxpayer, those decisions are arguably confined to their own facts and leave open the question as to the circumstances in which property retains its character on such a merger. Probably of more unequivocal assistance to taxpayers are the Supreme Court of Canada decisions in the *Continental Bank* cases.[69]

In considering an amalgamation of affiliated corporations, capital tax issues should be considered carefully although they are often overlooked. While the federal large corporations

tax has now been repealed, provincial capital taxes rely on financial statement values and an amalgamation can, in some cases, result in an alteration of those values, an amalgamation may result in a substantially greater liability for provincial capital tax.[70] Generally, no sales tax issues arise on an amalgamation.

2. Winding Up under Subsection 88(1) of the Act

Where a wholly-owned subsidiary is wound up into its parent corporation, a rollover at the corporate level and, in most cases at the shareholder level[71], is generally available. Also, as mentioned above, it is possible in certain cases to increase the tax cost of certain non-depreciable capital property on the winding up.

With respect to loss utilization, subsection 88(1.1) provides that where such a winding up occurs, for purposes of computing the taxable income and tax payable under Part I and Part IV of the parent for any taxation year commencing after the commencement of the winding up, the non-capital loss, restricted farm loss, farm loss or limited partnership loss of the subsidiary, to the extent not previously deducted by the subsidiary and which would have been deductible in computing the taxable income of the subsidiary for any taxation year beginning after the commencement of the winding up on the assumption that it had sufficient income for such year, will be deemed, for the taxation year of the parent in which the subsidiary's loss year ended, to be a non-capital loss, restricted farm loss, farm loss or limited partnership loss of the parent. Such losses of the subsidiary are not, however, deductible by the parent in computing its taxable income for any taxation year that commenced before the commencement of the winding up (i.e. the passing of the requisite shareholders' resolution authorizing the wind up). Subsection 88(1.2) provides essentially similar rules for net capital losses of the subsidiary.

Generally speaking, where the parent and subsidiary have the same year end, and the subsidiary is wound up at or near the year end, the results on a winding up in terms of the timing of utilization of loss carryforwards are identical to that on amalgamations. However, where the parent and the subsidiary have different year ends, the utilization of losses may be somewhat delayed, since the parent may only utilize losses in taxation years of the parent commencing after the commencement of the winding up.[72]

Paragraph 88(1.1)(f) provides that any loss of a subsidiary which is deemed by the foregoing rules to be a loss of the parent for a taxation year beginning after the commencement of the winding up may be treated, if the parent so elects in its income tax return for the particular taxation year, as a loss of the parent for its immediately preceding taxation year for purposes of computing the parent's taxable income for taxation years beginning after the commencement of the winding up. This provision is of assistance in accelerating by one year the utilization of the subsidiary's loss for the year in which the subsidiary is wound up.

As with amalgamations, the capital tax (as well as the sales tax) implications of windings up must be considered carefully.[73]

B. OTHER TECHNIQUES TO USE AND PRESERVE LOSSES WITHIN AN AFFILIATED CORPORATE GROUP

Set forth below is a description of a number of techniques not involving statutory corporate reorganizations whereby losses can be used or preserved within an affiliated corporate group. As mentioned above, the CRA is generally indulgent with respect to loss utilization techniques within an affiliated (formerly related) corporate group. Nevertheless, a degree of caution is in order. To a significant degree, this is an area where taxpayers are relying on administrative concessions from the CRA[74] and an update of the CRA's position on these issues is always warranted. The CRA's more aggressive use of the general anti-avoidance rule and the impact of recent case law must be thoroughly considered in the context of each fact situation.

At the Canadian Tax Foundation's Annual Conference in September, 2003, during the CRA/Practitioner Round Table, CRA officials confirmed that transferring losses within an affiliated corporate group continued to be acceptable and that the CRA will continue to entertain ruling requests regarding such transactions. It was suggested that in such ruling requests, a variety of information be contained, such as a summary of losses and incomes of members of the affiliated group for each year in question; the period of time the members had been affiliated; and a summary of the planned application of the losses to specific years. Further, the transactions entered into to achieve a loss consolidation should make some sense on a commercial level and rulings will not be given if the amounts or time frames are blatantly

artificial. The CRA official mentioned that the quickest route to demonstrate commercial reality was to obtain a commitment letter from a financial institution.[75]

1. Transfer Profitable Business to Lossco

Rather than using a formal corporate combination such as an amalgamation or winding up, a common loss utilization technique is to transfer the assets of a profitable business on a tax free basis to an affiliated loss corporation utilizing the provisions of subsection 85(1) of the Act and thereafter having the loss corporation carry on the business and earn the profits therefrom which may be sheltered by the non-capital loss carryforwards in the loss corporation[76, 77]

In transactions of this sort, it is essential, in order to avoid any challenge to the substance of the arrangement, that the transfer of the business to the subsidiary be legally effective and properly documented, so as to avoid any suggestion that the transaction is ineffective or that the loss subsidiary is merely a trustee or agent for the transferor corporation. As well, the commercial aspects of such a transaction should be considered, particularly where the loss corporation has significant actual or contingent liabilities.[78]

2. Rollover of Appreciated Assets to Loss Corporation and Subsequent Taxable Sale by Loss Corporation

Another method of utilizing loss carryforwards is to transfer an asset which has appreciated in value on a tax free basis pursuant to section 85(1) of the Act to the loss corporation in exchange for shares of the loss corporation. The loss corporation would then proceed to sell the asset to an arm's length third party thereby triggering a gain which may be sheltered by the non-capital or net capital losses of the loss corporation. (In all these types of transactions, the GST, retail sales tax and land transfer tax issues relating to each transfer should be considered carefully.)

In *Information Circular 88-2*, which deals with the general anti-avoidance rule, the CRA deals with this type of transaction and points out that there are specific anti-avoidance rules (subsection 69(11) to (13)) which restrict this type of transaction in the case of unrelated corporations. The CRA's historic view has been that since those specific provisions are confined

to unrelated corporations, the general anti-avoidance rule should not be applied in the context of a transaction involving related corporations and hence the transaction would be permissible. In light of the 1995 amendment to subsection 69(11) discussed above, this historic position is continued but modified to apply to affiliated corporations rather than related corporations.[79]

Formerly, a further issue with respect to this type of transaction was the tax treatment of any dividend of the net proceeds from the sale of the property by the loss corporation back to its parent or the transferor (leaving aside any corporate solvency issues). Since the loss corporation would not likely have any "safe income", a dividend of the net proceeds back to the parent or transferor could have been recharacterized as proceeds of disposition pursuant to subsection 55(2). That is, since the dividend would arguably have been received as part of a series of transactions involving the disposition of property to an unrelated person (the third party purchaser), the exception to subsection 55(2) in paragraph 55(3)(a) would not under the former rules have applied. These difficulties were alleviated, however, by the 1995 amendments to section 55. That is, paragraph 55(3)(a) now does not apply where, as part of the series of transactions including the dividend to which subsection 55(2) potentially might apply, there is a disposition of property to an unrelated person or partnership, provided the property is disposed of for proceeds that are not less than fair market value.[80]

A further concern where capital property of the transferor is sold by the loss corporation shortly after its acquisition is whether the CRA might seek to recharacterize the property as inventory rather than capital property in the hands of the loss corporation. The CRA has indicated administratively that it would not do so.[81] This position does not seem to have been affected by the Supreme Court of Canada decisions in *Mara Properties* and *Hickman Motors* which, while decided in favour of the taxpayers, still leave open the possibility of recharacterization in certain cases.[82] Moreover, the *Continental Bank Leasing* decision of the Supreme Court of Canada provides further strong support for the continuation of the CRA's administrative position.[83]

These types of transactions do not necessarily require that the asset be sold outside the group. For instance, in CRA Letter No. 2004-0098561R3 dated January 26, 2005 and 2005-0155451R3 January 11, 2006, Parentco transferred depreciable industrial property to its loss

subsidiary on a tax deferred basis to enable the subsidiary to earn income from the sale of the output of those assets and approximately one year later, Parentco repurchased the same assets at fair market value creating income from recapture which would be sheltered by non-capital losses and expiring tax credits of the subsidiary.

3. Techniques to Reduce Lossco's Interest Expense or to Generate Interest Income for Lossco

There are a variety of techniques available to utilize losses within an affiliated corporate group through the use of appropriate financing arrangements. The following are some simple examples:

1. Profitable parent has a loss subsidiary which carries on a business which needs additional capital. Additional bank borrowings by the subsidiary would exacerbate the subsidiary's loss position. Accordingly, the parent could borrow from the bank and subscribe for additional common shares of the subsidiary. The resultant interest charges would reduce the parent's income and the cash infusion would hopefully generate profits in the loss subsidiary.[84]

2. Profitable parent corporation has a wholly-owned subsidiary with non-capital losses. Parent borrows from the bank and uses the money to subscribe for common shares of the subsidiary. The subsidiary lends these monies to the parent at a commercial rate of interest. The parent uses the funds to repay the bank. As a result, the parent has deductible interest charges to reduce its taxable income and the subsidiary has interest income which will enable it to utilize its non-capital loss carryforwards.[85, 86]

3. Profitable parent corporation has a loss subsidiary with existing borrowings. Parent borrows from the bank and subscribes for shares of the loss corporation which uses the funds to pay its bank debt thereby reducing its interest expense and increasing the interest expense of the parent corporation.

Where the loss corporation is the parent in the group, for instance, similar arrangements can be undertaken in effect to transfer the parent's losses to a newly formed subsidiary in the group and subsequently merge the subsidiary with a another profitable subsidiary in the group. To take a simple example, parent has non-capital losses and a profitable subsidiary. Parent incorporates two new subsidiaries, Lossco and Shareco. Parent borrows money on a daylight loan basis within its borrowing capacity at an arm's length commercial rate from a financial institution. Parent lends the proceeds to Lossco, with the loan being payable on demand and bearing interest at a commercial market rate applicable to loans to Parent. Lossco uses the proceeds to subscribe for preferred shares in Shareco, which will carry a cumulative dividend rate and will enable Lossco to realize a profit on these investment activities. Shareco uses the proceeds received to make a demand interest free loan to Parent, who then uses the proceeds to repay the daylight loan. Lossco will accumulate losses since it will have interest expense and tax free dividend income. Parent will make contributions of capital to Shareco from time to time to fund the dividends payable by Shareco. After an appropriate passage of time, the process will be reversed and Lossco will then be merged with the profitable subsidiary in the group so that the losses "manufactured" in Lossco and siphoned off from Parent may be utilized by the profitable subsidiary.[87, 88]

Generally, the CRA is comfortable with these types of transactions from an anti-avoidance point of view, although it does require that the share subscription not exceed the amount that an arm's length borrower would have been prepared to lend to the loss subsidiary.[89] In the *CRB Logging* case[90], the CRA was not prepared to sanction interest deductibility where the funds were borrowed to subscribe for preferred shares on the basis that there was no realistic expectation of dividend income on the preferred shares. With arrangements of this sort, it is always wise to confirm that the proposed transaction is within the scope of the CRA's administrative policy. The recent Supreme Court of Canada decisions in *Singleton*[91] and *Ludco*[92] should generally be of assistance to taxpayers in justifying interest deductibility in this and other areas although in a *Singleton*-like situation, the taxpayer was unsuccessful in the recent 2006 Tax Court of Canada decision in *Lipson*[93] on the basis of the application of the GAAR.[94]

The CRA had indicated in a recent advance income tax ruling that while tax loss consolidation within an affiliated group is generally permissible, the refreshing of a loss

company's loss through a mechanism which resulted in a profitable affiliated company incurring interest expense which exceeded the profitable company's taxable income, hence creating a non-capital loss in the profitable corporation, was not permissible. The reason for this position was that such a transaction would effectively allow the losses of the loss corporation to be refreshed in a manner which extends the original seven (now twenty) year loss carryforward period. The CRA considered this to be an abuse of the temporal restrictions on loss carryforwards in section 111 of the Act. As one author pointed out, the restriction against a loss consolidation arrangement creating a loss in a profitable company would also preclude the profitable company from carrying back a loss "transfer" from the loss corporation against income of the profitable corporation for prior years. The policy rationale for this latter result is not clear.[95] Subsequently, the CRA clarified its position in *Income Tax Technical News No. 25* dated October 30, 2002 which states in part as follows:

> "Loss-consolidation transactions involving a "Lossco" lending at interest to an affiliated "Profitco" that subscribes for preferred shares of Lossco (or a subsidiary of Lossco) will not necessarily be considered to result in an abuse, within the meaning of subsection 245(4), merely because the interest deduction results in a non-capital loss in Profitco. In particular, the CRA would not ordinarily consider an abuse to result solely because the non-capital loss so created is carried back to a previous taxation year of Profitco in accordance with section 111. Furthermore, the CRA would not ordinarily consider an abuse to result solely because the non-capital loss so created has a carryforward period that extends beyond the original carryforward period for Lossco's losses, provided that it is deducted within the original carryforward period. Losses may be considered to be "refreshed" in a loss-consolidation transaction in which Lossco transfers depreciable property, on which there is unrealized recapture, to affiliated Profitco, thereby allowing Lossco to deduct losses before they expire and Profitco to acquire the depreciables at an increased undepreciated capital cost. However, such a transaction would not ordinarily be considered to result in an abuse solely because it avoids the expiry of a non-capital loss, since the loss is deducted against income (the recapture) that arose in the original loss carryforward period. It should be noted, of course, that a loss-consolidation transaction that seeks to circumvent other loss-limitation rules, such as those in subsection 111(5), could be considered to result in a misuse or an abuse."[96, 97]

The CRA commented further on corporate loss utilization transactions in *Income Tax Technical News No. 30* dated May 21, 2004 as follows:

> "A basic element of corporate tax planning is not to have one member of a corporate group pay income taxes while another is in a loss position.

Transactions are undertaken to transfer income or deductions in order to avoid this result. While this issue cannot be regarded as new, it is useful to be reminded of the dos and don'ts regarding this topic.

QUESTION 1

What are the basic parameters of loss utilization transactions, and what is the basis in law for these?

RESPONSE 1

As a starting point, all transactions that are undertaken must be legally effective and otherwise comply with the technical provisions of the *Income Tax Act*. Beyond this, the only technical concern is the application of the General Anti-Avoidance Rule, and particularly subsection 245(4), that is, is there a misuse or abuse. As noted in the Department of Finance's explanatory notes for the GAAR, the transfer of income or deductions within an affiliated group of corporations would not ordinarily fall within the scope of section 245 since they usually are not considered to result in a misuse or abuse.

There is a scheme to the Act, evidenced by certain provisions, including subsections 69(11) and 111(4) to 111(5.2), that restrict the claims by corporations for losses, deductions or credits incurred by a non-affiliated corporation. However, these limitations do not apply to transactions between affiliated corporations. In addition, several other provisions of the Act, notably the stop-loss provisions, prevent the recognition of losses on transactions undertaken within a corporate group. From this we can conclude that there is a scheme to the Act recognizing and accepting certain transactions between affiliated corporations as being undertaken by the same corporate group.

QUESTION 2

Can you provide us with a general summary of the corporate loss utilization framework?

RESPONSE 2

In general terms, we look at these transactions as a means of achieving a consolidated tax position for the group. Most of the information we require when considering a ruling request for a loss utilization transaction relates to this.

QUESTION 3

So what information would you be looking for in particular with regard to a loss consolidation ruling?

RESPONSE 3

We will ask for three things:

1. an explicit summary of accumulated losses and taxable incomes for all relevant years for all relevant corporations and the period of time for which these corporations have been or are expected to be affiliated;

2. an analysis of any loss carrybacks to be undertaken by a formerly profitable corporation; and

3. an analysis of the possibility of losses being refreshed beyond the 7 year carryforward limit.

QUESTION 4

There is some uncertainty in the tax community as to the continuing validity of comments in example 5 of Supplement 1 of the GAAR Information Circular 88-2. In particular, the example makes reference to borrowings in a loss consolidation transaction not exceeding what a corporation could reasonably be expected to borrow for use in its business on the basis solely of its credit form an arm's length lender. Can you clarify the CCRA's current view on this?

RESPONSE 4

As noted earlier, loss consolidation transactions must be legally effective. The decisions of the Supreme Court of Canada, notably in *Shell*, reinforce this concept. However, we would not feel comfortable providing a ruling on a loss consolidation transaction that contemplates dollar amounts and time frames that are blatantly artificial. Thus, in order to be provided with a ruling, we must be able to satisfy ourselves that the transactions are plausible, and the quickest way for us to obtain such assurance is through a commitment letter.

QUESTION 5

Another area of uncertainty relates to the *C.R.B. Logging* case. To refresh people's memories of this, the facts involved the indirect acquisition by a subsidiary or dividend paying preferred shares of the parent. The court ruled that there was no independent source of income from which the parent could fund the dividends, and thus the interest deductibility provisions were not met, and so the deduction for the interest was disallowed. What is the CCRA's current view on this type of situation for loss consolidation purposes?

RESPONSE 5

While we have not reached the point where we would state that *CRB Logging* is no longer good law, we have provided rulings on some upstream shareholding situations. The key criteria to be met in such situations is the existence of other assets in the parent company that can generate sufficient income to pay the dividends on the preferred shares held by the subsidiary."[98]

The shifting of interest expense is also a useful technique to utilize losses or take advantage of differential tax rates in an international context. For instance, a bank borrowing by a foreign parent to subscribe for shares in a Canadian loss subsidiary which then uses the subscription proceeds to pay down its Canadian bank debt will have the effect of shifting income from the foreign parent to the Canadian subsidiary by creating interest expense in the foreign parent and reducing the Canadian subsidiary's interest expense. In the reverse situation, a profitable Canadian subsidiary could borrow funds and distribute same to a foreign parent in a loss position which would then use the proceeds to pay down bank debt. The distribution by the Canadian subsidiary would preferably be by way of a return of capital (subject to any thin capitalization concern which the structure might generate), but could be done by way of dividends, although in the latter case, withholding tax would be a cost of the arrangement since the foreign parent would likely not obtain a foreign tax credit if it is in a loss position.

4. Sale of Assets by Loss Corporation in Exchange for Interest Bearing Debt

Another method of generating income in a loss corporation is for the loss corporation to sell assets (even if such assets have not appreciated) to a profitable corporation within the group and take back interest bearing debt in respect of the purchase price. The interest payments (and capital cost allowance if the asset is depreciable property) should generally be deductible to the profitable corporation and would be included in the income of the loss corporation thus permitting utilization of some of the loss corporation's loss carryforwards.[99]

It should be noted, however, that where the transferred asset is depreciable property on which the loss corporation has realized a capital gain, the transferee will not obtain a full write up of the asset to fair market value but rather the cost will, in general terms, be the cost to the loss corporation plus one-half of the loss corporation's capital gain by virtue of paragraph 13(7)(e). Obviously, the gain on the sale (in addition to the interest income) will utilize losses of the loss corporation.

5. Inter-Company Charges

Where a corporation is in a loss position, it is always useful to review inter-company charges within the affiliated group to determine if charges to the loss corporation may legitimately be reduced or charges by the loss corporation may legitimately be increased. Consideration could also be given to transferring management personnel to the loss corporation and then providing such management personnel to other corporations in the group for a management fee which marks up their services on a reasonable basis. Again, care should be taken to properly document these transactions and ensure that they have appropriate substance.[100]

6. Lease Assets to Affiliated Corporations

If it can be demonstrated that the projected rental income will exceed the capital cost allowance and other expenses from so doing, consideration should be given to having the loss corporation acquire assets and lease same to other corporations in the group.[101]

7. Taxable Preferred Share Financing

To the extent the loss corporation is able to obtain financing from third parties, the loss corporation could raise funds by issuing taxable preferred shares and using the funds to generate income in some fashion (e.g. lending the funds to other corporations in the group). While the loss corporation would potentially be subject to tax under Part VI.1 of the Act, generally, the first $500,000 of dividends on taxable preferred shares would not be subject to the tax. Moreover, the tax liability could be shifted to a related corporation pursuant to section 191.3 of the Act. If the related corporation is sufficiently profitable, the liability for Part VI.1 tax will generate a corresponding deduction in computing taxable income for Part I purposes pursuant to paragraph 110(1)(k) thereby potentially eliminating the effect of Part VI.1 tax for the group. (Care must be taken, however, that the effective tax rate under Part I of the transferee corporation is sufficiently high. The deduction under paragraph 110(1)(k) is presently nine-fourths of the Part VI.1 tax liability and accordingly, if the effective tax rate of the transferee corporation is less than 44.44%, a full recovery of the tax will not be available. This would occur, for instance, if the transferee corporation was eligible for the manufacturing and processing tax rate.) The November 9, 2006 Draft Legislation proposes, however, to change the 9/4ths multiple in paragraph 110(1)(k) to 3 for the 2003 and subsequent taxation years in light of recent and planned reductions in income tax rates in the Act.

8. Self Help

In addition to transactions with other corporations in the affiliated group, there are a number of methods whereby the loss corporation may on its own improve its tax position.

a. Sell Assets to Third Parties

An obvious technique for loss utilization would be to sell assets which have an accrued gain to arm’s length third parties thereby generating income or taxable capital gains to offset losses which may be on the verge of expiring.

b. Capitalize Interest under Section 21

Rather than deduct interest expense which will then be subject to the twenty year non-capital loss carryforward limitation, consideration should be given to capitalizing such interest under section 21 to the extent permissible. Section 21 would apply where, for instance, the taxpayer has borrowed money to acquire depreciable property.[102]

c. Apply Losses Against Part IV Tax

If non-capital losses are on the verge of expiring, as a last resort, consideration should be given to applying such non-capital losses to reduce Part IV tax. In computing the base on which Part IV tax is levied, a corporation is entitled to deduct non-capital losses if it so chooses in accordance with the usual carryover rules. Generally, one would not choose to use non-capital losses in this manner since they will be reducing a tax which is refundable in any event and which is levied at the rate of only 33-1/3% as compared to the normal corporate rates of approximately 36% in Ontario.

d. Non Use of Discretionary Deductions

Where a taxpayer is not in a taxable position, generally speaking, discretionary deductions, such as claims for capital cost allowance, eligible capital property and scientific research, should not be taken, particularly in the case of capital cost allowance classes which have a relatively rapid write-off. Similarly, while the Act permits a five year reserve on the disposition of capital property pursuant to paragraph 40(1)(a)(iii) and a three year reserve in respect of property sold in the course of a business which generates ordinary income (paragraph 20(1)(n)), a taxpayer with non-capital losses in danger of expiring may choose not to claim such reserves in order to recognize a sufficient amount of income to utilize the potentially expiring losses.

As well, the Act contains a number of so called “rolling reserves”, i.e. where the taxpayer claims a reserve in year 1, is required to include in year 2 the amount of the reserve claimed in year 1 and may then proceed to claim a fresh reserve for year 2. These reserves are generally discretionary and accordingly, if losses are in danger of expiring, a taxpayer could decline to

claim the reserve in a particular year, have the prior year's reserve come into income which will offset about to expire non-capital losses. Assuming the claim for reserves was constant over the period in question, this would have the effect of increasing in the taxpayer's income in the year in which the reserve was not taken and decreasing the taxpayer's income in the year in which the reserve was reinstated.

In addition, the CRA has issued *Information Circular 84-1* dealing with revision of capital cost allowance claims and other permissive deductions. Generally, where a revision is requested for a loss year, the request will be allowed provided there is no change in the tax payable for that year or any other year filed, including statute barred years, for which the time has expired for filing a notice of objection. Therefore, in situations where losses are about to expire, consideration should be given to refiling prior years' tax returns to reverse claims for capital cost allowance and other permissive deductions.

9. Use of Partnerships

Rather than transfer a business to a loss corporation, another possibility would be to create a partnership between the profitable corporation presently carrying on the business and the loss corporation. There may be a variety of commercial reasons why such an arrangement might be preferable to having the loss corporation acquire the business. In order for the loss corporation to have an appropriate share of the profits of the partnership, it will be necessary for the loss corporation to make an adequate financial contribution to the partnership and it will be necessary to find a method to achieve this. For instance, a dividend from an affiliated corporation could provide the proceeds for the loss corporation to invest in the partnership.

A number of points with respect to this type of arrangement should be noted. Firstly, the loss corporation will not obtain the benefit of the full income of the partnership as it would have if the business had been transferred to the loss corporation directly. Generally, care must be taken that the partnership arrangements are adequately documented and legally effective so that the transaction is effective for tax purposes.[103] Finally, care should be taken that the profit sharing ratio is justifiable so as to avoid a reallocation by the CRA pursuant to subsection 103(1.1) of the Act.[104]

An alternative to transferring appreciated property to the loss corporation under section 85 and having the loss corporation resell it, would be to establish a partnership between the owner of the property and the loss corporation for this purpose. This type of transaction is problematic not only for the reasons set forth above, but also because it runs the risk of not meeting the definition of partnership (i.e. two or more persons carrying on business in common with a view to profit). The transaction is also vulnerable if the partnership is set up for only a short period of time[105], although the *Continental Bank* decisions are of considerable assistance in this regard.

A recent case which addressed some of these issues is *West Topaz Property Ltd.*, a 2005 decision of the Tax Court of Canada, which was affirmed earlier this year by the Federal Court of Appeal.[106, 107] In that case, there was a partnership consisting of two corporations one of whom was West Topaz as to a 99% interest. The partnership was in the business of selling and managing real estate assets. It was anticipated that the partnership would sell a partnership asset (an apartment building) and realize a significant gain on the disposition. Prior to the sale of the apartment building, Woodwards, which had significant non-capital losses, became a member of the partnership. The partnership agreement was amended so that Woodwards' interest was tied to the sale of the apartment building in that 80% of the profit from the sale of the apartment building would be attributable to Woodwards, with the intention that Woodwards would use its non-capital loss to shelter the gain attributable to the sale of the apartment building. Shortly after the sale of the apartment building, Woodwards withdrew from the partnership by transferring its partnership to West Topaz for nominal consideration. Woodwards received approximately $550,000 to participate in this transaction and the two original corporate partners saved an excess of $2,000,000 in tax. The Tax Court applied section 103 to reallocate the income received by the partnership. In the course of the Court's decision, GAAR was also considered. The Court noted that GAAR was a provision of last resort and however far reaching section 245 may be, it does not confer discretionary powers on the Minister either in the decision to apply it or in the dermination of its consequences. As to the interrelation between section 103 and the GAAR, the Court observed that where a specific anti-avoidance provision (i.e. section 103) covers the transaction but does not in the Minister's view provide a remedy that the Minister considers sufficient, section 245 is not to be used to top up the more specific remedy the Minister believes

to be inadequate. In other words, GAAR is ousted by a specific anti-avoidance provisions in the Act.

10. Keeping the Group Affiliated but Allowing Outsiders Access to the Group's Losses

The foregoing discussion of utilization of losses within an affiliated group has implicitly assumed no change in the composition of the group. It is possible to introduce new shareholders into a loss corporation without necessarily triggering an acquisition of control of the loss corporation. To use a simple example, a parent corporation may have a wholly-owned loss subsidiary carrying on a particular business. An arm's length corporation which carries on a profitable business within the same industry might see the advantages of transferring its business on a section 85 rollover basis to the loss subsidiary in exchange for a minority interest in the loss corporation, the thought being that the combination of the two businesses would produce a synergy which would produce greater profits overall and utilize the existing losses in the loss corporation. Ostensibly, there is no acquisition of control, particularly if there is no shareholders agreement which gives extraordinary rights to the minority shareholder.

Care must be taken in this type of arrangement to ensure that the minority shareholder does not have its rollover denied pursuant to subsection 69(11) of the Act. Subsection 69(11) denies rollover treatment where the minority shareholder in the above example disposes of property for proceeds of disposition of less than fair market value (e.g. on a section 85 rollover), it can reasonably be considered that one of the main purposes of the series of transactions is to utilize the tax losses of the loss corporation, which was unaffiliated with the minority shareholder immediately before the series of transactions began, and arrangements for the subsequent disposition of any property so transferred to the loss corporation are made within three years of the acquisition by the loss corporation. This is a particularly significant issue with respect to inventory transferred for less than fair market value. Where a service industry is involved, there is more scope for avoiding this provision.

Moreover, while it should be possible to structure such an arrangement so that there is no acquisition of control, the CRA will not necessarily concede the issue. For instance, paragraph 7 and 8 of Interpretation Bulletin IT-302R3 read as follows:

> "7. A person may acquire a minority interest in a loss corporation by purchasing shares from one or more shareholders of the corporation and, usually, an acquisition of control will not occur. However, in cases involving the acquisition of a minority interest, all the circumstances must be examined. For example, the type of corporation (private, public, closely held), who previously controlled the corporation, the number or percentage of shares acquired, the method of acquisition (purchase of existing shares, transfer upon death, the issuing of treasury shares, purchase pursuant to a purchase/sale agreement, etc.), communities of interest, actions in concert and so on would be examined to determine whether control has been acquired. When shares are acquired, even by a minority shareholder, following negotiations involving the controlling shareholder or shareholders, it may sometimes be in order to presume that a group or a new group has acquired control of the corporation. For example, in the case of a small, private corporation with substantial losses, it would be unusual for a person to acquire a minority interest without obtaining certain guarantees from the majority shareholders and without acting pursuant to a prearranged plan (which suggests a common interest and action in concert). It is therefore natural to assume that the arrival of this new shareholder will trigger an acquisition of control by a new group of which he or she is part.
>
> Similarly, in the case of public corporations or when the group of shareholders is large, it may be in order to presume that control has not been acquired unless the new shareholder and the former controlling group clearly act in concert.
>
> 8. The same situation prevails when several shareholders act in concert to control a corporation and one of them sells his or her shares to the others. However, before concluding that a group acted in concert and that control has been acquired by the new smaller group, all the circumstances will be examined, including the number and the percentage of shares traded. The objective of the acquisition of control rules is to limit the transfer of losses in an acquisition of control situation. When the group of shareholders diminishes and includes only members of an initially larger group, there generally should be no acquisition of control for the purposes of the rules governing transfer of losses."

Generally, however, a person seeking access to another person's tax losses will not be inclined to accept a minority position without any meaningful protections, particularly where the loss corporation is dormant and a substantial business is being infused into the corporation by the third party.[108]

Obviously, situations involving what is tantamount to a "disguised" acquisition of control are fraught with peril. The recent spate of tax avoidance cases, the majority of which predate the enactment of the general anti-avoidance rule, indicate the CRA's concern and vigilance for "improper" utilization of tax losses. The holding in the first appellate GAAR decision (*OSFC Holdings* discussed in more detail below) that there is a general policy in the Act against the transfer of losses between arm's length parties only heightens the concerns with these types of transactions.

The most significant case in this area is *Duha Printers*[109] discussed in more detail below, where a complicated tax loss utilization scheme in which the taxpayers sought to avoid a technical acquisition of control of a corporation, having previously been struck down by the Federal Court of Appeal, on a review of all of the relevant documentation, was upheld by the Supreme Court of Canada. While the *Duha Printers* case is perhaps of some encouragement to tax planners, it must be borne in mind that it is a pre-GAAR case and therefore of limited definitive assistance for current tax planning. The tension that this case creates between hopefulness and anxiety for tax planners is perhaps best illustrated by the following two comments:

> "Obviously, the tax planning in the *Duha* case can only be described as aggressive. A consideration of the apparent facts would undoubtedly cause many tax practitioners a high degree of anxiety. In assessing the decision of the Supreme Court, it is necessary however to remember that the Supreme court was not asked to decide whether or not the relationships between Marr's and the Duha's was other than that which it legally appeared to be. Consequently, the case becomes entirely legal in nature and, on a careful reading, does not represent a significant departure from the existing law. Assuming that Marr's was truly the shareholder owning a majority of the voting power, the directors that it selected were unfettered in the discharge of their corporate responsibilities. There is no reason to believe that this analysis would not prevail in a case decided under GAAR.
>
> However, what cannot be predicted for the future is whether a mere finding that a Marr's type shareholder acquired *de jure* control would be sufficient to sustain the tax planning. It is entirely possible that a well-instructed court would conclude that, notwithstanding the acquisition of *de jure* control, the tax planning should not survive the invocation of GAAR. In this light, Linden JA's judgment may prove to be in advance of its time. His understanding of both the requirements of tax policy and the business fundamentals may suggest the way in which similar issues are approached in the post-GAAR world."[110]

> "Nevertheless, the decision leaves us somewhat uncomfortable. Our concern arises from the almost complete lack of substance in the transactions and the fact that, on the evidence, it is clear that the Duha family never relinquished control.
>
> The *Duha* case relates to taxation years that preceded the introduction of the general anti-avoidance rule (GAAR), and it is interesting to speculate whether the case would have been decided differently had the GAAR been available. For this purpose, the transactions considered in *Duha* would have been "avoidance transactions" because they were undertaken solely for the purpose of obtaining a tax benefit. Accordingly, the determination of whether the GAAR would apply would depend on the "abuse" or "misuse" test in subsection 245(4).
>
> Although the "object and spirit" of the acquisition-of-control rules is clearly to prevent loss trading between unrelated parties, it is difficult to see how a transaction that did not result in an acquisition of control under the *de facto* control test clearly set out by Mr. Justice Iacobucci in the *Duha* case could be considered to be a "misuse" of the acquisition-of-control rules or an "abuse" having regard to the provisions of the Act, other than the GAAR, read as a whole. The *Duha* case establishes that *de jure* control is to be determined only by reference to the constating documents of the relevant corporation, and it is difficult to see how the GAAR could be used to effectively override this clear statement of the law."[111]

Taxpayers who embark into this murky area must exercise extreme caution. As one writer puts it:

> "Given the CRA's hostile approach to extra group tax planning, prudent advisers should take pains to think through all potential technical weaknesses in a proposal and encourage the parties to add significant non-tax business substance to the transactions to assist in defending an assessment based on GAAR. All of the technical requirements inherent in each provision of the Act that is being relied upon to support the plan must be carefully followed. All specific anti-avoidance provisions must be identified and dealt with. The transactions must be carefully documented and the commercial relationships established by the documents must be consistently followed by the parties in actual practice....
>
> Taxpayers contemplating extra group transactions to access losses and other tax shield of unrelated corporations should expect audit scrutiny from the CRA and should guide themselves accordingly. Planning and implementation must be thoughtful and meticulous. The audit trail should be limited to the transaction documents and there should be limited, if any, retention of planning memoranda, meeting notes, and like materials. Taxpayers' document retention should be kept to a minimum, and advisers should conduct themselves so as to protect the solicitor-client privilege and generally to expect the likelihood of audit and possible litigation."[112]

Among the particular statutory provisions which should be considered would be subsection 69(11), the collateralized preferred share rules in section 112(2.4)*ff*, subsection 256(8) and most importantly, the general anti-avoidance rule itself.

In 2002, a CRA official stated:

> "Finance policy and CRA policy has always been to accept in-house loss utilizations. The qualifications are that the loss utilization transactions must be legally effective and they must meet the specific provisions of the Act…. One point that I would like to make on loss utilizations in general is that in-house loss utilizations are fine. Selling losses outside the corporate group is not acceptable *and we will use all the tools available to us to not allow loss utilization outside the corporate group. We're pretty serious about that.*" [*Emphasis added.]*[113]

At the CRA Round Table at the 2005 Canadian Tax Foundation Annual Conference, the CRA was asked whether restrictions in the Act regarding the use of losses applied to the sale of tax losses where *de facto* and not *de jure* control is acquired (e.g. 45% of votes) but substantially all the value of the loss company is acquired by a profitable company. The CRA's response was that matters to be considered included, as per *Duha Printers*, was "effective control" acquired; was the acquiror acting in concert with other shareholders so that a group or the acquirer itself acquired *de jure* control; and finally, do any of the various specific anti-avoidance provisions referred to above (256(8), 69(11), 112(2.4), etc.) apply. In addition, the CRA commented that the general anti-avoidance rule could apply consistent with the policy against trading in non-capital losses established in *OSFC Holdings* by the Federal Court of Appeal.[114]

11. CRA's Views on Provincial Loss Consolidation Issues

At the 2005 CRA Round Table referred to above, the CRA was also asked if it was concerned about provincial taxation implications of loss consolidation. The CRA responded that loss consolidation may affect provincial revenues and accordingly ruling requests on loss consolidation proposals must contain an analysis of the provincial tax implications of the proposed transactions. Further, issued loss consolidation rulings will provide no comfort as to the application of the GAAR of the affected provinces, although the CRA indicated that it was not aware of any instances where a province sought to apply a provincial GAAR to loss

consolidation transactions on which the CRA had ruled favourably. The CRA indicated that it does consult with provincial tax authorities before issuing loss consolidation rulings where the loss consolidation materially affects a province with which it has a tax collection agreement. If the impact on a province with which the Federal government has a tax collection agreement is minimal or if the ruling affects the province with which the Federal government has not entered into a tax collection agreement, the CRA will normally not consult prior to issuing the ruling but will forward a copy of the issued ruling to the affected province. The CRA cautioned that when a loss consolidation transaction affects a province with which the Federal government does not have a tax collection agreement, it may be advisable for the taxpayers to obtain a provincial ruling. The CRA further indicated that a working group is being created to review transactions that affect provincial tax bases, including loss consolidation. The CRA did not directly respond to a question as to whether it has taken steps to cause provinces with which it has tax collection agreements not to apply provincial GAAR provisions where the CRA has issued a favour loss consolidation ruling.[115]

C. TRANSFERRING LOSSES OUTSIDE THE GROUP, THE GENERAL ANTI-AVOIDANCE RULE AND THE COURTS: A BRIEF NOTE

The foregoing discussion has dealt with loss utilization techniques within an affiliated group of corporations. While there have been a number of cases dealing with arm's length tax loss transfers in the context of the predecessors to subsection 13(21.2) and subsections 40(3.3) to (3.6)[116] in a pre-general anti-avoidance rule context, it is only recently that the interplay between arm's length tax loss utilization schemes and the GAAR has been considered by appellate courts. In this regard, the most significant recent decisions on arm's length tax loss transfers are the Federal Court of Appeal decisions in *OSFC Holdings Ltd. v. HMTQ*[117] and *Water's Edge Village Estates (Phase II) Ltd. v. HMTQ*[118], which follows closely the reasons in the *OSFC Holdings* case. More recent still are the October, 2005 decisions of the Supreme Court of Canada in *The Queen v. Canada Trustco Mortgage Company*[119] and *Mathew v. The Queen*,[120] which extensively analyzed how generally the GAAR should be applied.

1. The GAAR in A Nutshell

A brief summary of the GAAR is perhaps appropriate. Subsection 245(1) of the Act defines a "tax benefit" as essentially a reduction, avoidance or deferral of tax under the Act. The 2004 Budget Amendments amended the definition of tax benefit to clarify that a tax benefit includes a reduction, avoidance or deferral of tax that would be payable under the Act but for a tax treaty. This amendment applies with respect to transactions entered into after September 12, 1988. Subsection 245(3) defines an "avoidance transaction" as basically any transaction that is part of a series of transactions which series, but for the GAAR, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for *bona fide* purposes other than to obtain the tax benefit. Subsection 245(2) sets out the basic rule, namely, that where a transaction is an avoidance transaction, the tax consequences to a person shall be determined as is reasonable in the circumstances in order to deny a tax benefit that, but for the GAAR, would result, directly or indirectly, from that transaction or a series of transactions that include that transaction. Subsection 245(4) then provides that subsection 245(2) does not apply to a transaction where it may reasonably be considered that the transaction would not result directly or indirectly in a "misuse" of the provisions of the Act or an "abuse" having regard to the provisions of the Act, other than the GAAR read as a whole. The 2004 Budget Amendments also amended subsection 245(4) with effect for transactions entered into after September 12, 1988 to clarify that the GAAR applies to a misuse or abuse of the provisions, not only of the Act, but also of the *Income Tax Regulations*, *Income Tax Application Rules*, a tax treaty or any other enactment that is relevant in computing tax or other amounts payable or refundable under the Act.

2. OSFC Holdings

The *OSFC Holdings* case is the first appellate decision to consider the GAAR. The facts in *OSFC Holdings* are not overly complex. In 1991, the Ontario Court of Justice ordered that Standard Trust Company ("Standard") be wound up as it had become insolvent. As a means of utilizing its tax losses, Standard incorporated a subsidiary, formed a partnership with the subsidiary and transferred a portfolio of non-performing mortgages to the partnership. As a consequence, Standard held a 99% interest in the partnership. By virtue of the provisions of subsection 18(13) of the Act as it then read, the partnership obtained an ACB in the mortgage

portfolio which was considerably in excess of the fair market value of the portfolio. Standard then sold its partnership interest to OSFC Holdings in an arm's length transaction. OSFC Holdings then syndicated its interest in the partnership through another partnership, units in which were purchased by various investors by pre-arrangement (members of a firm of tax lawyers). This left OSFC Holdings with a 24% interest in the second partnership. OSFC Holdings claimed non-capital losses as a consequence of some of the mortgages being sold and the remainder being written down to fair market value. The Minister reassessed on the basis of GAAR and the Minister's assessment was upheld by the Tax Court of Canada. OSFC Holdings thereupon appealed to the Federal Court of Appeal, which also dismissed the taxpayer's appeal.

The first issue was whether there had been a tax benefit in the circumstances. This was admitted by both parties. Secondly, was there a series of transactions and if so, which transactions were part of the series? The Court followed a line of UK case law and held that in order for there to be a series, each transaction must be pre-ordained to produce a final result. That is, when the first transaction is implemented, all of the essential features of the subsequent transactions are determined by persons who have the firm intention and ability to implement them so that there is no practical likelihood that the subsequent transactions will not take place. The Court also considered the provisions of subsection 248(10) of the Act, which provides that a series is deemed to include any related transactions or events completed in contemplation of the series. The Court held that in order for subsection 248(10) to apply, there must be: (a) an actual common loss series; (b) a transaction related to that series; and (c) completion of the related transaction in contemplation of the series (which contemplation need not be prospective). On the particular facts, the Court held that the formation of the subsidiary, formation of the partnership and transfer of the mortgage portfolio to the partnership by Standard all constituted an actual series. The sale by Standard of its partnership interest to OSFC Holdings was not pre-ordained and hence not part of the actual common law series, but was related to the series and completed in contemplation of the series and therefore deemed to be part of the series by virtue of subsection 248(10).

The Court then considered whether a tax benefit resulted from the series. The Court noted the significant tax losses that were realized by OSFC Holdings and held that this tax

benefit was part of the series and in particular held that the person who obtains a tax benefit need not necessarily have been the person who undertook or arranged the transactions in question.

The Court then considered what the primary purpose of the transactions in the series was. It held that all steps in the series must be analyzed and concluded that the sale of the partnership interest to OSFC Holdings contained both business and tax benefits, but the dominant purpose was to obtain the tax benefit, given in particular the large tax benefits flowing therefrom. Thus, there was an avoidance transaction and *prima facie*, the GAAR should apply.

The Court then went on to consider whether the taxpayer was excused from the application of the GAAR by virtue of subsection 245(4) referred to above. With respect to the question of whether the transactions in question constituted a "misuse" of the Act, the Court held that what constitutes a misuse depends upon the object and spirit of the particular provision under scrutiny (i.e. subsection 18(13) as it then read). The Court held that subsection 18(13) did not deal with transactions between arm's length parties and therefore there had not been any misuse of that provision.

With respect to the question of "abuse", it was necessary to look at the provision of the Act, other than the GAAR, read as a whole. It was then necessary to identify and invoke a tax policy in order to override the words of the statute itself. Since this process involves overriding the provisions of the Act, the Court stated that the policy to be applied must be clear and ambiguous. The Court then went on to hold that there was a general tax policy against the transfer of losses between arm's length parties. Applying that policy to the facts in question, the Court held that the losses originated with Standard and were used by an arm's length party, OSFC Holdings, and hence there had been an abuse of the Act and the GAAR did apply.

Leave to appeal to the Supreme Court of Canada was denied on June 20, 2002. The fact situation in *OSFC Holdings* in effect did come before the Supreme Court of Canada in that *Kaulius v. The Queen*,[121] the companion Supreme Court of Canada decision to *Canada Trustco* (discussed below), involved a number of individual partners in the same partnership as OSFC. The individual taxpayers did not fare any better at the Supreme Court of Canada level than did OSFC at the Federal Court of Appeal as their appeal was dismissed.

The *Water's Edge*[122] case involved a somewhat different set of facts but was essentially another arm's length utilization scheme. The Federal Court of Appeal applied the reasoning in *OSFC Holdings* to the facts in *Water's Edge* and concluded that the GAAR should apply.

3. The GAAR and the Supreme Court of Canada – *Canada Trustco*

The 2005 *Canada Trustco*[123] case involved a so-called leveraged lease transaction. Without delving into the facts in any detail, the issue was whether capital cost allowance deducted by Canada Trustco was inappropriate in the circumstances. The Supreme Court of Canada took the opportunity to engage in an extensive conceptual discussion of the GAAR. This discussion in fact takes up a majority of the reasons for judgment. While endorsing the *OSFC Holdings* analysis with respect to what constitutes a series of transactions both at common law and under subsection 248(10), the Supreme Court of Canada appears to give an even broader scope to subsection 248(10) than did the Federal Court of Appeal in *OSFC Holdings*. At paragraph 26 of the Reasons for Judgment, the Court stated:

> "…this occurs where the parties to the transaction "knew of the …. series, such that it could be said they took it into account when deciding to complete the transaction'. We would elaborate that "in contemplation" is read not in the sense of actual knowledge but in the broader sense of "because of" or "in relation to" the series. The phrase can be applied to events either before or after the basic avoidance transaction found under s.245(3)."[124]

The Court also rejected the Federal Court of Appeal's approach to subsection 245(4) involving separate analyses of the "misuse" and "abuse" concepts. The Court held that there was really one test of whether there was "abusive tax avoidance".[125] In considering whether there was abusive tax avoidance, the Court rejected analysis based on considerations of tax policy and instead stated that subsection 245(4) requires a "single unified approach to the textual, contextual and purposive interpretation of the specific provisions of the *Income Tax Act* that are relied upon by the taxpayer in order to determine whether there was abusive tax avoidance".[126] The Court then suggests a two-step process to determine if there was abusive tax avoidance as follows:

> "The first task is to interpret the provisions giving rise to the tax benefit to determine their object, spirit and purpose. The next task is to determine whether

the transaction falls within or frustrates that purpose. The overall inquiry thus involves a mixed question of fact and law…"[127]

In summary, the Supreme Court of Canada set out its analytical framework for the GAAR as follows:

"1. Three requirements must be established to permit application of the GAAR:

(1) A *tax benefit resulting from a transaction* or part of a series of transactions (s.245(1) and (2));

(2) That the transaction is an *avoidance transaction* in the sense that it cannot be said to have been reasonably undertaken or arranged primarily for a *bona fide* purpose other than to obtain a tax benefit; and

(3) That there was *abusive tax avoidance* in the sense that it cannot be reasonably concluded that a tax benefit would be consistent with the object, spirit or purpose of the provisions relied upon by the taxpayer.

2. The burden is on the taxpayer to refute (1) and (2), and on the Minister to establish (3).

3. If the existence of abusive tax avoidance is unclear, the benefit of the doubt goes to the taxpayer.

4. The courts proceed by conducting a unified textual, contextual and purposive analysis of the provisions giving rise to the tax benefit in order to determine why they were put in place and why the benefit was conferred. The goal is to arrive at a purposive interpretation that is harmonious with the provisions of the Act that confer the tax benefit, read in the context of the whole Act.

5. Whether the transactions were motivated by any economic, commercial, family or other non-tax purpose may form part of the factual context that the courts may consider in the analysis of abusive tax avoidance allegations under s.245(4). However, any finding in this respect would form only one part of the underlying facts of a case, and would be insufficient by itself to establish abusive tax avoidance. The central issue is the proper interpretation of the relevant provisions in light of their context and purpose.

6. Abusive tax avoidance may be found where the relationships and transactions as expressed in the relevant documentation lack a proper basis relative to the object, spirit or purpose of the provisions that are purported

to confer the tax benefit, or where they are wholly dissimilar to the relationships or transactions that are contemplated by the provisions.

7. Where the Tax Court has proceeded on a proper construction of the provisions of the Income Tax Act and on findings supported by the evidence, appellate tribunals should not interfere, absent a palpable and overriding error."[128]

While the methodology set out by the Supreme Court of Canada differed from that of the Federal Court of Appeal in *OFSC Holdings*, the Supreme Court did not dispute the findings in *OFSC Holdings* relative to there being a general policy against arm's length tax loss transfers.

4. Profitco Transactions

Rather than sell a loss corporation with all of the attendant difficulties, some transactions have proceeded on the basis of in effect a transfer of a "profitco"; that is, a corporation stripped of its operations so that it has nothing but a tax liability and a co-equal amount of cash. The buyer acquires the shares of the corporation for in effect a negotiated fee and proceeds to transfer the entitlement to tax deductions to the profitco to eliminate the tax liability and permit extraction of the cash. While these types of transactions raise avoidance issues in their own right, it is interesting that the recent case of *VIH Logging Ltd.*,[129] which dealt primarily with subsection 55(2) and safe income calculations, did not make any adverse comments about the series of transactions which did involve a "profitco" type of transaction.[130]

5. Rollovers and GAAR

Another interesting recent decision is the *Loyens* case.[131] In that case, the taxpayers were real estate developers and hence any real estate they held was on income account. The taxpayers also owned a corporation which had non-capital losses. Since it is not possible to transfer real estate inventory on a tax deferred basis pursuant to subsection 85(1) of the Act, the taxpayers established a partnership and transferred the real estate inventory to the partnership utilizing the rollover provisions of subsection 97(2) of the Act. The taxpayers then proceeded to transfer the partnership interests to the loss corporation using the provisions of subsection 85(1) of the Act. As a consequence of this transfer, the partnership ceased to exist. The loss corporation thereupon sold the land to an unrelated third party realizing income to offset its non-capital

losses. The Minister denied the loss utilization on the bases that the transaction was in essence a purported section 85 rollover of real property inventory which was not permissible and that the GAAR applied to deny the benefit.

The taxpayers' appeals were allowed by the Tax Court of Canada. The Court concluded that the rollovers used by the taxpayers were technically valid and thus the case turned on the application of the GAAR. The Court held that the transactions were entered into for *bona fide* business purposes and that there was no misuse or abuse of the provisions of the Act, but rather the rollover provisions were simply being utilized for the very purpose for which they were designed. The Court noted that the purpose of the prohibition on the rollover of real estate inventory under section 85 is to prevent a real estate developer from transforming what would otherwise be an inventory gain into a capital gain through the subsequent sale of shares of the corporation, and that no such concern existed where a partnership was utilized since the sale by the partnership would give rise to ordinary income allocable to the partners. In the present case, the sale to the third party again gave rise to business income and hence the GAAR did not apply.

IV. TREATMENT OF TAX LOSSES ON AN ACQUISITION OF CONTROL

As a result of what the CRA perceived to be a surfeit of abusive tax loss trading schemes, the acquisition of control rules were significantly tightened in 1987. A cornerstone of these rules is subsection 249(4) of the Act which provides for a deemed year end of a corporation upon the acquisition of control thereof by a person or group of persons. Losses therefore fall into two categories, those occurring before, and those occurring after, the acquisition of control. This may result in a short fiscal period which, aside from the "streaming rules" described below, will foreshorten the period during which a corporation may utilize its non-capital losses.

Subsection 256(9) of the Act provides that for purposes of the Act, where control of a corporation is acquired by a person or a group of persons at a particular time on a day, control of the corporation will be deemed to have been acquired at the commencement of that day and not at the particular time unless the corporation elects in its income tax return for the taxation year ending on the acquisition of control to have subsection 256(9) not apply. In the result, absent an election under subsection 256(9), an acquisition of control on, for example, August 1, 2006, will result in a year end for the target corporation on July 31, 2006.

An interesting recent case considered the significance of subsections 256(9) and 249(4) in the context of an attempt by a corporation to claim an allowable business investment loss ("ABIL"). In *La Survivance v. HMTQ*[132], a public corporation tendered its controlling interest in a target corporation to a private corporation on July 5, 1994 with the result that control of the target public corporation was deemed to have been acquired on July 5, 1994 resulting in a July 4, 1994 year end for the target. On the basis that the target corporation was, after the acquisition of control, a Canadian-controlled private corporation by virtue of then being controlled by a private corporation rather than a public corporation, La Survivance, the taxpayer public corporation, sought to claim an ABIL rather than an ordinary capital loss in respect of the disposition of its shares of the target corporation. La Survivance's appeal was dismissed by the Tax Court. The Tax Court held that the sole purpose of subsection 256(9) is to ensure that the year end of the corporation upon an acquisition of control terminates on the date previous to control changing hands rather than at the particular time of day at which control actually changes hands to avoid the awkward situation in which the deemed year end could occur in the middle of the business day. The Tax Court held that such deeming provision should be narrowly construed and therefore subsection 256(9) did not deem La Survivance to have simultaneously ceased to maintain control of the target corporation at the commencement of July 5, 1994. Therefore, when La Survivance actually disposed of its shares of the target corporation, the target was not a CCPC and hence La Survivance was not entitled to treat its loss as an ABIL. The rationale of the Tax Court was dubious particularly in light of the fact that the opening words of subsection 256(9) are: "For the purposes of this Act," and the case was appealed.

On appeal to the Federal Court of Appeal, La Survivance's appeal was allowed. The Federal Court of Appeal held that the Tax Court judge had erred in his analysis of the subsection 256(9) presumption when he concluded that while the acquiror was deemed to have acquired control of the target at the commencement of July 5, 1994, La Survivance was not affected by the same presumption and hence maintained control of the target to the point when the shares were registered in the acquiror's name. The Court held that this interpretation was not consistent with the ordinary meaning and context of the words of subsection 256(9) and that the subsection was intended by Parliament to apply to both the corporation acquiring control and the corporation relinquishing control.

A. CONTROL

Control for purposes of the acquisition of control rules in subsection 249(4) and subsections 111(4) to (5.5) is *de jure* control, not *de facto* control. This is in contrast, for instance, to the use of the *de facto* control test (i.e. controlled directly or indirectly in any manner whatever) in the "affiliated persons" definition described above. "Control" is not defined in the Act for this purpose, although there is an extensive jurisprudence dealing with the concept. In its simplest terms, control is traditionally understood to mean the right of control that rests in the ownership of such a number of shares as carries with it the right to a majority of votes in the election of the board of directors (i.e. generally 50% plus one of the voting shares).[133] More recent cases have explored various subtleties of the concept of *de jure* control and, as a general proposition, it appears that the courts have been moving over the last twenty years away from the narrow, traditional approach to one of determining who has effective control of the corporation.[134] Control can also be indirect and accordingly an acquisition of control of a corporation will cause all downstream controlled corporations to have been subject to an acquisition of control as well.

The most significant recent case on the issue of *de jure* control is the 1998 Supreme Court of Canada decision in *Duha Printers*.[135] Very briefly, the facts in the case are as follows. Mr. and Mrs. M controlled M Ltd. which in turn controlled O Ltd. which had non-capital losses. D Ltd., controlled by the D family, issued voting preferred shares to M Ltd. giving M Ltd. 55.71% of the voting rights in D Ltd. On the same day, a shareholders agreement respecting D Ltd. was entered into by all of the shareholders providing that D Ltd. was to be managed by a board of directors elected by the shareholders and composed of any three of Mr. D, Mrs. D, Mr. M and Mr. Q (a close friend of both Mr. D and Mr. M). The agreement restricted the transfer of shares so that no shares could be transferred without consent of the majority of the board of directors, prohibited any shareholder from selling its shares and provided that new shares could only be issued with the unanimous consent of the existing shareholders. The next day, D Ltd. purchased all of the outstanding shares of O Ltd. for a nominal consideration and D Ltd. and O Ltd. amalgamated. Thereupon, the shares held by M Ltd. were redeemed and the shareholders agreement terminated. The amalgamated corporation then sought to utilize the non-capital loss carryforwards of O Ltd. The Minister challenged the utilization of the non-capital loss

carryforwards of O Ltd. by the amalgamated corporation. The taxpayer succeeded at the Tax Court of Canada level and the Federal Court of Appeal reversed this decision. The taxpayer's appeal to the Supreme Court of Canada was successful.

In its reasons for judgment, the Supreme Court confirmed that under the Act, "control" of a corporation normally refers to *de jure* control and not *de facto* control. The Court went on to state:

> "However it must be recognized at the outset that this test is really an attempt to ascertain who is in effective control of the affairs and fortunes of the corporation. That is, although the directors generally have, by operation of the corporate law statute governing the corporation, the formal right to direct the management of the corporation, the majority shareholder enjoys the indirect exercise of this control through his or her ability to elect the board of directors. Thus, it is in reality the majority shareholder, not the directors *per se*, who is in effective control of the corporation....
>
> Viewed in this light, it becomes apparent that to apply formalistically a test like that set out in *Buckerfield's*, without paying appropriate heed to the reason for the test can lead to an unfortunately artificial result....
>
> The general approach to the determination of control, as I have already noted, has been to examine the share register of the corporation to ascertain which shareholder, if any, possesses the ability to elect a majority of the board of directors and, therefore, has the type of power contemplated by the *Buckerfield's* test, *supra*. The case law seems to point only to limited circumstances in which other documents may be examined and then only to a narrow range of documents which may be considered....
>
> It is entirely proper to look beyond the share register when the constating documents provide for something unusual which alters the control of the company. To consider every legally binding arrangement between shareholders as such, however, is another matter entirely. ... the distinction between contractually binding agreements outside the constating documents on the one hand, and legally binding provisions within the constating documents on the other, is crucial."[136]

The Court then went on to confirm that as a general rule, external agreements are not to be taken into account as determinative of *de jure* control, although it was recognized that a trust agreement is an exception to this rule due to the fiduciary obligations it imposes on trustees.

Of critical importance is that the Court concluded that the agreement in question was a unanimous shareholders agreement as contemplated by the relevant corporate statute and further went on to conclude that as such, it was part of the constating documents of the corporation. The Court concluded:

> "Therefore, I would conclude that, while "ordinary" shareholder agreements and other external documents generally should not be considered in assessing *de jure* control, in keeping with the long line of jurisprudence to this effect, the USA *[i.e. unanimous shareholders agreement]* is a constating document and as such must be considered for the purposes of this analysis....
>
> The Appellant correctly points out that to recognize the USA as affecting *de jure* control begs the question of how much power must be removed from the directors before one may safely conclude that the majority voting shareholder no longer has *de jure* control. Certainly, the existence of a USA does not necessarily imply the loss of *de jure* control."[137]

The Court then held that the unanimous shareholders agreement in question did not in fact result in the loss of *de jure* control of D Ltd. by M Ltd.

In *Silicon Graphics Limited*[138], the issue was whether the corporation in question ("Alias") was a Canadian-controlled private corporation. Alias' shares were publicly traded in the US and were relatively widely held so that at the relevant times no shareholder held more than 13% of its shares, although more than 50% of its shares were held by nonresident persons with no evidence of any common connection between them. The Tax Court of Canada held that since a majority of the shares were held by nonresidents, the corporation was controlled *de jure* by nonresident persons so that Alias was not a CCPC. The Federal Court of Appeal commented that most cases that addressed the issue of control involved situations where one or a few persons held a controlling interest, whereas in the present case, the critical issue was whether a simple majority of shares held by nonresidents can lead to an inference of *de jure* control by those nonresidents or whether some common connection or nexus must exist amongst those shareholders to support such an inference. Based on prior case law, the Court concluded that:

> "…simple ownership of a mathematical majority of shares by a random aggregation of shareholders in a widely held corporation with some common identifying feature (e.g. place of residence) but without a common connection does not constitute *de jure* control as that term has been defined in the case law…. In order for more than one person to be in a position to exercise control, it is necessary that there be a sufficient common connection between the individual shareholders. The common connection might include, *inter alia*, a voting agreement, an agreement to act in concert or business or family relationships."[139]

In the *Silicon Graphics* case, no such common connection was present and therefore *de jure* control did not rest with nonresidents. The Court cited with approval the *Duha Printers* decision. (The Court also concluded that in order to find *de facto* control, a person or a group of persons must have a clear right and ability to effect a significant change in the board of directors or the powers of that board or to influence in a very direct way the shareholders who would otherwise have the ability to elect the board of directors.)

At the 2005 CRA Round Table referred to above, the CRA was asked whether unanimous shareholder agreements must be considered in determining whether corporations are affiliated in the context of loss consolidation transactions. The CRA's response was that unanimous shareholder agreements were relevant as per *Duha Printers*. The CRA further indicated that it will issue rulings, in accordance with its usual parameters, respecting unanimous shareholder agreements and loss consolidation transactions.[140]

In the recent Federal Court of Appeal decision in *Sedona Networks Corporation*,[141] the taxpayer sought to qualify as a Canadian-controlled private corporation. Under paragraph 125(7)(b), a corporation is deemed not to be a CCPC if each of its shares owned by non-resident persons or public corporations are owned by a "particular person", and the corporation is controlled by that "particular corporation". Shares of *Sedona* were held by the Bank of Montreal Capital Corporation. Under the terms of a Management Agreement, the voting rights to these shares were transferred to a resident CCPC. The Court held that the owner of voting shares who transfers decision-making powers to another entity under a contract or management agreement does not, as a general rule, divest itself of the ownership rights to such shares and as a result is not deprived of *de jure* control, as per *Duha Printers*. Accordingly, the Bank of Montreal Capital Corporation did not divest itself of its ownership of shares of *Sedona* under the

Management Agreement. Moreover, the Management Agreement was neither a constating document under corporate law nor a unanimous shareholders agreement within the meaning of the *Canada Business Corporations Act* and therefore *Sedona* did not qualify as a CCPC. The case is in a sense a fairly straightforward application of the principles in *Duha Printers*.

B. ACQUISITION

The acquisition of control rules require that there be an "acquisition" of control by a person or group of persons, rather than a mere change of control. Thus, for example, where all of the shares of a wholly-owned subsidiary are sold by the parent through a public secondary offering so that the shares are widely held, there is arguably no acquisition of control since there is no identifiable group of persons who control the corporation, unless a specific group of persons acting in concert can be identified. As to what constitutes a "group" for this purpose, the CRA states as follows in *Interpretation Bulletin IT-302R3* dated February 28, 1994:

> "3. ... The meaning of group of persons is more limited in the context of the acquisition of control rules discussed in this bulletin. A group of persons who own the majority of the voting shares of a corporation will be considered as having collectively acquired control of the corporation where there is an agreement amongst them to vote their shares jointly, when there is evidence that they act in concert to control the corporation, or when there is evidence of their intention to act in concert to control the corporation (see 4-6 below). When dealing with groups it is always a question of fact as to whether any group of persons who own the majority of the voting power in a corporation is in control of the corporation. However, where a corporation is controlled by a single person, this precludes a group from also controlling the corporation (*Southside Car Market Ltd. v. The Queen*, 82 DTC 6179, [1982] CTC 214 (F.C.T.D.)).
>
> A group of persons could be regarded as acting in concert when the group acts with considerable interdependence in transactions involving a common purpose. A predetermined agreement which sets out how the group is to act in certain situations would normally constitute acting in concert. In widely held corporations, the fact that a majority of shareholders vote collectively to take some action does not by itself indicate that the group of shareholders is acting in concert. However, in closely held corporations the fact that shareholders jointly adopt specific mutually advantageous measures is an important indicator of actions in concert.
>
> In *Vina-Rug (Canada) Ltd. v. M.N.R.*, 68 DTC 5021, [1968] CTC 1 (S.C.C.), some persons in a group of persons were related and others had been business associates for many years. This represented a common link which was sufficient to enable them to exercise control. Similarly, in *Express Cable T.V. v. M.N.R.* 82

> DTC 1431, [1982] CTC 2447, the Tax Review Board stated that the existence of voting trusts, community of interest and other common links between shareholders were important in determining which group controlled two corporations.
>
> The purpose of seeking a link or common interest within a group of persons is to ensure that the acquisition of control by a given group of persons is not fortuitous or coincidental, but the outcome of an action or an event organized by the group. *Seeking a tax advantage arising from the accumulated losses of a corporation may well provide a link or a common interest among the members of a given group.* For a further discussion of acting in concert see the current version of IT-419, *Meaning of Arm's Length*." [*Emphasis added*].

While not defining control for this purpose, the Act does contain a number of provisions that deem control either not to have been acquired or to have been acquired. In general terms, related party transactions do not give rise to an acquisition of control. Specifically, subparagraph 256(7)(a)(i) of the Act provides that for various purposes, including the loss carryover rules in section 111, control of a particular corporation will be deemed not to have been acquired at a particular time solely because of the acquisition of shares of any corporation by:

(A) a particular person who acquired the shares from a person to whom the particular person was related immediately before that time (otherwise than because of a right referred to in paragraph 251(5)(b));

(B) a particular person who was related to the particular corporation immediately before that time (otherwise than because of a right referred to in paragraph 251(5)(b));

(C) an estate that acquired the shares because of the death of a person; or

(D) a particular person who acquired the shares from an estate that arose on the death of another person to whom the particular person was related.

Under 2004 Budget Amendments, unused charitable deductions of a corporation cease to be deductible upon an acquisition of control of a corporation. Also, subsection 256(7) now applies to subsection 110.1(1.2).

The November 9, 2006 Draft Legislation, carried forward in Bill C-10, proposes that subparagraph 256(7)(a)(i) be amended effective with respect to acquisitions of shares after 2000 to add clause (E) which will preclude an acquisition of control of a corporation on a butterfly reorganization pursuant to paragraph 55(3)(b) of the Act which involves a so-called public company spin-off. The November 9, 2006 Technical Notes point out that where, for example, a public corporation ("Public Co.") distributes shares of a wholly-owned subsidiary ("Subco") to a new corporation ("Newco") (established for purposes of the distribution) where the shareholders of Public Co. and Newco are the same and no person or group of persons controls Public Co. and Newco, an acquisition of control of Subco would occur upon Newco's acquisition of the Subco shares. New clause 256(7)(a)(i)(E) will remedy this situation by deeming an acquisition of control not to occur in these circumstances.[142]

Further, subparagraph 256(7)(a)(ii) deems there to be no acquisition of control on the redemption or cancellation of shares or a change in the share conditions of shares of a particular corporation or of a corporation controlling the particular corporation where each person or each member of each group of persons that controls the corporation immediately after that time was related to the corporation immediately before that time or immediately before the death of a person where the shares were held immediately before the redemption, cancellation or change by an estate that acquired them on the death of the person (otherwise than by virtue of a right referred to in paragraph 251(5)(b)).

Paragraph 256(7)(a) as presently drafted is not without its anomalies, however. For instance, where shares are issued by a corporation to an unrelated person such that control shifts from the one person who previously controlled the company to a related group of persons (for instance, husband owns 51%, wife owns 5% and the shares issued to the outsider result in husband owning 49% but the related group of husband and wife still owning more than 50%), an acquisition of control will occur. A similar result would obtain if husband sold a portion of his shares to a unrelated party. In contrast, if husband's shares were purchased for cancellation or redeemed in the above circumstances, no acquisition of control would occur as a consequence of subparagraph 256(7)(a)(ii). Also, subparagraph 256(7)(a)(i) would apply if husband were to transfer 5% of the voting shares to his spouse in the above example.

In order to correct these anomalies, the November 9, 2006 Draft Legislation subparagraph 256(7)(a)(iii), which will apply to the acquisition of shares after 2000, and which will provide that where there is an acquisition of any shares of a corporation, there will be no acquisition of control of the corporation by a related group of persons if each member of each group of persons that controls the corporation was related to the corporation immediately before the acquisition of shares. This amendment would appear to rectify the anomalies described in the previous paragraph.[143]

Paragraph 256(7)(b) deals with amalgamations and provides that an acquisition of control will not be deemed to occur except as described in subparagraphs 256(7)(b)(ii) or (iii). Subparagraph 256(7)(b)(ii) provides that where a person or a group of persons control the amalgamated corporation immediately after the amalgamation and did not control a particular predecessor corporation immediately before the amalgamation, that person or group of persons is deemed to have acquired control of the particular predecessor corporation and each corporation controlled by it immediately before the amalgamation (thereby triggering the acquisition of control rules in section 111). Paragraph 256(7)(b) does not apply, however, if the person or group of persons who control the amalgamated corporation would not have been considered to have acquired control of the particular predecessor corporation if that person or group of persons had acquired all of the shares of the predecessor corporation immediately before the amalgamation. Therefore, on the amalgamation of two or more predecessor corporations which were controlled by related corporations prior to the amalgamation, paragraph 256(7)(a) would apply so that control of the particular predecessor corporation will not be treated as having changed.[144]

The 1995 amendments significantly expanded paragraph 256(7)(b) by adding subparagraph (iii). Subparagraph 256(7)(b)(iii) deems control of a particular predecessor corporation and of each corporation controlled by it before the amalgamation to have been acquired by a hypothetical person or group of persons unless:

(A) the predecessor corporation was related (otherwise than because of a right referred to in paragraph 251(5)(b)), immediately before the amalgamation, to each other predecessor corporation,

(B) if one person had immediately after the amalgamation (hypothetically) acquired all of the shares of the amalgamated corporation received by shareholders of the particular predecessor corporation (or of another predecessor that controlled that predecessor) on the amalgamation in consideration for their shares of the predecessor corporation (or the other predecessor, as the case may be), that person would have acquired control of the amalgamated corporation, or

(C) subparagraph 256(7)(b)(iii) would otherwise deem control of every predecessor corporation to have been acquired, in an amalgamation of two corporations or two corporations and one or more controlled subsidiaries -- as it would, for example, if two corporations of equal value amalgamated, with the shareholders of each taking back half the shares of the new corporation.[145]

Paragraphs (c) to (e) of subsection 256(7) were also added in the 1995 amendments. Paragraph 256(7)(c) deals with reverse takeover transactions and provides that where two or more persons (the "transferors") dispose of shares of a particular corporation in exchange for shares of another corporation (the "acquiring corporation"), control of the acquiring corporation and of each corporation controlled by it immediately before the exchange is deemed to have been acquired at the time of the exchange by a person or a group of persons unless the particular corporation and the acquiring corporation were related (otherwise than by virtue of paragraph 251(5)(b)) to each other immediately before the exchange, or, if all of the shares of the acquiring corporation acquired by the transferors were acquired by one person, that person would not control the acquiring corporation. This latter provision is intended to deal with the situation where, for instance, the shares of a widely held public corporation are exchanged for shares of a loss corporation such that there is no identifiable group that controls the loss corporation after the acquisition. This rule would deem all of the shareholders of the public corporation to be one

notional person and if that notional person held a majority of the shares of the loss corporation after the exchange, there would be deemed to be an acquisition of control of the loss corporation.

Paragraph 256(7)(d) provides that no acquisition of control of a particular corporation will be considered to have occurred solely because of a share-for-share exchange for shares of an acquiring corporation where the person or group of persons who controlled the particular corporation before the exchange control both the particular corporation and the acquiring corporation immediately after the exchange and did not as part of a series of transactions or events that includes the share-for-share exchange, cease to control the acquiring corporation after the exchange.[146]

Paragraph 256(7)(e) provides that no acquisition of control of a particular corporation will be considered to have occurred solely because of an exchange of all of the shares of the particular corporation solely for shares of the acquiring corporation where the acquiring corporation is not controlled by a person or group of persons immediately after the exchange and the fair market value of the shares of the particular corporation is not less than 95% of the fair market value of the assets of the acquiring corporation. The November 9, 2006 Draft Legislation, carried forward in Bill C-10, proposes that paragraph 256(7)(e) be amended, for shares acquired after 1999, to ensure that it applies on the acquisition of any shares of the particular corporation by the acquiring corporation if, immediately after the acquisition, the acquiring corporation owns all of the shares of the capital stock of the particular corporation (other than shares of a specified class) and the 95% test is met. The provision is also to be amended to deem control not to be acquired if shares of the particular corporation are acquired as part of a plan of arrangement and, upon completion of the arrangement, the acquiring corporation owns all the shares of the capital stock of the particular corporation (other than shares of a specified class) and the 95% test is met. Thus, the proposed amendments would result in paragraph 256(7)(e) applying in circumstances where the acquiring corporation owns shares of the capital stock of the particular corporation before the acquisition being examined. Shares of a specified class are excluded on the basis that they are non-voting securities similar to debt and should not be considered in determining whether control is being acquired for purposes of paragraph 256(7)(e). They are defined in paragraph 88(1)(c.8) of the Act.[147]

The amendment also ensures that, in circumstances where the acquisition occurs as part of a plan of arrangement, the acquiring corporation includes a new corporation formed on an amalgamation of the acquiring corporation and a subsidiary controlled corporation of the acquiring corporation. As a result, paragraph 256(7)(e) may apply to a situation where the acquiring corporation owns shares of the particular corporation indirectly through a subsidiary controlled corporation if the acquiring corporation and the subsidiary controlled corporation are amalgamated as part of a plan of arrangement that includes the acquisition.[148]

Subsection 256(8) of the Act provides that if a taxpayer acquires a right referred to in paragraph 251(5)(b) of the Act with respect to shares and it can reasonably be concluded that one of the main purposes of acquiring the right is to avoid the application of a variety of rules, including the acquisition of control rules, the taxpayer will be deemed to have acquired the shares. Subsection 256(8) was amended in 1998 in several respects, including to provide that an acquisition of a right that is intended to avoid the application of the "affiliated persons" rules in section 251.1 of the Act will result in the taxpayer being treated as being in the same position as if the right had been exercised. Further, since paragraph 251(5)(b) of the Act refers not only to a right to acquire shares, but also to a right to control the voting rights of shares, subsection 256(8) was amended so that if the purpose test in subsection 256(8) has been met, a right to control the voting rights of shares will be treated as having been exercised also.

C. IMPACT OF AN ACQUISITION OF CONTROL ON LOSS UTILIZATION

1. Net Capital Losses

Subsection 111(4) of the Act provides that upon an acquisition of control, net capital losses of a corporation for taxation years ending before the acquisition of control may not be carried forward. Moreover, net capital losses incurred in taxation years ending after the acquisition of control may not be carried back for utilization in taxation years ending prior to the acquisition of control.

In addition to dealing with realized net capital losses, subsection 111(4) also provides for a deemed realization of accrued but unrealized capital losses. (The policy parallel with the stop-loss rules discussed above is obvious.) This is achieved in paragraph (c) by reducing the

adjusted cost base of each non-depreciable capital property with an accrued loss to the fair market value thereof and in paragraph (d) by deeming the reduction to be a capital loss for the taxation year ending on the acquisition of control. Thus, such deemed capital losses are subject to the prohibition on carryforward referred to above.

Subsection 111(4) does contain a relieving provision that permits the corporation to elect to have a deemed disposition of other capital properties in the taxation year ending prior to the acquisition of control for proceeds of disposition selected by the taxpayer between the adjusted cost base and the fair market value of the asset, thereby triggering a capital gain that may then be offset against the capital losses deemed realized on the loss properties referred to above. The properties selected for the deemed disposition by the taxpayer are deemed to have been reacquired at a cost equal to the proceeds of disposition. Thus, to the extent that there are properties with sufficient accrued gains, the taxpayer may realize an increase in the adjusted cost base of such properties by an amount up to the amount of the deemed capital loss without triggering a tax liability. The designation must be made by the corporation in its income tax return for the taxation year ending on the acquisition of control or in a prescribed form, filed with the Minister within 90 days after the corporation is assessed in respect of the year ending on the acquisition of control. As a planning point, therefore, on any acquisition, the acquiror should insist that the target company take appropriate steps or ensure itself that the target takes appropriate steps to utilize otherwise expiring non-capital losses by obtaining a bump in the adjusted cost base of other capital properties with accrued but unrealized gains.

2. Non-Capital Losses

As with net capital losses, the rules relating to the treatment of non-capital losses on an acquisition of control deal both with realized non-capital losses and with accrued losses.

a. Accrued Losses

Dealing firstly with accrued losses, subsection 111(5.1) requires that where the undepreciated capital cost to the corporation of depreciable property of a prescribed class exceeds the total of the fair market value thereof and the amount of capital cost allowance taken by the corporation in respect of that class for the taxation year ending on the acquisition of

control and any terminal loss deducted in that same year in respect of property of that class, the excess is required to be deducted as capital cost allowance in computing the income of the corporation for the taxation year ending on the acquisition of control as capital cost allowance. This will reduce the income or increase the non-capital loss of the corporation for its year ending on the acquisition of control, thereby rendering any non-capital loss created subject to the acquisition of control rules discussed below.

A recent technical interpretation deals with the interaction of subsection 111(5.1) and Schedule III (dealing with leasehold interests) of the Regulations.[149] The interpretation deals with an example where there is a leasehold interest with a capital cost of $2,400, a lease term of 20 years and a fair market value at the beginning of year ten (at which time the acquisition of controls occurs) of $840. The capital cost allowance claimed through to the end of the year nine results in an undepreciated capital cost of $1,320 before the application of subsection 111(5.1) of the Act. After the acquisition of control, the annual CCA claim permitted will continue to be $120 with the result that the remaining undepreciated capital cost will be written off after seven years, being the sixteenth year of the lease. The CRA comments that for purposes of the Act, the Regulations and Schedule III, neither the capital cost of the property nor the term of the lease has changed. Therefore, it is possible that the remaining undepreciated capital cost allowance of the leasehold interest may be claimed over a period that is less than the remaining lease term.

Similarly, where the cumulative eligible capital of the corporation in respect of a business exceeds the total of three-quarters of the fair market value of the eligible capital property in respect of the business and the amount deducted under paragraph 20(1)(b) of the Act in the year ending on the acquisition of control, the excess is required to be deducted under paragraph 20(1)(b) by the corporation for its taxation year ending on the acquisition of control, thereby again potentially increasing the non-capital loss of the corporation for such year.

Finally, the corporation is not permitted to deduct any amount as a doubtful debt reserve under paragraph 20(1)(l) in computing its income for its taxation year ending on the acquisition of control and instead, the greatest amount that would otherwise have been deductible under paragraph 20(1)(l) is deemed to be a separate debt that is to be deducted as a bad debt under paragraph 20(1)(p) of the Act in such year.

In the normal course, as a consequence of the deemed year end, inventory will generally also be written down to the lower of cost and fair market value so that accrued losses on inventory to the date of acquisition of control will be realized.[150]

b. Realized Losses

On an acquisition of control of a corporation, unlike net capital losses, non-capital losses may still potentially be carried forward and back in the usual fashion, but the application of such losses is subject to the "streaming" rules contained in subsection 111(5) of the Act discussed below. The 2004 Budget Amendments extended the carry forward period for non-capital losses incurred in taxation years ending after March 22, 2004 from seven to ten years for purposes of both Parts I and IV of the Act. A further amendment was made by the 2006 Budget Amendments to extend the carryforward period for 20 years in respect of losses that arise in the 2006 and subsequent taxation years.

Losses from a non-business source (i.e. losses from property and allowable business investment losses) are treated in the same fashion as net capital losses in that such losses incurred prior to an acquisition of control are not capable of being carried forward to taxation years after the acquisition of control. Correspondingly, no carry back of such losses incurred post acquisition to taxation years ending before the acquisition of control is permitted. Of some assistance in this regard is the Supreme Court of Canada decision in *Canadian Marconi*[151], which indicates that there is a rebuttable presumption that income arising from a corporation's activities, if carried on for profit, is considered to be from a "business" and not from property.

With respect to losses from a business, such non-capital losses may be carried forward and utilized in taxation years ending after the acquisition of control if two tests are met. Firstly, the business that gave rise to the loss must be carried on by the corporation for profit or with a reasonable expectation of profit throughout the particular taxation year to which the non-capital loss is to be carried forward (the "same business test"). Secondly, the non-capital loss may only be used in such year to the extent of the corporation's income for that year from that business and, where properties were sold, leased, rented or developed or services rendered in the course of

carrying on that business before that time, from any other business substantially all of the income of which was derived from the sale, leasing, rental or development of similar properties or the rendering of similar services (the "income test"). The converse applies where the corporation seeks to carry back a non-capital loss incurred after the acquisition of control to taxation years ending prior to the acquisition of control.

With respect to the "same business test", this is obviously a question of fact and it is difficult to formulate any precise guidelines. The CRA offers some guidelines in paragraph 14 of *IT-302R3* which reads as follows:

> "14. ... Whether the corporation carried on "that business" is a question of fact. Factors to be considered in determining whether "that business" was being carried on include the following:
>
> (a) location of the business carried on before and after the acquisition of control,
>
> (b) nature of the business,
>
> (c) name of the business,
>
> (d) nature of income-producing assets,
>
> (e) existence of a period or periods of dormancy,
>
> (f) extent to which the original business constituted a substantial portion of the activities of the corporation in the allocation of time and financial resources."

Factors considered by the courts in past decisions relating to the "same business test" include:

- sale of assets
- laying off of employees
- change of business name
- change of location
- periods of inactivity or dormancy
- bankruptcy proceedings
- change in the nature of the business
- mere formalities

- separate operations
- more than one business being operated by the same company
- franchise
- sham transaction
- degree of integration
- collection of accounts receivable (being held sufficient to constitute the continuation of a business).[152]

In the end, a detailed analysis will have to be made of each particular fact situation in order to determine whether the same business continues to be carried on. Obviously, the business is not likely to be carried on in precisely the same form since in the vast majority of cases, the acquiror will wish to make some changes in order to effect a turnaround. The obvious issue is to what extent changes can be made without jeopardizing the loss carryforwards.

It is worth noting that the loss business could be transferred to a partnership of which the corporation is a general or a limited partner and the corporation would still be considered to be carrying on the loss business by virtue of being a partner in the partnership.[153]

In addition, under the "same business test", it is a requirement that the business be carried on with a reasonable expectation of profit. There is an extensive body of literature and case law as to what constitutes a reasonable expectation of profit which will not be repeated here.

A recent example of the application of the "same business test" is the decision of the Federal Court of Appeal in *Garage Montplaisir*.[154] In that case, M Ltd. acquired control of P Ltd., a corporation with non-capital losses and thereupon the two corporations were amalgamated. The amalgamated corporation sought to deduct the relevant portion of P Ltd.'s accumulated losses but the Minister disallowed the deductions on the basis that there was no evidence to show that the taxpayer had continued to carry on any significant portion of P Ltd.'s business during the relevant years "for profit or with a reasonable expectation of profit" within the meaning of subparagraph 111(5)(a)(i) of the Act. Apparently, P Ltd. had disposed of all of its tangible assets and had no more employees or activities and its activities following the acquisition of control were limited to selling used cars for three months, although such sales were "on paper" only. The Federal Court of Appeal affirmed the Federal Court Trial Division's

dismissal of the taxpayer's appeal on the basis that the business was not carried on for profit or with a reasonable expectation of profit during the years in question. The Court pointed out that under subsection 111(5), the business of a corporation subject to an acquisition of control always has to continue actively after such change if the corporation resulting from an amalgamation is to have access to accumulated losses.[155]

The second test is the "income test". That is, the loss may only be applied against income of the corporation in another taxation year to the extent of the income of the corporation from that business or what might very loosely be described as a similar business (e.g. a similar business injected into the loss corporation by the acquiror). Again, the question as to what constitutes a similar business is a factual test. In *IT-302R3* the CRA gives the following examples in paragraphs 14 and 15 thereof:

> "14. ...The word *similar* in the context of subsection 111(5) is generally interpreted as "of the same general nature or character". However, a determination of the similarity of properties sold, leased, rented or developed and services rendered in two or more different businesses for the purposes of paragraph 111(5)(a) or (b) is primarily a question of fact that can only be determined having regard to all the relevant facts and circumstances in each case. For additional comments on determining whether a corporation was carrying on the same business (i.e., "that business"), see the current version of IT-206, *Separate Businesses*.
>
> To illustrate the application of paragraph 111(5)(a), consider the following example:
>
> Corporation B, a manufacturer of electrical appliances, has a December 31 taxation year end and has accumulated non-capital losses of $100,000 to December 31, 19_3. Corporation B sustains losses of $20,000 from business operations for the six months ended June 30, 19_4. On July 1, 19_4 Corporation A acquires control of Corporation B.
>
> *Situation X*
>
> Corporation A is a successful and profitable manufacturer of electrical appliances and causes Corporation B to continue the manufacture of its electrical appliances under the efficient and dynamic management of Corporation A. Corporation B realizes a profit of $35,000 for the last six months of 19_4. No part of Corporation B's business is discontinued in the 19_4 and subsequent taxation years.
>
> *Situation Y*

> Corporation A is also a manufacturer of electrical appliances and on July 1, 19_4 causes Corporation B to commence the manufacture and sale of Corporation A's profitable line of electrical appliances in addition to its own line. Corporation B makes a profit of $25,000 for the last six months of 19_4 and continues that same business throughout its 19_5 and subsequent taxation years.
>
> *Situation Z*
>
> Corporation A is a manufacturer of wheeled goods (tricycles, bicycles, wagons, baby carriages, etc.) and in 19_4 causes Corporation B to discontinue the manufacture of electrical appliances, to retool and to commence the manufacture of baby carriages. Corporation B makes a profit of $25,000 in 19_4 from the sale of baby carriages.
>
> In each of the three situations Corporation B will have accumulated a non-capital loss of $120,000 in respect of taxation years ending before its control was acquired on July 1, 19_4. In situation X, the income of Corporation B for its taxation years ending after control was acquired on July 1, 19_4 was derived from a business carried on for profit which was the same business which gave rise to the non-capital losses of $120,000 accumulated at June 30, 19_4. In situation Y, the income of Corporation B for those same taxation years was derived from a business carried on for profit, this business was comprised of the same business which was carried on before the time at which control changed and another business which derived all its income from the sale of properties similar to those sold by the same business. Accordingly, paragraph 111(5)(a) applies in either situation X or Y to permit the application, within the limits otherwise provided in subsection 111(1), of Corporation B's non-capital losses of $120,000 to the extent of the profit, if any, realized by it in a taxation year ending after July 1, 19_4. In situation Z, the business which gave rise to Corporation B's losses was discontinued. Accordingly, no part of Corporation B's $120,000 of non-capital losses may be deducted in any taxation year ending after July 1, 19_4."

Obviously, these are fairly straightforward examples and one can conceive of many situations which are far less clear cut. Again, a detailed examination must be made in each fact situation.[156]

An interesting example of the similar business concept in the "income test" is the 1998 Federal Court of Appeal decision in *Manac Inc. Corp.*[157] In that case, Q Inc. acquired from M Inc. all of the shares of Nortex, a manufacturer of panels being used by M Inc. in the manufacturer of trailers and semi-trailers. Nortex was immediately wound up into Q Inc. under subsection 88(1) of the Act. M Inc. was thereupon merged with Q Inc. to form the corporate taxpayer who thereafter continued through its Nortex division to manufacture panels for use in eight types of truck trailers that it sold. In addition, it sold six other types of truck trailers that it

manufactured using steel and aluminum panels assembled from other raw materials that it had acquired. The taxpayer sought to deduct the non-capital losses incurred by Nortex prior to the acquisition of control. The Tax Court concluded that the business being operated by Nortex at a loss prior to the change in its control had involved the sale of panels whereas the taxpayer was involved in the sale of trailers and the panels that it manufactured in its Nortex division lost their identity by becoming part of the trailers. Therefore, the panels were not "similar" to the trailers for purposes of subsection 111(5)(a)(ii). This decision was upheld by the Federal Court of Appeal. The Court noted that to succeed, the taxpayer had to show that (a) the goods that it was selling were "similar properties" to those which Nortex had been manufacturing; and (b) that it was deriving substantially all of its income from the sale, leasing, rental or development of "similar properties". Therefore, even if it could be said that the panels manufactured by the taxpayer were "similar" to the panels that it was manufacturing in its Nortex division, the taxpayer did not derive "substantially all" of its income from the sale or development of the panels in question and therefore could not utilize the losses.

V. DEBT RESTRUCTURING, DEBT FORGIVENESS AND LOSS PRESERVATION

Debt restructuring and tax loss utilization or preservation are companion topics. It is not at all infrequent that a corporation with tax losses finds itself in some level of financial difficulty which compels it to seek accommodations from its creditors. Unfortunately, if care is not taken, these accommodations can trigger the debt forgiveness rules and a consequent erosion of the debtor's tax attributes including, first and foremost, otherwise available loss carryforwards.

This section of the paper will provide a broad overview of selected aspects of the debt forgiveness rules, discuss various debt restructuring techniques which can avoid a triggering of the debt forgiveness rules and finally consider a number of techniques to manage or minimize the impact of debt forgiveness, including in the context of an acquisition of control of the debtor corporation.

A. THE DEBT FORGIVENESS RULES – A THUMBNAIL SKETCH[158]

The present debt forgiveness rules were introduced with the 1994 Federal Budget. While much has been made of the complexity of the rules, commentators seem to be fairly unanimous that the rules are soundly drafted, although the level of complexity is regrettable.

The debt forgiveness rules apply where a "commercial obligation" has been settled or extinguished and as a consequence, there is a "forgiven amount". A "commercial obligation" is defined to mean a "commercial debt obligation" or a "distress preferred share" issued by the debtor. A "commercial debt obligation" is defined to mean a debt obligation issued by the debtor in respect of which interest was deductible but for certain provisions of the Act[159] or would have been deductible if interest had been paid or payable on the debt by the debtor pursuant to a legal obligation. Thus, a commercial debt obligation would include an interest free loan in appropriate circumstances. Essentially, a "distress preferred share" is a share issued by a corporation in financial difficulty in exchange for debt of the corporation. If the technical requirements are met, the debt forgiveness rules do not apply on the conversion of the debt to distress preferred shares and the borrower corporation will presumably have lower servicing costs since the dividends on the distress preferred share will be lower than the interest payments on the debt which was converted into the distress preferred share. A detailed discussion of distress preferred shares is beyond the scope of this paper. A "forgiven amount" in respect of a commercial obligation issued by a debtor is defined to be, in essence, the excess of the lesser of the amount for which the obligation was issued and the principal amount thereof over the amount paid at the time of the settlement in satisfaction of the principal amount of the obligation[160].

A number of detailed rules of application are set out in subsection 80(2) of the Act. Among the more noteworthy for present purposes are the following. Paragraph (a) provides that an obligation is settled at any time where the obligation is settled or extinguished at that time. Paragraph (b) provides that interest payable by a debtor in respect of an obligation is deemed to be a separate obligation issued by the debtor that has a principal amount and was issued by the debtor for an amount equal to the portion of the amount of such interest that was or would have been deductible for subsections 18(2) or (3.1) or section 21. Thus, the forgiveness of interest will lead to the application of the debt forgiveness rules. Paragraph (g) provides that where a corporation issues a share[161] to a person as consideration for the settlement of a debt issued by

the corporation and payable to the person, the amount paid in satisfaction of the debt because of the issuance of the share is deemed to be equal to the fair market value of the share at the time it is issued. Paragraph (g.1) is a companion provision which provides that where a debt issued by a corporation and payable to a person is settled at any time, the amount that can reasonably be considered to be the increase, as a consequence of the settlement of the debt, in the fair market value of shares of the corporation owned by the person (other than any shares acquired by the person as consideration for the settlement of the debt) is deemed to be an amount paid at that time in satisfaction of the debt. Paragraph (h) provides that where any part of the consideration for the settlement of the debt is the issuance to the creditor of a new commercial debt obligation by the debtor, an amount equal to the principal amount of the new obligation is deemed to be paid by the debtor at that time and the new obligation will be deemed to have been issued for an amount equal to, in essence, the lesser of the principal amount of the new obligation and the amount for which the old obligation was issued. In other words, if a debt obligation is settled by the issuance of a new debt obligation having the same principal amount, no debt forgiveness will occur.

Subsection 80.01(3) provides that where a debtor and creditor amalgamate and as a consequence a debt is settled, the indebtedness will be deemed to have been settled immediately before the time that is immediately before the amalgamation (in other words, in the last taxation year of the predecessor corporations) by a payment by the debtor to the creditor equal to the amount that would have been the creditor's "cost amount" as defined in subsection 248(1) of the Act if that definition were read without reference to paragraph (e) thereof and that cost amount included amounts included in the creditor's income in respect of the portion of the indebtedness representing unpaid interest to the extent not deducted as bad debts in respect of such unpaid interest by the creditor. Therefore, an amalgamation will generally only result in a forgiven amount where the creditor's cost amount, calculated as described above, is less than the principal amount of the debt. A similar rule applies in subsections 80.01(4) and (5) in respect of subsection 88(1) wind ups, except that the parent must make an election for those provisions to apply.

Among the most opaquely drafted provisions in the debt forgiveness rules are the so called "debt parking" rules contained in subsections 80.01(6) to (8). In essence, these rules apply

where debt which is not worth its face value is neutralized by being transferred to a party in control of the corporation so that it is "parked" rather than forgiven. For instance, a debt will be a "specified obligation" of the debtor at a particular time where at any previous time, a person who owned the obligation dealt at arm's length with the debtor or did not have a "significant interest" in the debtor (essentially, ownership of shares representing 25% or more of the votes or fair market value of all the shares in the corporation). A debt will then be a "parked obligation" if it is a specified obligation of the debtor and the holder does not deal at arm's length with the debtor or have a significant interest in the debtor. Where a commercial debt obligation of a debtor becomes a parked obligation and the adjusted cost base of the obligation if it is a capital property to the creditor or in any other case, the cost amount to the creditor is less than 80% of the principal amount of the obligation, the obligation will be deemed to have been settled at that time and the forgiven amount will generally be the excess of the principal amount over the specified cost to the creditor. For an example of a case in which the court declined to apply the GAAR to a debt parking arrangement under the old debt forgiveness rules, see *Jabin Investments Limited v. HMTQ*, 2003 DTC 5027 (F.C.A.) (aff.) 2001 DTC 1002.

Where a debt becomes statute barred, subsection 80.01(9) provides that the obligation will be deemed to have been settled at that time and therefore, a debt forgiveness of the full amount of the debt will occur.

Taking the above rules into account, a forgiven amount is applied to the debtor's tax attributes as follows:

"1. Automatic application of prior years losses in the following order:

(i) Non-capital losses

(ii) Farm losses

(iii) Restricted Farm Losses

(iv) Allowable business investment losses

(v) Net capital losses

2. Discretionary application upon election by debtor among the following accounts, in any order:

- Undepreciated capital cost of depreciable property
- Cumulative eligible capital
- Resource expenditures
  - Canadian exploration expense
  - Canadian development expense
  - Canadian oil and gas property expense

3. After maximum application to all above accounts, discretionary application upon election by the debtor to the following accounts, in the following order:

   (i) Adjusted cost base of capital property (e.g., land and portfolio investments), excluding:

   - shares and debts of corporations of which the debtor is a "specified shareholder" (i.e., a shareholder who holds 10% or more of the corporation's shares)
   - interests in "related" partnerships

   (ii) Adjusted cost base of shares and debts of corporations of which the debtor is a specified shareholder but not including related corporations

4. After maximum application to all above accounts, application to current-year capital losses in excess of capital gains

5. After maximum application to all above accounts, application to adjusted cost base of shares and debts of related corporations and interests in related partnerships after tax attributes of corporations controlled by the debtor corporation have been eliminated.

6. 50% of any remaining unapplied forgiven amount which is not transferred to a related corporation is included in taxable income."[162]

With respect to the application of a forgiven amount to debtor's loss carryforwards, the definition of "relevant loss balance" is important. It provides that the amount of a debtor's non-capital loss, farm loss, restricted farm loss or net capital loss for a particular taxation year will be the amount of such loss that would be deductible in computing the debtor's taxable income for the taxation year if the debtor had sufficient incomes from all sources and sufficient taxable capital gains, the debt forgiveness rules did not apply to reduce such loss at or after that time and paragraph 111(4)(a) (which extinguishes net capital losses on an acquisition of control) and subsection 111(5) (which streams non-capital losses on an acquisition of control subject to the

income test and same business test discussed above) did not apply to the debtor. Where, however, the debtor is a corporation the control of which was acquired at a previous time and the particular loss year ended before the previous time, the relevant loss balance will be deemed to be nil unless the obligation which was subject to the debt forgiveness rules was issued before and not in contemplation of the acquisition of control or all or substantially all of the proceeds from the issue of the obligation in question had been used to satisfy the principal amount of another obligation which had been issued before and not in contemplation of the acquisition of control.

B. DEBT RESTRUCTURING TECHNIQUES (AVOIDING DEBT FORGIVENESS)

Where a debtor corporation finds itself in some degree of financial difficulty, it is almost inevitable that it will seek some concessions from its creditors. There are a number of restructuring techniques that the debtor and creditor may agree to implement which fall short of actually triggering the debt forgiveness rules. This section will set out some examples of such techniques.

1. Informal Moratorium

The mere fact that a debtor is unable to pay its obligations as they become due and defaults on principal and interest payments under a debt instrument does not in and of itself give rise to a debt forgiveness situation. Indeed, the debtor continues to be entitled to deduct interest on an accrual basis despite such non-payment.[163] The mere fact that the creditor does not insist on payment and enforce its obligations does not trigger the debt forgiveness rules.

2. Changing the Terms of the Debt Instrument: Issuance of New Debt Instrument

Paragraph 80(2)(h) discussed above is a very helpful rule in the context of debt restructuring. In essence, it provides that if a debt obligation is replaced by a new debt obligation having the same principal amount as the original obligation, no debt forgiveness will occur. Therefore, provided this rule is complied with, there can be considerable latitude in restructuring (i.e., postponing) the timing of principal and interest obligations provided that there remains a legal obligation under the new debt instrument to pay the same amount of principal

and interest (accrued to the date of conversion) as before. A reduction in the interest rate going forward would be permissible as would a considerably later maturity date. The cash flow relief to the debtor that this type of restructuring provides may very well be sufficient to enable the debtor to get back on its feet.

It may be possible to make minor modifications to the existing indebtedness without a new obligation being created. More fundamental changes can, however, result in a new obligation being created.[164] Moreover, the CRA in *Interpretation Bulletin IT-448* entitled *Dispositions – Changes in Terms of Securities*, has indicated that while a change in the underlying security supporting a debt obligation will not usually be regarded as a disposition of the obligation itself, the following changes to the debt obligation (unless carried out pursuant to an authorizing provision in its original terms) are considered to be so fundamental as to almost invariably result in a disposition:

(a) a change from interest bearing to interest free or vice versa,

(b) a change in repayment schedule or maturity date (unless the degree of change is minimal and of relatively little importance in the circumstances),

(c) a change or decrease in the principal amount,

(d) the additional, alteration or elimination of a premium payable upon retirement,

(e) a change in the debtor, and

(f) a conversion of a fixed interest bond to a bond in respect of which interest is payable only to the extent that the debtor has made profit or vice versa.[165]

In any event, given the safe harbour that paragraph 80(2)(h) provides, the only real prohibition is on forgiveness of any portion of the principal or interest accrued to the date of the change in the debt instrument.

3. <u>Conversion of Debt to Equity</u>

The conversion of debt to equity of the debtor can result in the debt forgiveness rules applying. If, however, it can be demonstrated that the fair market value of the shares received by

the creditor have a fair market value equal to the principal amount of the debt so converted or that the forgiveness of such debt results in a coequal increase in the fair market value of the creditor's existing shares in the debtor corporation, or any combination thereof, relief from the debt forgiveness rules is provided by paragraphs 80(2)(g) and (g.1). This technique could have application where, for instance, the debtor is experiencing cash flow difficulties but is still solvent, so that a $1.00 reduction in debt will provide a $1.00 increase in the fair market value of the creditor's equity in the corporation; where this is not the case, the debt forgiveness rules would apply.

Where the debt is converted into preferred shares, care must be taken to ensure that the special taxes imposed by Parts IV.1 and VI.1 do not apply. In non-arm's length situations, this may often be alleviated by reliance on the substantial interest exemption contained in those provisions.

It may be that, technically, a subscription by a creditor for shares for cash, which cash is then used to repay the indebtedness owing to the creditor could be successful in avoiding a debt forgiveness. On its face, paragraph 80(2)(g) would not apply and there have been some indications that the CRA would in some circumstances accept this type of transaction, although they have also indicated that the GAAR would be applied to such transactions. Great care must be taken with this type of approach.[166]

4. Conceding Capital Losses to Preserve Non-Capital Losses

In order to avoid the application of the debt parking rules and the debt forgiveness rules generally, it may be prudent for a parent corporation which has debt receivable from a loss subsidiary to forego its accrued capital loss on the debt in order to preserve the non-capital losses of the loss subsidiary for the benefit of a potential buyer. This technique has been described in section II. E. above, but will be repeated here for ease of reference. The technique is described in CRA *Advance Tax Ruling ATR-66* dated April 20, 1995 and relies upon paragraph 40(2)(e.1) of the Act. For example, Holdco owns all of the shares of Opco and holds a note receivable from Opco (the "Opco Note"). As a consequence of losses from its operations, Opco has non-capital loss carryforwards and the principal amount of the Opco Note held by Holdco is greater than its

fair market value. Purchaseco wishes to acquire the shares and indebtedness of Opco so that it can access Opco's non-capital losses. It is therefore critical that in any dealing with the Opco Note, the debt forgiveness rules in section 80*ff* of the Act not apply.

The transactions were therefore structured in the following manner. Opco incorporated a new wholly-owned corporation, Subco. Holdco sold its Opco Note to Subco at fair market value in exchange for a note payable from Subco having a lower principal amount (the "Subco Note"). The loss realized by Holdco on this transaction is denied pursuant to paragraph 40(2)(e.1) and the amount of the denied loss is added to the adjusted cost base of the Opco Note in the hands of Subco pursuant to paragraph 53(1)(f.1) so that the adjusted cost base equals the principal amount of the Opco Note. Subco is then wound up into Opco under subsection 88(1) of the Act and Opco elects pursuant to subsection 80.01(4) of the Act (or alternatively is amalgamated and subsection 80.01(3) applies) so that the Opco Note is deemed to have been settled or extinguished for its cost amount (i.e. the principal amount) and hence no debt forgiveness occurs. As a consequence of the winding up or amalgamation, Opco now owes Holdco an amount equal to the principal amount of the Subco Note (the "New Opco Note"). Holdco then sells its shares and the New Opco Note to Purchaseco for fair market value. As a consequence of this structure, Purchaseco is acquiring the New Opco Note for a price equal to the principal amount thereof so the debt parking rules do not apply, no debt forgiveness of the Opco Note has occurred by virtue of subsection 80.01(3) or (4), as the case may be, and therefore the non-capital losses of Opco are preserved. The only detriment to Holdco is that its accrued capital loss on the debt instrument owing by Subco has been lost.

5. <u>Staying within the Debt Parking Limitations</u>

As discussed above, the debt parking rules only apply if the parked obligation is transferred for less than 80% of the principal amount of the debt. Therefore, where possible, if the debt parking is potentially an issue, care should be taken not to exceed this limitation.

If, however, it appears that the limitation would be exceeded, consideration should be given to selling the debt into two tranches: for instance, the first tranche would be sold for 80% of the principal amount of the indebtedness and the second tranche would be forgiven outright.

In this way, arguably the debt parking rules would only apply to the second tranche because the first tranche met the 80% requirement in subsection 80.01(8).[167] In any event, the GAAR implications of this technique must be carefully considered.

As well, the debt parking rules only apply where the debt itself is transferred. It may be possible in certain circumstances to avoid the debt parking rules by transferring the shares of the corporation holding the debt instead.[168] For instance, if Corporation A owns all of the shares of Corporation B which in turn owns debt which has declined in value and all of the shares of Corporation C, a sale of the debt for less than 80% of its value and all of the shares of Corporation C to Purchaseco would trigger the debt forgiveness rules. In contrast, a sale of the shares of Corporation B by Corporation A would not trigger the debt parking rules.

C. MANAGING DEBT FORGIVENESS; PRESERVING THE DEBTOR'S LOSSES AND OTHER TAX ATTRIBUTES

In situations where a debt forgiveness is inevitable, including in the context of an acquisition of control, careful consideration of the technical debt forgiveness and acquisition of control rules can offer a number of opportunities.

1. Section 80.04 – Transfer of a Forgiven Amount to a Related Party

After a forgiven amount has completely reduced the tax attributes of the debtor, section 80.04 permits the remainder of the forgiven amount to be transferred to and applied against the tax attributes of eligible related parties. This provision, coupled with an anticipatory corporation reorganization, can be a very effective means of controlling the application of the debt forgiveness rules. For instance, where a corporation's only assets are land worth $3,000,000 and a building with a an undepreciated capital cost of $3,000,000 and shares of a subsidiary with a net capital loss of $3,000,000 and it is proposed that there be a debt forgiveness of $3,000,000, it may be advantageous for the corporation to transfer the land and building to a new subsidiary before undergoing a forgiveness of debt. In this situation, after the reorganization, the corporation's only assets will be shares of the two subsidiaries. The corporation could then enter into an agreement with the subsidiary with the net capital losses to transfer the forgiven amount to that subsidiary with the result that the net capital losses would be reduced but the adjusted cost

base of the land and the undepreciated capital cost of the building held in the other subsidiary would be preserved. In this way, the more valuable of the loss corporation's tax attributes would be preserved.[169]

It may also be the case that on a section 80.04 election, a transfer to a majority shareholder for cash in exchange for accepting the transfer of a forgiven amount may be attractive in that the majority shareholder would be receiving cash in exchange for the loss of a relatively unattractive tax asset, such as net capital losses, or the adjusted cost base of non-depreciable property.[170]

2. Amalgamation or Wind-up with a Related Corporation to Mix Tax Attributes

In a similar fashion, it would be possible to merge two corporations by way of an amalgamation or subsection 88(1) wind-up in order to mix the tax attributes of the amalgamating corporation prior to a debt forgiveness. For instance, if Sister Corporation A wished to have some of its debt forgiven and its only assets were rapid write-off depreciable capital property and Sister Corporation B had no meaningful tax attributes other than non-capital losses which were close to expiry (but not in their last year before expiry), it would be possible to amalgamate the two corporations with the result that a subsequent forgiveness would be applied to reduce the soon to expire non-capital losses of the amalgamated corporation rather than reduce the undepreciated capital cost of depreciable property held by the former Sister Corporation A.[171]

3. Utilizing Expiring Loss Carryforwards

The object in managing debt forgiveness issues generally is to ensure that either the rules do not apply at all or that they apply to the least useful tax attribute of the debtor as much as possible. If, for instance, a debtor has a non-capital loss which is about to expire, consideration could be given to triggering an impending debt forgiveness before the expiry so that the debt forgiveness eliminates a potentially useless tax attribute of the debtor.[172]

4. Statute Barred Debt

A debt forgiveness occurs when debt becomes statute barred. Where this occurs at a disadvantageous time, particularly where the debt is non-arm's length indebtedness, consideration might be given to preserving the creditor's rights. This could occur, for instance, by the exchange of the existing debt instrument for a new debt instrument having the same principal amount. The debt could then be forgiven subsequently at a more advantageous time.[173]

5. Acquisition of Control Issues

The debt forgiveness rules and the acquisition of control rules operate within somewhat different parameters. With the exception of the debt parking rules, the debt forgiveness rules do not apply automatically on an exchange of control. Moreover, while capital losses may not be carried forward after an acquisition of control and non-capital losses are subject to streaming rules for purposes of the acquisition of control rules generally, these prohibitions generally do not apply for purposes of the debt forgiveness rules. On an acquisition of control, as discussed above, there will be a writedown of the corporation's capital and depreciable assets to their fair market value with a consequent increase in the net capital losses and non-capital losses of the corporation prior to the acquisition of control.

Where this writedown in assets would increase the non-capital losses of the corporation, consideration might be given to having the debt forgiveness occur before the acquisition of control so that the debt forgiveness only applies to a smaller amount of non-capital losses and the non-capital loss resulting from the writedown on the acquisition of control is preserved.[174] On the other hand, where the writedown in assets would produce significant capital losses and the debtor's only tax attributes are, for instance, rapid write-off undepreciated capital cost, consideration might be given to triggering the forgiveness of debt after the acquisition of control so that the debt forgiveness will apply to the capital losses generated on the acquisition of control and not to the reduction of the undepreciated capital cost of the depreciable property.

Where the loss corporation has significant capital losses, but little or few non-capital losses, consideration should be given to forgiving the debt before the acquisition of control so that the net capital losses, which are of no use after the acquisition of control, are reduced. In

contrast, if the debt forgiveness occurred after the acquisition of control it may be that the writedown of assets contemplated by the acquisition of control rules would create net non-capital losses which would then have to be reduced.[175]

In a similar fashion where paragraph 111(4)(e) may be used to obtain a writeup in capital assets, consideration should be given to having the debt forgiveness occur before the acquisition of control so that the forgiveness would be applied to other tax attributes.[176]

As another example, consider the situation where a corporation has no assets other than shares of a subsidiary with an adjusted cost base of $5,000,000 and a fair market value of nil as well as a debt of $5,000,000. If the debt is forgiven before an acquisition of control, an income inclusion could potentially result to the corporation, whereas if the debt is forgiven after the acquisition of control, the $5,000,000 capital loss from the writedown of the shares of the subsidiary could be utilized against the $5,000,000 of forgiven amount.[177]

VI. CONCLUSION

The utilization of tax losses and debt restructuring are areas where the ingenuity of taxpayers and the policy concerns of the CRA and the Department of Finance will always be in tension, as the spate of recent amendments to the stop-loss rules and of recent case law demonstrates. Hopefully, this paper will provide a useful reference for corporate taxpayers in planning to use both their accrued and realized tax losses.

ENDNOTES

[*] I would like to thank James A. Hutchinson and Steven R. McLeod for their assistance in preparing this paper.

[1] Or a deemed disposition where the event in question, while not giving rise to monetary proceeds, is considered appropriate to be treated as a realization, e.g. a deemed disposition upon a change in use of property.

[2] While the CRA attacked numerous of these types of arrangements, the rules contained in subsection 85(5.1) for depreciable property and paragraph 40(2)(e) and subsection 85(4) for non-depreciable capital property did offer (subject possibly to the application of the usual host of anti-avoidance rules) the opportunity in effect to transfer a portion of such accrued losses to persons outside the affected corporate group. For instance, depreciable property with an accrued loss could be transferred by corporation A to a partnership (carrying on a business) of which it was a majority interest partner (e.g. 51%) with an arm's length party as the minority partner. Assuming the transferred property constituted all of the property of the prescribed class, the partnership would inherit the UCC balance of the transferor corporation and could claim capital cost allowance accordingly notwithstanding that the fair market value of the transferred assets was considerably less than the UCC. Thus, 49% of the capital cost allowance so generated would in effect be transferred to the minority partner. A fascinating example of this genre of tax planning (or abuse in the eyes of the revenue authorities) is the 1999 Tax Court of Canada decision in *Husky Oil Limited v. HMTQ*, 1999 DTC 308 (T.C.C.), where such a structure, albeit on its particular facts, passed muster under GAAR. Similarly, depreciable property with an accrued loss could be transferred to a wholly-owned subsidiary (which, for simplicity, had no income) thereby triggering subsection 85(5.1). The shares of the subsidiary could then be sold to an arm's length party. While the acquisition of control rules would apply in this situation so that the excess of the UCC over the fair market value of the property would be mandatorily deducted by the subsidiary in the taxation year ending on the acquisition of control, thereby creating or increasing a non-capital loss of the subsidiary prior to the acquisition of control, provided the streaming rules in subsection 111(5) were met, the resultant non-capital loss could be utilized after the acquisition of control. It is precisely these types of tax planning opportunities which gave rise to the 1995 amendments and the present stop-loss rules. See Heakes, *"New Rules, Old Chestnuts, and Emerging Jurisprudence: The Stop-Loss Rules"*, 1995 Conference Report, Canadian Tax Foundation, 1996, 34:1 at 34:8.

[3] In the context of non-depreciable capital property, examples of more "flagrant" (i.e. from the CRA's perspective) utilization of these provisions involving the transfer of accrued losses to or for the benefit of arm's length parties before the 1987 amendments to the acquisition of control rules and subsection 111(4) in particular are the decisions of the Federal Court of Appeal in *HMTQ v. Husky Oil Limited*, 1995 DTC 5244, *HMTQ v. Nova Corporation of Alberta*, 1997 DTC 5229 and *Hollinger Inc. v. HMTQ*, 1999 DTC 5500.

[4] For a worthwhile discussion and analysis of the affiliated person rules, see S. Carson and K. Watson, *"Affiliated Person Rules: A Review of Recent Technical Amendments and Practical Issues Relating to Stop Loss Rules"*, 2004 BC Tax Conference Report, Canadian Tax Foundation, 2004, 13:1.

[5] Subsection 251.1(3). See *Transport M.L. Couture Inc. v. Canada*, 2004 DTC 6141 (F.C.A.) for a recent consideration of the *de facto* control concept by the Federal Court of Appeal.

[6] For further examples, see Bernstein, *"Loss Utilization by Individuals and Private Corporations"*, 1996 Conference Report, Canadian Tax Foundation, 1997, 58:1 at 58:18 to 58:19.

[7] CRA Letter No. 9710065 dated September 4, 1997.

[8] *Vineland Quarries and Crushed Stone Limited v. MNR*, 1966 DTC 5092 (Ex. Ct.) Aff'd 1967 DTC 5283 (S.C.C.).

[9] See subsection 251(3).

[10] See Heakes at 34:5.

[11] See, for instance, the association rules in section 256.

[12] Under the former rules, where an estate controlled a corporation and none of the executors of the estate were affiliated persons, it was the CRA's view that the estate would be affiliated with the corporation under subparagraph 251.1(1)(b)(i). See CRA Letter No. 2000-0024775 dated February 23, 2001. In contrast, where an estate, which has more than one executor none of whom is affiliated with another, did not itself have control over a corporation, but the corporation was controlled by a related group consisting of the executors, the estate would not normally be affiliated with the corporation as it was not a person described in (a), (b) or (c) of the definition of "affiliated persons". This assumes that under the terms of the will any decision requires majority approval of the executors. See CRA Letter No. 2000-0052345 dated February 20, 2001.

[13] De Angelis, *"The Stop-Loss Rules: Pitfalls and Opportunities"*, 2003 Conference Report, Canadian Tax Foundation, 2004, 50:1 at 50:5.

[14] For the definition of beneficially interested, see subsection 248(25) of the Act.

[15] The provision was originally only applicable to a corporation, trust or partnership, but was amended in 2001, applicable after November, 1999, to apply to any "person or partnership", thus extending the application of the rule to natural persons, subject to certain transitional rules.

[16] See the discussion of superficial losses in II.G. below.

[17] Prior draft versions of this rule placed the notional property in a separate class with the same depreciation rate, thereby permitting the terminal loss to be triggered when one of the events described below occurred; under the final version, this only occurs if the transferred property is the only remaining property in the class.

[18] This rule would seem to create an administrative nightmare. For instance, if property with an accrued loss was transferred to a majority partner on the dissolution of the partnership, a minority affiliated partner would be required to check constantly with the majority partner to ascertain if the property had been disposed of or any of the other triggering events listed in subsection 13(21.2) had occurred.

[19] CRA Document No. 1999-0012425 dated December 7, 1999.

[20] For an example of a recent case where a taxpayer failed to sufficiently disengage itself from its affiliated subsidiary under the prior rules, see *Terminal Norco Inc.*, 2006 DTC 2897 (T.C.C.).

[21] See CRA Document No. 2004-0091061E5 dated March 21, 2007.

[22] As one writer points out, in light of uncertainties created by certain case law regarding the continued characterization of property, for instance, as depreciable property, on an amalgamation or wind up, these rules may present a planning opportunity. For instance, rather than winding up a subsidiary into its parent or amalgamating the subsidiary with its parent where the subsidiary has depreciable property with an accrued loss whose character may change on the reorganization, the property could be sold to an affiliated corporation prior to the reorganization thereby triggering the application of subsection 13(21.2) so that the transferor acquires a notional depreciable property as described above. See Dunn, *"Corporate Consolidations: To Amalgamate or Not To Amalgamate?"*, 1996 Conference Report, Canadian Tax Foundation, 1997, 13:1 at 13:10 and 13:15-16. The subsequent Supreme Court of Canada decisions in *Mara Properties Limited v. HMTQ*, 1996 DTC 6309 (S.C.C.), *Hickman Motors Limited v. HMTQ*, 1997 DTC 5363 (S.C.C.), *Continental Bank Leasing Corporation v. HMTQ*, 1998 DTC 6505 (S.C.C.) and *HMTQ v. Continental Bank of Canada*, 1998 DTC 6501 (S.C.C.) do alleviate a considerable amount of this uncertainty, however.

[23] See Note 19.

[24] See Dunn, Note 22.

[25] See CRA Letter No. 2004-0071821E5 dated June 14, 2004.

[26] Heakes at 35:9.

[27] See De Angelis at 50:12.

[28] See the discussion on the superficial loss rules in II.G. below.

[29] This is similar to the superficial loss rules before the 1995 amendments. See discussion below.

[30] See CRA Letter No. 2002-0180915 dated February 18, 2003.

[31] See CRA Letter No. 2001-0088155 dated July 4, 2001.

[32] See CRA Letter No. 2002-0161447 dated November 14, 2002.

[33] De Angelis at 50:10.

[34] See CRA Letter No. 2001-0107241 dated January 23, 2002.

[35] De Angelis at 50:10.

[36] *Explanatory Notes* issued by the Department of Finance on November 9, 2006.

[37] *Ibid*. See also Bill C-10.

[38] CRA Letter No. 2003-0182977 dated March 14, 2003.

[39] See CRA Letter Nos. 2003-0182977 dated March 14, 2003 and 2005-0141191C6 dated October 7, 2005.

[40] See CRA Letter Nos. 1999-0010805 dated February 21, 2000, 1999-0010825 dated February 22, 2000 and 1999-0015705 dated March 2, 2000.

[41] See CRA Letter No. 2000-0052345 dated February 22, 2001.

[42] For an example of the application of this concept in the context of subsection 85(4), the predecessor to subsection 40(3.6), see *Estate of Carl Edward Miller v. HMTQ*, 2002 DTC 1228 (T.C.C.).

[43] See CRA Letter No. 2000-0062505 dated March 6, 2001.

[44] See CRA Letter No. 2002-0151025 dated January 16, 2003.

[45] See CRA Letter No. 2000-0052345 dated February 22, 2001 and CRA Letter No. 2000-0024775 dated February 23, 2001. See also CRA Letter No. 2000-0031107 dated October 13, 2000 for an unfortunate example where the loss otherwise available for carryback under subsection 164(6) was denied by virtue of subsection 40(3.6).

[46] See CRA Letter No. 2001-0070795 dated March 5, 2001.

[47] See CRA Letter No. 2001-0074145 dated March 29, 2001.

[48] See CRA Letter No. 9818605 dated November 26, 1998.

[49] See CRA Letter No. 2003-0035135 dated September 18, 2003.

[50] See CRA Letter No. 2000-0001065 dated June 1, 2000.

[51] i.e. a disposition deemed to have occurred by section 70, subsection 104(4), section 128.1, paragraph 132.2(1)(f), subsection 138(11.3) or subsection 149(10).

[52] Under the November 9, 2006 Draft Legislation, as a consequence of the proposed restructuring of section 132.2 of the Act, the reference in paragraph 18(14)(c) to paragraph 132.2(1)(f) is to be replaced by references to paragraphs 132.2(3)(a) and (c) with respect to dispositions that occur after 1998.

[53] A minor amendment is proposed in Bill C-10 to paragraph 18(14)(c).

[54] See CRA Letter No. 2003-0017075 dated May 27, 2003, CRA File No. 2001-0100155 dated January 7, 2002, CRA File No. 2000-0056115 dated January 11, 2001 and CRA Letter No. 9726485 dated January 19, 1998 and

[55] See CRA Letter No. 2001-0106905 dated December 20, 2001.

[56] 2001 DTC 861 (T.C.C.); aff'd 2003 DTC 5007 (F.C.A.).

[57] For a relatively recent discussion of the dividend stop loss rules, see Suarez, *"The Capital Property Dividend Stop-Loss Rules"*, Corporate Tax Planning, Canadian Tax Journal (2005) Vol. 53, No. 1 at 269 and Kakkar, *"Section 112 Stop-Loss Rules Prevail"*, Taxation for the Owner Manager (2005) Vo. 5, No. 3 at 3.

[58] The CRA's position is set forth in *"Income Tax Technical News No. 9"* dated February 10, 1997.

[59] See Sinclair, *"High Cost of Leaving, Loss Utilization: A Review of Recent Positions of the Department of National Revenue"*, 1996 Conference Report, Canadian Tax Foundation, 1997, 7:1 at 7:20.

[60] Much has been written about the tax issues involved in amalgamations and the reader is referred to that body of literature. This paper focuses solely on the aspects of amalgamations which are relevant for purposes of loss utilization within an affiliated corporate group. See, for instance, Kakkar, *"An Overview of the Technical Aspects of the New Legislative and Administrative Issues involving Wind-ups and Amalgamations"*, 2005 Ontario Conference Report, Canadian Tax Foundation 2005 at 4B:1, Crowe and Senyk, *"Amalgamation and Wind-up: What's the Difference?"*, 2003 Prairie Provinces Conference Report, Canadian Tax Foundation, 2003 at 10:1, Schwartz, *"Statutory Amalgamations, Arrangements, and Continuations: Tax and Corporate Law Considerations"*, 1991 Conference Report, Canadian Tax Foundation, 1992 at 9:1 and Dunn, *op. cit.*

[61] Prior to the enactment of this rule, by far the safer route for amalgamating a loss subsidiary with a profitable parent was to wind up the subsidiary utilizing the provisions of subsection 88(1) discussed further below. Specifically, prior to the enactment of subsection 87(2.11), if the profitable parent and loss subsidiary had been amalgamated and the amalgamated corporation incurred losses, the losses would not be available for carryback against the predecessor parent's income. In some cases, if the loss could have been carried back, the resultant tax refund could have saved the amalgamated corporation from bankruptcy. In contrast, on a wind-up under subsection 88(1), the parent corporation is the surviving entity and losses of the parent incurred subsequent to the winding up of the subsidiary can be carried back to be offset against income of the parent in prior years subject to the usual temporal restrictions.

[62] See Strother, *"Creative Corporate Tax Planning"*, 1994 Conference Report, Canadian Tax Foundation, 1995, 11:1 at 11:4.

[63] CRA Letter No. 9802725 dated November 20, 1998.

[64] For another variation dealing with the interplay between subsection 87(2.1) and subsection 87(2.11), see CRA Letter No. 2006-0170341E5 dated October 26, 2006.

[65] For instance, if it is intended to amalgamate an unprofitable subsidiary with a profitable one, it must be remembered that, subject to subsection 87(2.11) (which only applies in limited circumstances), losses of the new corporation cannot be carried back to predecessor corporations (i.e., tax paid by the profitable predecessor corporation prior to amalgamation can never be recovered) and accordingly, it may be prudent to amalgamate the

corporations as quickly as possible in order that the ongoing profits of the business of the profitable corporation may be sheltered from tax by the carryforward of losses from the unprofitable predecessor corporation to the new corporation. However, where a presently profitable corporation has non-capital losses of prior years which are in danger of becoming staledated by virtue of the (seven, ten or) twenty year carryforward limitation, it will be necessary to make some projections as to the ongoing profits of the new corporation in order to determine the risk that these losses may be staledated before they can be effectively utilized by the new corporation by virtue of there being a short fiscal period on an amalgamation.

[66] For instance, where the paid-up capital exceeds the parent's adjusted cost base of the shares of the subsidiary because the parent acquired the subsidiary from a third party.

[67] For examples of rulings dealing with the "bump" under subsection 87(11), see CRA Letter No. 2007-0231331R3 dated November 7, 2007, CRA Letter No. 2007-0237482R3 dated November 7, 2007, CRA Letter No. 2006-0194321R3 dated May 30, 2007 and CRA Letter No. 2006-0198211R3 dated March 7, 2007.

[68] *Mara Properties Limited v. HMTQ*, 1996 DTC 6309 (S.C.C.) and *Hickman Motors Limited v. HMTQ*, 1997 DTC 5363 (S.C.C.).

[69] *Continental Bank Leasing Corporation v. HMTQ*, 1998 DTC 6505 (S.C.C.) and *The Queen v. Continental Bank of Canada*, 1998 DTC 6501 (S.C.C.). For very worthwhile commentaries on these cases, see Bauer, *"Partnerships: A Matter of Substance"*, Current Cases, Canadian Tax Journal (1998), Vol. 46, No. 5 at 1067 and Monaghan and Raizenne, *"Recent Cases of Interest to Corporate Financing Transactions"*, 1998 Conference Report, Canadian Tax Foundation, 1998, 13:1 at 13:12*ff*.

[70] See Desloges and Marley, *"Group Taxation – Canada"*, 2004 Cahiers de Droit Fiscal International, International Fiscal Association, 2004, 197 at 206.

[71] As mentioned in Note 63 above, it is possible for the parent to have a capital gain on the disposition of the shares of subsidiary. This is obviously a matter which should be investigated prior to undertaking the winding up.

[72] To take an extreme example, if a parent has a calendar year end, the subsidiary a January 31 year end, and the winding up commences January 1, 2006, the losses may only be utilized by the parent in its taxation year ending December 31, 2007.

[73] See Note 70 above.

[74] See, for instance, the comments of the Court in *Mark Resources Inc. v. HMTQ*, 93 DTC 1004 (T.C.C.) at 1017. See also *CRB Logging Co. Limited v. HMTQ*, 2000 DTC 6542 (F.C.A.) (affirming 99 DTC 840) and the CRA's comments on that case in *Income Tax Technical News No. 18* dated June 6, 2000.

[75] See Lynch, Boychuk, Perry and Thivierge, *"CCRA Round Table"*, 2003 Conference Report, Canadian Tax Foundation, 2004 at 8A:1 to 8A:10*ff* and CCH Canadian *Tax Topics* Report No. 1648 dated October 9, 2003.

[76] This type of arrangement was expressly approved of by the Supreme Court of Canada in *Stubart Investments v. HMTQ*, 84 DTC 6305 (S.C.C.). The CRA has also commented positively on such an arrangement in paragraph 8 of *Information Circular 88-2* entitled *"General Anti-Avoidance Rule – Section 245 of the Income Tax Act"* dated October 31, 1988.

[77] See CRA Letter Nos. 2004-0098561R3 dated January 26, 2005 and 2005-0155451R3 January 11, 2006.

[78] See Stadtegger, *"Corporate Loss Utilization: Where Are We Now and What Can Be Done?"* 2003 Conference Report, Canadian Tax Foundation, 2004, 30:1 at 30:9 for a more detailed commentary.

[79] On the other hand, the CRA is apparently of the view that subsection 69(11) would apply to a deemed disposition of property under paragraph 111(4)(e). The CRA in 1996 considered a situation similar to that described above, except that the transferee corporation did not resell the property, but in an unrelated transaction within three years

after the transfer of the property, there was an acquisition of control of the transferee and the transferee elected under paragraph 111(4)(e) to revalue its property including that contributed by the transferor. The CRA concluded that subsection 69(11) was applicable in the circumstances. See CRA File No. 9639150 (Round Table response at Tax Executives Institute) December 5, 1996.

[80] For further discussion of these amendments to section 55, see Ton-That and Bilodeau, *"Breaking Up is Hard to Do"*, 1996 Conference Report, Canadian Tax Foundation, 1997, 11:1 at 11:10.

[81] See paragraph 9 of *Information Circular 88-2*.

[82] In the CRA review at the 1995 Canadian Tax Foundation Conference, Michael Hiltz indicated that the CRA would maintain its position notwithstanding the Federal Court of Appeal decision in *Mara Properties* which went against the taxpayer. Since *Mara Properties* was reversed on appeal to the Supreme Court of Canada and the Supreme Court of Canada similarly found in favour of the taxpayer in *Hickman Motors, a fortiori*, this position appears to continue.

[83] See Note 69 above.

[84] See paragraph 19 of *Information Circular 88-2*.

[85] See paragraph 5 of the *Supplement to Information Circular 88-2* dated July 13, 1990.

[86] For a variation on this theme, see CRA Letter No. 2002-0177363 dated February 12, 2003.

[87] See, for example, CRA Letter Nos. 2003-0181283 dated September 3, 2003 and 2003-0013723 dated June 18, 2003. For an interesting variation, see CRA Letter Nos. 2003-0020553 dated August 14, 2003, 2005-0118061R3 dated August 24, 2005, 2005-0132891R3 dated November 9, 2005 2005-0160471R3 dated March 8, 2006. See also the discussion of the foregoing in *Welch and Borgman, "Recent CRA Views of Interest"*, Canadian Life and Health Insurance Association, Tax Officers Conference, 2006.

[88] For further examples of these types of transactions, see CRA Letter Nos. 2005-0118061R3 dated August 24, 2005, 2005-0143711R3 dated September 14, 2005, 2004-0109481R3 dated October 5, 2005, 2005-0118951R3 dated October 5, 2005, 2005-0139621R3 dated October 5, 2005, 2005-0132891R3 dated November 9, 2005, 2006-0185221R3, 2006-0171291R3 dated July 19, 2006 and 2006-0180261R3 dated August 23, 2006. For a somewhat different variant see CRA Letter No. 2005-0160471R3 dated March 8, 2006. See also CRA Letter Nos. 2007-0226151R3 dated October 10, 2007, 2007-0226931R3 dated September 12, 2007, 2007-022921R3 dated May 16, 2007, 2006-0219051R3 dated May 9, 2007 and 2007-0220051R3 dated March 14, 2007.

[89] See *Information Circular 88-2*, Advance Tax Ruling ATR-44 and CRA Letters Nos. 9728683 dated April 17, 1998 and 9727343 dated April 17, 1998, for examples. See also Kellough & McQuillan, *"Taxation of Private Corporations and Their Shareholders"*, Canadian Tax Foundation, 1999 at 13:31 to 13:33.

[90] *Supra* Note 74.

[91] *HMTQ v. Singleton*, 2001 DTC 5533 (S.C.C.).

[92] *Ludco Enterprises Ltd. et al v. HMTQ*, 2001 DTC 5505 (S.C.C.).

[93] 2006 DTC 2687.

[94] See also *Overs v. HMTQ*, 2006 DTC 2192 for a similar situation in which the taxpayer was unsuccessful based on GAAR at the Tax Court of Canada level.

[95] See F. Ahmed, *Interest Deductibility Update*, Canadian Current Tax, May, 2002. See also CRA Letter No. 2001-0090213 dated February 6, 2002.

[96] *Income Tax Technical News No. 25* dated October 30, 2002.

[97] See also generally Stadtegger at 30:5 *ff* and Desloges and Marley at 210.

[98] *Income Tax Technical News No. 30*, dated May 21, 2004. For examples of recent CRA rulings, see CRA Letter No. 2005-0132891R3 dated November 9, 2005, CRA Letter No. 2004-0109481R3 dated October 5, 2005, CRA Letter No. 2005-0139621R3 dated October 5, 2005, CRA Letter No. 2005-0143711R3 dated September 14, 2005, CRA Letter No. 2005-0118061R3 dated August 24, 2005, CRA Letter No. 2005-0117641R3 dated June 3, 2005, CRA Letter No. 2004-0105821R3 dated March 23, 2005, CRA Letter No. 2004-0098071R3 dated January 26, 2005, CRA Letter No. 2003-0049361R3 dated January 26, 2005, CRA Letter No. 2004-0100991R3 dated January 19, 2005, CRA Letter No. 2004-0089181R3 dated November 10, 2004.

[99] For an example of this type of planning, see CRA Letter No. 9615073 dated March 7, 1997.

[100] See Vukets, *"Structural Issues in Utilization of Domestic Loss Carryforward Pools"*, 1993 Conference Report, Canadian Tax Foundation, 1994, 23:1 at 23:17.

[101] See Bernstein at 58:36.

[102] See Bernstein at 58:36.

[103] See Note 69 *supra*.

[104] See Strother at 11:6*ff*.

[105] See Strother at 11:10. See also Vukets at 23:11*ff*. Also noteworthy with respect to the topic of partnerships are the more recent Supreme Court of Canada decisions in *Backman v. HMTQ*, 2001 DTC 5149 (S.C.C.) and *Spire Freezers Ltd. et al v. HMTQ*, 2001 DTC 5158 (S.C.C.).

[106] 2005 DTC 1731 (T.C.C.).

[107] 2007 DTC 5146 (F.C.A.).

[108] See Stadtegger at 30:16 for an interesting example of such a transaction.

[109] *Duha Printers (Western) Ltd. v. The Queen*, 1998 DTC 6334 (S.C.C.). See Part IV.A. below.

[110] See Monaghan and Raizenne, *"Recent Cases of Interest to Corporate Financing Transactions"*, 1998 Conference Report, Canadian Tax Foundation, 1998, 13:1 at 13:12*ff*.

[111] See Haney, *"A Return to The Traditional Test of Control"*, Current Cases, Canadian Tax Journal (1998), Vol. 46, No. 4 at 839.

[112] Strother at 11:15.

[113] Jack, Lynch, Perry & Shultis, *"Interest Deductibility: Where From, Where To, Where Now?"*, 2002 Conference Report, Canadian Tax Foundation, 2003, 11:1 at 11:10.

[114] See *Income Tax Technical News No. 34*, dated April 27, 2006.

[115] *Ibid*.

[116] See the discussion in Part II.B. and C. above.

[117] 2001 DTC 5471 (F.C.A.).

[118]2002 DTC 7172 (F.C.A.)

[119] 2005 DTC 5523 (S.C.C.).

[120] 2005 DTC 5538 (S.C.C.).

[121] 2005 DTC 5538 (S.C.C.).

[122] See Note 118, *Supra*.

[123] For a more detailed analysis of the *Canada Trustco* case, see John M. Campbell, *"Current Income Tax Cases"*, 2005 CICA National Conference on Income Taxes.

[124] *Canada Trustco Mortgage Company* paragraph 26.

[125] *Canada Trustco Mortgage Company* paragraph 39.

[126] *Canada Trustco Mortgage Company*, paragraph 43.

[127] *Canada Trustco Mortgage Company*, Paragraphs 44 and 45.

[128] *Canada Trustco Mortgage Company*, Paragraph 66.

[129] 2005 DTC 5095 (F.C.A.).

[130] See McDonnell, *"Profit Trading as an Acceptable Tax Minimization Technique"*, Current Cases, Canadian Tax Journal (2005), Vol. 53, No. 3 at 754.

[131] *Loyens and Loyens v. HMTQ*, 2003 DTC 355 (T.C.C.).

[132] 2006 DTC 6288 (F.C.A.).

[133] See *Buckerfield's Ltd. et al v. MNR*, 1964 DTC 5301 (Ex. Ct.).

[134] See for example *HMTQ v. Imperial General Properties Limited*, 1985 DTC 5500 (S.C.C.) where even though the voting rights of two unrelated groups of shareholders were identical, it was held that the right of one shareholder to cause the company to be wound up, in which case the vast majority of the value of the corporation would be distributed to that shareholder, constituted "control" of the corporation for the purposes of rendering the corporation to be associated with another corporation within the meaning of section 256 of the Act. See also *Oakfield Developments Limited v. MNR*, 1971 DTC 5175 (S.C.C.). In the Federal Court Trial Division decision in *International Mercantile Factors Ltd. v. HMTQ*, 1990 DTC 6390 (F.C.T.D.); aff'd 1994 DTC 6365 (F.C.A.), it was held that a corporation whose shares were held 50% by public corporations and 50% by a Canadian resident individual did not qualify as a Canadian-controlled private corporation since the majority of the board of directors were nominees of the public corporations and neither side could effectively change the composition of the board of directors.

[135] Supra, Note 109.

[136] *Ibid* at 6341-2.

[137] *Ibid* at 6347-8.

[138] *Silicon Graphics Limited v. HMTQ*, 2002 DTC 7112 (F.C.A.).

[139] *Ibid* at 7117.

[140] See *Income Tax Technical News No. 34* dated April 27, 2006.

[141] *Sedona Networks Corporation v. HMTQ*, 2007 DTC 5359 (F.C.A.).

[142] *Explanatory Notes* issued by the Department of Finance on November 9, 2006.

[143] *Ibid.*

[144] See *IT-302R3*, paragraph 28.

[145] *Explanatory Notes* published by Department of Finance on December 8, 1997.

[146] See CRA Letter No. 2004-0092261E5 dated September 29, 2004.

[147] *Explanatory Notes* issued by the Department of Finance on November 9, 2006.

[148] *Ibid*.

[149] See CRA Letter No. 2004-0071821E5 dated June 14, 2004.

[150] There are a variety of other provisions in the Act relating to various types of deductions and tax credits that are impacted by an acquisition of control which are not strictly relevant to the subject matter to this paper.

[151] *Canadian Marconi Company Limited v. HMTQ*, 1986 DTC 6526 (S.C.C.).

[152] See W. Bies, *Tax Considerations in Share Acquisitions*, 2005 Conference Report, Canadian Tax Foundation, 2006 (publication pending).

[153] For an example of this see CRA Letter No. 2006-0198421R3 dated April 11, 2007.

[154] *Garage Montplaisir Inc. v. HMTQ*, 2001 DTC 5366 (F.C.A.).

[155] For a further example of judicial consideration of the issue of continuity of the business, see *HMTQ v. Diversified Holdings Limited*, 1997 DTC 5203 (F.C.A.).

[156] For a number of specific examples that the CRA has considered, see CRA Letter No. 9627815 dated October 17, 1996. See also CRA Letter No. 2002-0148045 dated July 22, 2002 for a discussion of these issues.

[157] *Manac Inc. Corp. v. HMTQ*, 1998 DTC 6352 (F.C.A.).

[158] This portion of the paper is not intended to be an exhaustive treatment of the debt forgiveness rules. The reader is referred to the substantial body of literature on this topic, including Steeves and Tunney, *"The tax consequences of restructuring of indebtedness (debt work – outs)"*, 2006 cahiers de droit fiscal international, International Fiscal Association, 2006, 167; Baek, *"Tax Planning for Resessionary Times"*, 2003 Conference Report, Canadian Tax Foundation, 2004, 53:1; Tunney, *"Update on Debt Forgiveness"*, 2003 Ontario Tax Conference, Canadian Tax Foundation, 2004, 9:1, Glass, *"Section 80: An Update"*, 2002 BC Tax Conference, Canadian Tax Foundation, 2002, 16:1, Black, *"Debt Forgiveness and Its Effect on Loss Utilization"*, 1999 BC Tax Conference, Canadian Tax Foundation, 1999, 1:1, Ahmed and Silverson, *"The New Debt-Forgiveness Rules: Planning Opportunities and Traps for the Unwary"*, 1996 Conference Report, Canadian Tax Foundation, 1997, 21:1, Bernstein, *"Update on Debt Forgiveness and Mortgage Foreclosure Proposals"*, 1995 Corporate Management Tax Conference, Canadian Tax Foundation, 1995, 21:1, Pickford and Tunney, *"The Tax Treatment of Forgiveness of Debt and Foreclosures: The Proposed New Rules"*, 1994 Conference Report, Canadian Tax Foundation, 1995, 3:1.

[159] Subsections 15.1(2) and 15.2(2), paragraph 18(1)(g), subsections 18(2), (3.1) and (4) and section 21.

[160] The definition of "forgiven amount" is much more detailed and excludes from the forgiven amount amounts otherwise included in income and certain excluded obligations as defined in section 80 of the Act.

[161] Other than an excluded security as defined in subsection 80(1).

[162] Taken from Tunney, *"Update on Debt Forgiveness"*, at 9:4.

[163] See Steeves and Tunney, at 171.

[164] See *General Electric Capital Equipment Finance Inc. v. HMTQ*, 2002 DTC 6734 (F.C.A.).

[165] See IT-448, paragraph 6 to 8.

[166] See Baek at 53:27. See also CRA Letter No. 2002-0141005 dated September 9, 2002.

[167] See Baek at 53:25 and Tunney, *"Update on Debt Forgiveness"*, at 9:19.

[168] See Tunney, *"Update on Debt Forgiveness"*, at 9:19.

[169] See Tunney, *"Update on Debt Forgiveness"*, at 9:13 – 14.

[170] See Tunney, *"Update on Debt Forgiveness"*, at 9:15.

[171] See Tunney, *"Update on Debt Forgiveness"*, at 9:15 and Baek, at 53:21.

[172] See Tunney, *"Update on Debt Forgiveness"*, at 9:20.

[173] See Tunney, *"Update on Debt Forgiveness"*, at 9:21.

[174] See Tunney, *"Update on Debt Forgiveness"*, at 9:16.

[175] See Glass at 16:29.

[176] *Ibid.*

[177] For a variant on this, see Tunney, *"Update on Debt Forgiveness"*, at 9:16 -17.