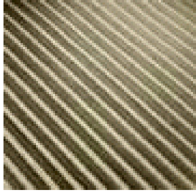

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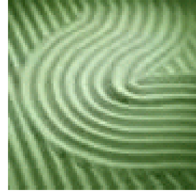
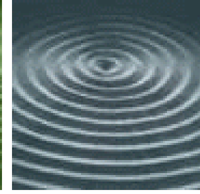
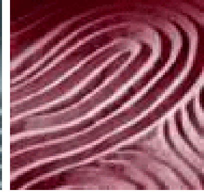

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Utilization of Tax Losses

by Gerald D. Courage
January 2003

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Introduction*

The effective 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. 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. Finally, the paper will examine the impact of an acquisition of control of a corporation on the utilization of its tax losses.

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 *Income Tax Act* (Canada) (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 abuses 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 "1998 amendments"). One important feature of these rules is the "affiliated persons" concept contained in new 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. 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.

Statutory history – the former stop-loss rules

Depreciable property – former subsection 85(5.1)

In order to understand the rationale for the present stop-loss rules, it is useful to review briefly the former rules and the concerns they created for Revenue Canada (as it then was, now, the Canada Customs and Revenue Agency) (hereinafter, the "CCRA") and the Department of Finance.

Former subsection 85(5.1) applied where a person or partnership had disposed of depreciable property of a prescribed class having a fair market value that was less than both the cost thereof to the transferor and the proportionate amount (based on the relative fair market values of the properties in the class) of the undepreciated capital cost ("UCC") of all property of the particular class to a transferee that was within a defined group. The defined group was as follows:

(a) a corporation that, immediately after the disposition, was controlled *de facto* [2] by the transferor, the transferor's spouse or by a person, group of persons or partnership having *de facto* control of the transferor;

(b) a person, spouse of a person, or member of a group of persons or partnership that immediately after the disposition had *de facto* control of the transferor; or

(c) a partnership of which the transferor was a "majority interest partner" within the meaning of subsection 97(3.1) immediately after disposition.

If subsection 85(5.1) applied, the transferor's proceeds of disposition and the transferee's cost of the property were deemed to be the lesser of the cost to the transferor of the property and the proportionate amount of UCC in the class. Thus, the accrued loss was either wholly or partly denied. For instance, if the transferred property was the only property in the class, its capital cost was $100, its UCC was $80 and its fair market value was $50, the proceeds of disposition would be $80, no terminal loss would arise and the accrued loss of $30 would be denied. If, for some reason, the UCC was $100 and the cost was $80 in the above example, the proceeds of disposition would be $80 and a terminal loss of $20 would arise. Where two or more properties of the same class were disposed of at the same time, subsection 85(5.1) permitted sequencing of the dispositions. In some fact situations, this permitted the realization of a terminal loss (but not of the entire accrued loss) on the transfer of the properties. For instance, if the proportionate

value of UCC of a particular asset was greater than its cost, by designating that asset last, a terminal loss could have been generated. [3] The cost to the transferor of any property received in exchange was basically the fair market value thereof.

Subsection 85(5) provides that for purposes of recapture, the capital cost of the property to the transferee is deemed to be the capital cost to the transferor and the excess of such capital cost over the deemed acquisition price is deemed to have been previously claimed as capital cost allowance by the transferee, thereby generating the potential for recapture on a subsequent disposition.

Thus, while subsection 85(5.1) did not permit the accrued loss to be recognized within the defined group, it did permit the accrued loss to be moved from one corporation to another. While the CCRA is still in the process of attacking some of these types of arrangements, these rules 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* [4] 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 [5], provided the streaming rules in subsection 111(5) were met, the resultant non-capital loss could be utilized after the acquisition of control. [6], [7] It is precisely these types of tax planning opportunities which gave rise to the 1998 amendments and the present stop-loss rules.

Non-depreciable capital property – former paragraph 40(2)(e) and subsection 85(4)

Former paragraph 40(2)(e) denied a capital loss to a corporate taxpayer on the disposition of property to a person by whom it was *de facto* controlled or to a

corporation under common *de facto* control. In a similar fashion, former subsection 85(4) provided that where a taxpayer or partnership disposed of non-depreciable capital property with an accrued loss to a corporation that immediately after the disposition was *de facto* controlled by the taxpayer, the taxpayer's spouse or a person or group of persons by whom the taxpayer was *de facto* controlled, the capital loss was deemed to be nil. Where the transferor owned shares of the transferee, the amount of the loss was added to the adjusted cost base of such shares. [8] Where the transferor did not own shares of the transferee, the loss was added to the adjusted cost base of the property in the hands of the transferee. [9] This latter provision enabled the loss to be shifted within a corporate group provided the transferor did not own directly any shares in the transferee (e.g. the transfer of property to a second tier subsidiary would enable the second tier subsidiary to add the loss to the adjusted cost base of the property and thus use the loss on an arm's length disposition [10]). Examples of more "flagrant" (i.e. from the CCRA's perspective) utilization of these provisions involving the transfer of the 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 *Husky* [11], *Nova* [12] and *Hollinger* [13] decisions of the Federal Court of Appeal.

The legislative response – the present rules

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.

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. 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. [14]

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 CCRA in a technical interpretation [15] 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 Xco. The CCRA commented that 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 CCRA referred to the Supreme Court of Canada decision in *Vineland Quarries* [16], 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 CCRA 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 CCRA's view that that partner controls the corporation. Thus, Xco, which controls the general partner of each of the two limited partnerships, Zco, Aco and Bco are affiliated persons for purposes of section 251.1.

Three specific points should be noted regarding the affiliated persons definition. Unlike certain other rules in the Act [17], there are no specific rules for trusts that look through to the beneficiaries of the trusts. A trust itself could, however, be an affiliated person under these rules (if, for instance, the trust controlled a corporation). [18] Secondly, 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. [19] Finally, 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. [20]

Depreciable property – subsection 13(21.2)

Under the 1998 amendments, subsection 85(5.1) was repealed and replaced by subsection 13(21.2). Subsection 13(21.2) applies where a person or

partnership [21] disposes, subject to certain limited exceptions [22], 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. Both of these concepts constitute an expansion beyond the scope of former subsection 85(5.1). If the foregoing circumstances obtain, 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. Essentially, this portion of the rule is the same as former subsection 85(5.1). 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. (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.) 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. [23]

It is the CCRA'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 realize a terminal loss in a taxation year in which the transferor is no longer deemed to own the property. [24]

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). 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. The rules in paragraph 87(2)(g.3) or 88(1)(e.2) as the case may be, would provide for retention of the characteristics of the notional property on the reorganization [25] and hence permit claims for capital cost allowance in respect thereof.

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 form 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). [26]

As one writer [27] 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.

Subsection 13(21.2) does not totally preclude the transfer of accrued losses to unaffiliated parties, however. Rather, the methodology will differ 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. [28]

Obviously, tax planning to utilize accrued losses is considerably different (and more difficult) from that under the former rules, not only at the time of utilization of the loss, but also in devising appropriate corporate structures. Whereas under the former rules, it was possible to shift losses within a corporate group by transferring the loss property, now the loss will rest with the party that incurred the loss. Where the parent corporation is the party that has the accrued loss, there are practical difficulties in transferring assets with accrued gains from other corporations in order to utilize the loss. This might militate, for instance, against using an operating corporations as a holding corporation for other operating subsidiaries. [29]

Non-depreciable capital property – subsections 40(3.3) to (3.6)

The 1998 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 [30]); (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. [31]

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.

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 continued 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 CCRA 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 CCRA has the same administrative policy for superficial losses. [32]

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 released through a

transaction under one of those sections. In this regard, the Explanatory Notes (the "2002 Technical Notes") relating to the draft technical legislation issued by the Department of Finance on December 20, 2002 (the "2002 Draft Legislation") 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 loss-deferral 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. [33]

The 2002 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 the 2002 Draft Legislation 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 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). [34]

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 the subsection 88(1) wind up) (the "transferee") is deemed 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). Similarly, 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 CCRA and the Department of Finance are aware of this anomaly. [35]

The CCRA has issued a number of interpretations dealing with subsection 40(3.6) in the context of estates having their shares purchased by a corporation. 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. [36] If the estate did control the corporation, the estate and the corporation would be affiliated and subsection 40(3.6) would apply. [37] The CCRA 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). [38]

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. [39] Similarly, the CCRA also recently 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. [40]

The CCRA also takes the position that a corporation, all of the shares which are owned equally by four trusts with each trust having the same corporate trustee, will 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. [41]

In a 1998 technical interpretation [42], the CCRA 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.

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. Formerly, however, the stop-loss rule

in subsection 85(4) applied to eligible capital property as well as non-depreciable capital property as described above. With the repeal of subsection 85(4), the stop-loss rules for eligible capital property are now 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).

Accrued loss on debt instruments

One stop-loss rule that remained untouched in the 1998 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 CCRA 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. [43]

An interesting example of using a stop-loss rule to advantage is described in a CCRA 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). 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 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 CCRA confirmed that the general anti-avoidance rule would not apply in the circumstances since no doubling up of losses occurred.

Adventures in the nature of trade

New stop-loss rules were introduced by the 1998 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 [44], [45] 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.

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

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 1998 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,"

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 2002 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. [46] 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. [47]

As indicated above, a trust and an individual would not be considered to be affiliated persons for purposes of the definition in section 251.1. Therefore, an individual and his RRSP would not be affiliated. In a 1999 technical interpretation [48], the CCRA expressed the view that where an individual disposes of a capital property at a loss and contributes the proceeds to his or her RRSP, which then purchases an identical property, the loss would not constitute a superficial loss since the RRSP and the individual are not affiliated. The CCRA went on to express the view, however, that GAAR could apply in this situation since economically the transaction is identical to a transfer of the property to the RRSP where subparagraph 40(2)(g)(iv) would apply to deny the loss. [49] The CCRA expressed a similar view where an individual disposes of shares to a

personal holding company and the holding company immediately thereafter disposes of the same shares to the individuals' self-directed RRSP. [50]

For an interesting example of a flawed attempt to exploit the superficial loss rules, see *Graphic Packaging Canada Corporation v. HMTQ*. [51]

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.

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. Not only did the 1998 amendments make fundamental changes to the stop-loss rules, including the definition of the affected group through the use of the "affiliated persons" concept, in the view of the CCRA these amendments also caused a redefinition of the group within which

a variety of loss utilization techniques described more particularly below are permissible.

Just as the new stop-loss rules use the definition of "affiliated person" as the organizing (or limiting) principle, in the context of permissible loss utilization within a corporate group, the governing criterion was, until the 1998 amendments, that the corporations involved must be related. The CCRA derived this position from a variety of specific anti-avoidance provisions in the Act, such as subsections 69(11) and 111(4) to (5.4), which restrict the claiming of losses, deductions and other amounts by unrelated parties.

At the 1996 Canadian Tax Foundation Conference, the CCRA indicated that in light of the April 26, 1995 proposals (ultimately embodied in the 1998 amendments) to amend 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 then existing law, it was altering its position on loss consolidation within a corporate group. In the CCRA's view, with which the Department of Finance concurs, these amendments represent a change to the scheme of the Act relating to the ability to transfer losses between corporations and 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 will be considered to be subject to the general anti-avoidance rule. The change to the CCRA's position is effective with respect to any series of

transactions that began after April 26, 1995. The CCRA official at the Conference went on to note that many loss transfers will be unaffected by the change since many corporations that are related will also be affiliated under proposed section 251.1. [52]

The 1998 amendments to subsection 69(11) use 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 CCRA uses the concept of *de jure* control in determining whether corporations are affiliated in applying this administrative position. [53]

While one might debate whether the amendments really did effect such a shift in the policy of the Act, particularly given that there were no corresponding changes to the loss carryover rules in section 111 or the rules in subsection 256(7), in most cases, the shift from "related" to "affiliated" does not have any significant impact.

Corporate reorganizations

Amalgamations [54]

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). [55]

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 [56], 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 [57], the CCRA 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 CCRA 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 CCRA'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 CCRA'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.

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 CCRA takes the position that absent a specific time being specified in the certificate of amalgamation, 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. [58]

One other provision contained in the 1998 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 [59], 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, an investigation should be made to ensure that no capital gain will result on the amalgamation.

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* [60] 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. [61] Where continuity of characterization is in doubt,

consideration might be given to other techniques for triggering accrued losses prior to the merger. [62]

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 [63], 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 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 to be losses of the parent for the taxation year of the parent in which the subsidiary's loss year ended. 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.

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.

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. [64]

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 CCRA 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 CCRA [65] and an update of the CCRA's position on these issues is always warranted. The CCRA'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.

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. [66]

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.

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 the 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 *Information Circular 88-2*, which deals with the general anti-avoidance rule, the CCRA 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 CCRA'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 1998 amendment to subsection

69(11) discussed above, this historic position is continued but modified to apply to affiliated corporations rather than related corporations.

On the other hand, the CCRA is apparently of the view that subsection 69(11) would apply to a deemed disposition of property under paragraph 111(4)(e). The CCRA 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 CCRA concluded that subsection 69(11) was applicable in the circumstances. [67]

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 1998 amendments to section 55. That is, while the present paragraph

55(3)(a) generally 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, there is an exception provided where the property is disposed of for proceeds that are not less than fair market value. [68]

A further concern where capital property of the transferor is sold by the loss corporation shortly after its acquisition is whether the CCRA might seek to recharacterize the property as inventory rather than capital property in the hands of the loss corporation. The CCRA has indicated administratively that it would not do so. [69] 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. [70] Moreover, the *Continental Bank Leasing* decision of the Supreme Court of Canada provides further strong support for the continuation of the CCRA's administrative position. [71]

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 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. [72]

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. [73]

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, similar arrangements can be undertaken although generally it is necessary to interpose a third corporation in order to comply with the so-called corporate incest rules in the relevant corporate legislation.

Generally, the CCRA 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. [74] In the *CRB Logging* case [75], the CCRA 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 CCRA's administrative policy. The recent Supreme Court of Canada decisions in *Singleton* [76] and *Ludco* [77] should generally be of assistance to taxpayers in justifying interest deductibility in this and other areas. The CCRA is in the process of preparing a new Interpretation Bulletin relating to paragraph 20(1)(c) of the Act in light of the recent case law.

The CCRA has 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 results in a profitable affiliated company incurring interest expense which exceeds the profitable company's taxable income, hence creating a non-capital loss in the profitable corporation, is not permissible. The reason for this position is that such a transaction would effectively allow the losses of the loss corporation to be refreshed in a manner which extends the seven year loss carryforward period. The CCRA considers this to be an abuse of the temporal restrictions on loss carryforwards in section 111 of

the Act. As one author points 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. [78]

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) or 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.

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. [79]

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. Obviously, the gain on the sale (in addition to the interest income) will utilize losses of the loss corporation.

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. [80]

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. [81]

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

would apply where, for instance, the taxpayer has borrowed money to acquire depreciable property. [82]

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 37% in Ontario.

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 CCRA 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, or 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.

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 asset. 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. [83] Finally, care should be taken that the profit sharing ratio is justifiable so as to avoid a reallocation by the CCRA pursuant to subsection 103(1.1) of the Act. [84]

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

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 CCRA 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

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 [85], although *the Continental Bank* decisions are of considerable assistance in this regard.

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 business 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.

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 2002 Draft Legislation proposes, however, to change the 9/4ths multiple in paragraph 110(1)(k) to 3 in light of recent and planned reductions in income tax rates in the Act.

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.

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.

Capitalize interest under section 21

Rather than deduct interest expense which will then be subject to the seven year non-capital loss carryforward limitation, consideration should be given to capitalizing such interest under section 21 to the extent permissible. Section 21

(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.

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 CCRA's concern and vigilance for "improper" utilization of tax losses.

The most significant recent case in this area is *Duha Printers* [86] 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 (highlighting once again the very divergent viewpoints of the Federal Court of Appeal and the Supreme Court of Canada on tax avoidance matters). While the *Duha Printers* case is 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 Duhas 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." [87]

"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." [88]

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

"Given the CCRA'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 CCRA 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." [89]

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.

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 recent 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) [90] in a pre-general anti-avoidance rule ("GAAR") 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 two most significant decisions of the Federal Court of Appeal are *OSFC Holdings Ltd. v. HMTQ* [91] and *Water's Edge Village Estates (Phase II) Ltd. v. HMTQ* [92], which follows closely the reasons in the *OSFC Holdings* case.

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. 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* tax 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 *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 Federal Court of Appeal decision is significant not only for being the first appellate GAAR decision, but also for the detailed analytical framework which it sets out for analyzing the application of GAAR to a particular set of facts.

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 *Water's Edge* 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.

These two cases and in particular the Federal Court of Appeal's analysis of the "misuse" and "abuse" provisions of the GAAR will clearly have an inhibiting affect on loss utilization schemes involving arm's length parties.

Treatment of tax losses on an acquisition of control

As a result of what the CCRA 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.

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 (i.e. controlled directly or indirectly in any manner whatever) test 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 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). [93] More recent cases have explored various subtleties of the concept of control and, as a general proposition, it appears that the courts are moving away from a strict *de jure* approach to determining who has effective control of the corporation. [94] 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 this issue is the 1998 Supreme Court of Canada decision in *Duha Printers*. [95] 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." [96]

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." [97]

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.

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 CCRA 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.)).

4. 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.

5. 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.

6. 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.

The 2002 Draft Legislation 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 2002 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. [98]

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 2002 Draft Legislation proposes new 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 change of control. This amendment would appear to rectify the anomalies described in the previous paragraph. [99]

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)(a)(ii) or (iii). Subparagraph 256(7)(a)(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. [100]

The 1998 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 and their 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. [101]

Paragraphs (c) to (e) of subsection 256(7) were also added in the 1998 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 cvcnts that includcs the share-for-share exchange, cease to control the acquiring corporation after the exchange.

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 2002 Draft Legislation 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. [102]

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. [103]

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.

Impact of an acquisition of control on loss utilization

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 by reducing the adjusted cost base of each non-depreciable capital property with an accrued loss to the fair market value thereof and 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.

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.

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 fair market value thereof, the excess is required to be deducted 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.

Similarly, where the cumulative eligible capital of the corporation in respect of a business exceeds three-quarters of the fair market value of the eligible capital property in respect of the business, 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.

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 (i.e. back three years and forward seven years), but the application of such losses is subject to the "streaming" rules contained in subsection 111(5) of the Act. 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* [104] 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 CCRA 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."

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 affect the 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.

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*. [105] 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. [106]

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 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 CCRA 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*.

15. 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.

An interesting example of the similar business concept in the "income test" is the 1998 Federal Court of Appeal decision in *Manac Inc. Corp.* [107] 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.

Conclusion

The utilization of tax losses is an area where the ingenuity of taxpayers and the policy concerns of the CCRA 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 Brennan Debbo for his 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. i.e., "controlled, directly or indirectly in any manner whatever" as defined in subsection 256(5.1).

3. See Vukets, *"Structural Issues in Utilization of Domestic Loss Carryforward Pools"*, 1993 Conference Report, Canadian Tax Foundation, 1994, 23:1 at 23:14 and Strother, *"Creative Corporate Tax Planning"*, 1994 Conference Report, Canadian Tax Foundation, 1995, 11:1 at 11:12.

4. *Husky Oil Limited v. HMTQ*, 1999 DTC 308 (T.C.C.).

5. See subsection 111(5.1).

6. For a more detailed discussion of the acquisition of control rules see the discussion in IV below.

7. 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.

8. See paragraph 53(1)(f.2).

9. See paragraph 53(1)(f.1).

10. See Vukets, at 23:16.

11. *HMTQ v. Husky Oil Limited*, 1995 DTC 5244 (F.C.A.).

12. *HMTQ v. Nova Corporation of Alberta*, 1997 DTC 5229 (F.C.A.).

13. *Hollinger Inc. v. HMTQ*, 1999 DTC 5500 (F.C.A.).

14. 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.

15. CCRA Letter No. 9710065 dated September 4, 1997.

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

17. See, for instance, the association rules in section 256.

18. Where an estate controls a corporation and none of the executors of the estate are affiliated persons, it is the CCRA's view that the estate would be affiliated with the corporation under subparagraph 251.1(1)(b)(i). See CCRA 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, does not itself have control over a corporation, but the corporation is controlled by a related group consisting of the executors, the estate would not normally be affiliated with the corporation as it is 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 CCRA Letter No. 2000-0052345 dated February 20, 2001.

19. See subsection 251(3).

20. See Heakes at 34:5.

21. 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.

22. See the discussion of superficial losses in II.F. below.

23. 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.

24. CCRA Document No. 1999-0012425 dated December 7, 1999.

25. 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.

26. See Note 24.

27. See Dunn, Note 25.

28. Heakes at 35:9.

29. See Spindler, *Comments*, 1996 Conference Report, Canadian Tax Foundation, 1997, 7:27 at 7:28.

30. See the discussion on the superficial loss rules in II.F. below.

31. This is similar to the superficial loss rules before the 1998 amendments. See discussion below.

32. See CCRA Letter No. 2000-0088155 dated July 4, 2001.

33. *Explanatory Notes* issued by the Department of Finance on December 20, 2002.

34. *Ibid.*

35. See CCRA File Nos. 1999-0010805, 1999-0010825 and 1999-0015705.

36. See CCRA Letter No. 2000-0052345 dated February 22, 2001.

37. 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.).

38. See CCRA Letter No. 2000-0062505 dated March 6, 2001.

39. See CCRA Letter No. 2000-0024775 dated February 23, 2001. See also CCRA 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).

40. See CCRA Letter No. 2001-0070795 dated March 5, 2001.

41. See CCRA Letter No. 2001-0074145 dated March 29, 2001.

42. CCRA Letter No. 9818605 dated November 26, 1998.

43. See CCRA Letter No. 2000-0001065 dated June 1, 2000.

44. 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).

45. Under the 2002 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.

46. CCRA File No. 2000-0056115 dated January 11, 2001. See also CCRA Letter No. 9726485 dated January 19, 1998.

47. See CCRA Letter No. 2001-0106905 dated December 20, 2001.

48. CCRA Letter No. 9830825 dated January 28, 1999.

49. See also CCRA Letter No. 2001-0088485 dated August 1, 2001 and CCRA Letter No. 2001-0105435 dated October 24, 2001.

50. See CCRA Letter No. 2001-0112055 dated February 18, 2002.

51. 2001 DTC 861 (T.C.C.); aff'd (F.C.A.) (not yet reported).

52. The CCRA's position is set forth in *"Income Tax Technical News No. 9"* dated February 10, 1997.

53. 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.

54. 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 for purposes of loss utilization within a related corporate group. See, for instance, 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.

55. 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.

56. See Strother at 11:4.

57. CCRA Letter No. 9802725 dated November 20, 1998.

58. 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 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.

59. 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.

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

61. *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.*

62. See the discussion on 87(2)(g.3) in Section II.A.2.b. above and Dunn, op. cit at 13:15.

63. As mentioned in Note 59 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.

64. 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, 2001, the losses may only be utilized by the parent in its taxation year ending December 31, 2002.

65. 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*, 99 DTC 840 and the CCRA's comments on that case in *Income Tax Technical News No. 18* dated June 6, 2000 issued by the CCRA.

66. 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 CCRA has also commented positively on such an arrangement in paragraph 18 of

Information Circular 88-2 entitled *"General Anti-Avoidance Rule – Section 245 of the Income Tax Act"* dated October 31, 1988.

67. See CCRA File No. 9639150 (Round Table response at Tax Executives Institute) December 5, 1996.

68. 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.

69. See paragraph 9 of *Information Circular 88-2*.

70. In the CCRA review at the 1995 Canadian Tax Foundation Conference, Michael Hiltz indicated that the CCRA 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 should continue.

71. See Note 61 above.

72. See paragraph 19 of *Information Circular 88-2*.

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

74. See *Information Circular 88-2*, See also advance tax ruling ATR-44. See CCRA 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.

75. *Supra* Note 65.

76. *HMTQ v. Singleton*, 2001 DTC 5533 (S.C.C.).

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

78. See F. Ahmed, *Interest Deductibility Update*, Canadian Current Tax, May, 2002. See also CCRA Letter No. 2001-0090213 dated February 6, 2002.

79. For an example of this type of planning, see CCRA Letter No. 9615073 dated March 7, 1997.

80. See Vukets at 23:17.

81. See Bernstein at 58:36.

82. See Bernstein at 58:36.

83. See the cases referred to in Note 61 *supra*.

84. See Strother at 11:6*ff.*

85. See Strother at 11:10. See also Vukets at 23:11*ff.* Also noteworthy with respect to the topic of partnerships are the 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.).

86. *Duha Printers (Western) Ltd. v. The Queen*, 1998 DTC 6334 (S.C.C.).

87. See Monaghan and Raizenne, *"Recent Cases of Interest to Corporate Financing Transactions"*, 1988 Conference Report, Canadian Tax Foundation, 1998, 13:1 at 13:12*ff.*

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

89. Strother at 11:15.

90. See the discussion in Part II.A above.

91. 2001 DTC 5471 (F.C.A.)

92. 2002 DTC 7172 (F.C.A.)

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

94. See 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.

95. Supra, Note 86.

96. Ibid at 6341-2.

97. Ibid at 6347-8.

98. *Explanatory Notes* issued by the Department of Finance on December 20, 2002.

99. *Ibid.*

100. See IT-302R3, paragraph 28.

101. *Explanatory Notes* published by Department of Finance on December 8, 1997.

102. *Explanatory Notes* issued by the Department of Finance on December 20, 2002.

103. *Ibid.*

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

105. *Garage Montplaisir Inc. v. HMTQ*, 2000 DTC 6216 (F.C.A.).

106. 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.).

107. *Manac Inc. Corp. v. HMTQ*, 1997 DTC 5352 (F.C.A.).