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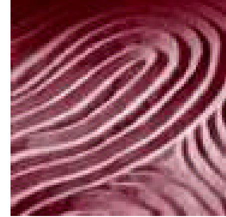

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Recent Corporate and Income Tax Developments of Interest

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INTRODUCTION

The purpose of this paper is to provide an update on some recently enacted or proposed legislative changes in corporate and income tax law. This is not an exhaustive review of all recent changes in corporate and income tax law but is a survey of those changes that are of greatest interest to me or of greatest relevance to my practice.

CBCA AND PROPOSED ABCA AMENDMENTS

Over the past several years, Alberta Government Services has been consulting with interested parties in respect of a proposal for comprehensive amendments to the *Business Corporations Act.* During this period, the *Canada Business Corporations Act* has been amended and the Alberta process has therefore been expanded to include analysis of the CBCA amendments and consideration of the extent to which those amendments should be adopted by Alberta either for uniformity or in order to avoid placing the ABCA and Alberta at a competitive disadvantage.

At the time of writing (December, 2002), Alberta Government Services is in the process of finalizing a discussion paper containing their preliminary recommendations for amendment of the ABCA, designed to elicit further input from the legal profession. The present timetable appears to put the ABCA amendments on track for passage in the spring of 2004.

Based on my involvement in the Edmonton Focus Group, which participated with Alberta Government Services in the analysis of the CBCA amendments, the following is my understanding of some of the significant amendments currently proposed for the ABCA and of areas of divergence from the CBCA.

Part 5 - Corporate Finance

Section 27 - Stock Splits. Because the ABCA requires fair value consideration to be paid for a share at the time of issuance, the consensus view is that stock splits and consolidations require an amendment of the Articles in accordance with Section 173 of the ABCA. Unfortunately, this requirement is frequently ignored in situations involving closely held private corporations, and since the change occasioned by the stock split is only to the issued number of shares, which is not ordinarily a matter of public record, there is not any compelling reason for requiring Articles of Amendment for this action. Consequently, there is a proposal to grant a corporation's directors the power to cause the exchange of all of the issued shares of a class for some multiple of those shares (including a fraction, so that consolidations could be accommodated through the same procedure) subject, where the issued classes extend beyond common shares which are all treated equally, to approval by special resolution of the shareholders of each issued class.

There is no similar provision of the CBCA, which continues to require Articles of Amendment for a stock split.

Section 32 - Prohibited Share Holdings. The CBCA has added an exception to its prohibition against corporate incest, which permits cross shareholdings in a very narrow set of circumstances, involving an international transaction. There is a recommendation to permit temporary corporate incest, on a broader scale, provided that the cross shareholding arises for the purpose of a corporate reorganization and is eliminated within 30 days. There is no comparable broad authority for temporary corporate incest under the CBCA.

Sections 35 and 36 - Clarification of Financial Capacity Tests. In recent years, the Canadian Institute of Chartered Accountants has instituted rules that require the value of a corporation's obligations to the holders of redeemable preferred shares to be added into the corporation's liabilities. This is contrary to the principles of corporate law, which clearly provide that the entitlements of shareholders are equity, to be dealt with separate from (and subsidiary to) any corporate obligations to creditors. The principles of corporate law also operate to safeguard the stated capital attributable to the issued shares of a corporation, for the protection of creditors. The financial capacity tests in the ABCA prevent a corporation from carrying out various transactions, the

results of which would be a return of stated capital to the shareholders, unless those financial capacity tests are met.

In the recent CBCA amendments, the intrusion of the CICA into matters of corporate law has been dealt with in paragraphs 35(3)(b) and 36(2)(b), respecting alternative acquisitions of the corporation's shares and redemption of shares, by the addition of clarification that after any such reduction of capital the realizable value of the corporation's assets must exceed its liabilities plus the amount required to redeem shares having an equivalent or prior entitlement to return of capital, unless the amount has already been included in liabilities.

The approach which has been recommended for the ABCA is to clarify, for the purposes of the Section 35 and Section 36 financial capacity tests, that liabilities do not include either the stated capital attributable to preferred shares or the amount payable, on redemption or liquidation, in respect of preferred shares. This will ensure that the principles of corporate law continue to apply in respect of the financial capacity tests and that they are not effectively overridden by the accounting rules that have been enacted without proper regard to corporate law. In addition, it has been recommended that the financial capacity tests in Section 34 respecting a corporation’s acquisition of its own shares and Section 43 for the payment of dividends also clarify that

liabilities are to be interpreted in accordance with corporate law rather than the CICA rules.

Section 44 - Stock Dividends. For a number of years there has been a relatively vigorous debate over whether CBCA type statutes permit the issuance of “high-low” stock dividends, which are stock dividends of shares with high redemption value but low stated capital. The debate has focused on the words “the declared amount of the dividend stated as an amount of money shall be added to the stated capital account”, and whether the “declared amount” can be an arbitrary amount determined by the directors, or must be the full value of the stock dividend shares, again as determined by the directors. Papers have been written, and professionals have come down on both sides of the debate.

My view is that the “declared amount” of the dividend is intended to be the value of the dividend and not an arbitrary amount. Based on my review of the legislative history of section 44 and similar legislation, I believe that the phrase “declared amount” should merely operate to permit the directors to establish this value free of any obligation to justify the valuation or make a more formal determination of value. Formal valuation would be particularly problematic where common shares are issued in satisfaction of the stock dividend.

Despite the uncertainty over the interpretation of the phrase "declared amount", many high-low stock dividends have been declared. A recommendation will therefore be made to amend subsection 44(2) to permit the directors to add any portion of the value of a stock dividend to stated capital.

Section 45 - Financial Assistance. The recent CBCA amendments have included a total repeal of Section 44 of the CBCA, the section that provided restrictions on a corporation's ability to provide financial assistance. The equivalent Alberta rules have, of course, been the subject of extensive review and revision. In consequence of that review, including the 1987 and 1989 Institute of Legal Research and Reform papers, the Alberta financial assistance provisions were finally amended in 2000. Presently, there is some reluctance to totally repeal Section 45 for uniformity with the CBCA and I believe that it is more likely than not that Section 45 will remain in its present form.

Part 9 - Directors and Officers

Section 105 - Residency Requirements. The CBCA has reduced its Canadian residency requirement for the board of directors to one quarter. Following the lead of New Brunswick and the Yukon Territory, British Columbia is apparently considering abolishing the Canadian residency requirement in its entirety. A decision must be made as to

the appropriate residency requirement for ABCA corporations.

Section 109 - Removal of Directors. The equivalent section of the CBCA, Section 109, has been amended by the addition of new subsections 109(4) and (5) which provide that when a corporation has no directors, then a person who manages or supervises the management of the business and affairs of the corporation is deemed to be a director for the purposes of the CBCA. The ABCA contains no equivalent provisions and the absence of such provisions has been permitted certain financially troubled corporations, such as Canadian Airlines, to continue in operation, notwithstanding the resignation of all of the corporation's directors. There appears to be a significant divergence in views among practitioners as to whether an equivalent provision should be added to the ABCA.

While there is a legitimate concern that the pendulum has swung too far in widening the range of personal liabilities that may be imposed on directors under federal and provincial law, particularly in the difficult circumstances of a corporation struggling for survival, Alberta should not be a haven for directorless corporations. The recommendation of the Law Society's Corporate Commercial Advisory Committee, for a comprehensive approach to directors' personal liability, is a sensible one.

The CBCA contains other provisions that address the issue of directorless corporations. Subparagraph 212(1)(a)(iv) permits the Director (the equivalent of the Registrar under the ABCA) to dissolve a corporation which does not have any directors. Practitioners should consider whether Alberta should adopt a similar provision in subsection 212(1) so as to permit the Registrar to dissolve a corporation with no directors.

Section 120 - Disclosure by Directors and Officers in relation to contracts. There is a proposal to amend subsection 120(8) of the ABCA in a manner consistent with the equivalent subsection of the CBCA (ss. 122(7.1)), so that where the directors have failed to make the required disclosure under Section 120, a contract may not be invalid and the directors may be absolved from any obligation to account for the profit if: the shareholders approve or confirm the transaction by special resolution; appropriate disclosure is made; and the contract or transaction was reasonable and fair to the corporation when it was approved or confirmed.

Section 124 - Indemnification by Corporation. The CBCA has been amended to specifically authorize a corporation to advance monies to a director, officer or other individual for the costs, charges and expenses of actions for which indemnification may be provided under the other terms of the section (CBCA Section 124). There is a recommendation

that the ABCA be amended to permit such advances in relation to indemnification made in accordance with the terms of Section 124 of the ABCA.

Part 10 - Insider Trading. The ABCA insider trading provisions are significantly less sophisticated than the provisions of Part 11 of the CBCA, which also deals with insider trading. The CBCA provisions apply to all corporations. In contrast, the ABCA provisions apply only to corporations which are not "distributing corporations." In my view, it is appropriate that overlap between the ABCA and *Alberta Securities Act* be avoided and therefore it would be reasonable for the insider trading provisions of the ABCA to have application only in circumstances where a non-distributing corporation is an insider for the purposes of Part 10 in respect of a "business combination" as defined in Section 129 of the ABCA.

However, in order for overlap between the ABCA and *Securities Act* to be avoided, the definition of "distributing corporation" in the ABCA must be amended. Currently, the definition provides that a distributing corporation is a corporation that has made a distribution to the public and has more than 15 shareholders. This definition does not correspond with the *Securities Act* concept of a "reporting issuer" and also puts a distributing corporation outside the terms of a "private issuer" for the purposes of the *Securities*

Act, since a private issuer may not have distributed shares to the public. In my view, it is not useful to have this distinct category of corporation, which is neither a reporting issuer nor a private issuer under the *Securities Act*, for the purposes of the ABCA. The recommendation which has gone forward from the Edmonton Focus Group was that the CBCA amendments should be adopted, so that the definition of distributing corporation be made co-extensive with the definition of reporting issuer in the *Securities Act.*

Part 11 - Shareholders

Section 131 - Place of Shareholder's Meetings. The CBCA has been amended in order to permit shareholders meetings to be conducted through electronic means, such that each of the shareholders may "communicate" with each other. Section 131 of the ABCA requires that each of the shareholders be able to hear each other.

The CBCA was amended in a number of other areas to facilitate electronic equivalents for transactions such as voting, access to records, etc. I believe that all of these changes are being considered by Alberta Government Services for inclusion in the upcoming ABCA amendments.

Section 134 - Notice of Meeting, Adjournment of Business and Notice of Business. The CBCA has been amended to permit corporations that are not distributing corporations to shorten the statutory periods for the delivery of notices of

meetings through their Articles or Bylaws. I believe that the ABCA should be amended in this manner to permit shorter notice periods for non-distributing corporations (or non reporting issuers should the definition of distributing corporation be aligned with the reporting issuer definition contained in the *Securities Act*).

Section 136 - Shareholder Proposals. The CBCA has been amended extensively to modify the conditions for submission of a proposal to an annual meeting of shareholders. I anticipate that the ABCA Discussion Paper will identify the key amendments and seek recommendations on items such as the criteria for eligibility to submit proposals.

Section 146 - Unanimous Shareholder Agreement. The CBCA has been amended in order to permit the transfer of rights, powers, duties and liabilities of a director to the parties to a Unanimous Shareholder Agreement who are given the power to manage or supervise the management of the business and affairs of the corporation under the USA. There is also specific acknowledgment that the parties given the right to manage have all of the defences that are available to the directors. The Edmonton Focus Group was of the view that the ABCA should be conformed to the provisions of the CBCA for the purpose of clarifying the availability of defences and that the manager's powers and obligations extend to powers arising under statutes other

than the ABCA. Our group was not in favour of permitting the rights, duties and obligations of the directors to be passed to parties to the USA who are not also shareholders.

Part 12 - Proxies

Section 149 – Mandatory Solicitation. With the change to the CBCA definition of "distributing corporation", the mandatory solicitation provisions of the CBCA have also been amended, so that corporations with not more than 50 shareholders, which are not distributing corporations (i.e., not reporting issuers for the purposes of the applicable securities law) are now not required to make mandatory proxy solicitations.

The Edmonton Focus Group has recommended that Alberta relax the analogous provisions of Section 149 of the ABCA. If this does not occur, Alberta will continue to require all corporations with more than 15 shareholders to solicit proxies and therefore provide proxy circulars to their shareholders. In my experience, the mandatory proxy solicitation provisions of Section 149 have been a significant burden upon small Alberta businesses. The extension of the exception for proxy circulars to 50 shareholder corporations which are not reporting issuers (and I would go further than the CBCA, by broadening the exception to also exclude employee shareholders, consistent with the *Securities Act*

private issuer definition) would be a welcome change, and would not overlap or be inconsistent with the *Securities Act*.

This entire Part of the ABCA should also be amended in order to restrict its application to corporations that are not reporting issuers.

Section 150 - Soliciting proxies. The CBCA has been amended to permit proxy solicitations other than by or on behalf of management, without the requirement of a dissident's proxy circular, where the solicitation is to 15 or fewer shareholders. The rules have also been relaxed in order to permit non-management solicitations to be made by way of public broadcast, speech or publication, where substantially all of the information required in a dissident proxy circular is communicated by that alternative means. Again, for conformity and to eliminate overlap with the *Securities Act*, these provisions should be adopted in the upcoming ABCA amendments.

Currently section 150 of the ABCA gives an exception from the requirement to provide a proxy circular where proxies are solicited from the holders of shares of any corporation (reporting issuer or not), either by management or anyone else, so long as the solicitation is to not more than 15 shareholders. Parts of this rule overlap (and are inconsistent with) the *Securities Act*, and it should be limited to non-

management solicitations in relation to corporations that are not reporting issuers.

It is my understanding that there may be some relaxation of the Alberta requirement for a proxy circular, independent of the obligation to send proxies. If such a change is made, then it should have application only to corporations which are not reporting issuers.

Part 16 – Take-over Bids – Compulsory Purchase

Section 194 – Definitions. Historically, the takeover bid provisions of the ABCA have been a part of the Alberta legislation that differs substantively from the CBCA and other provincial corporate legislation. Most importantly, the ABCA take-over bid provisions are **not** restricted in their application to distributing corporations or reporting issuers. Therefore, these provisions are available to facilitate the purchase of private issuers. The Edmonton Focus Group's recommendation was that the take-over bid provisions should continue to apply to non-distributing corporations. The application of this part of the ABCA should also be restricted to non-distributing corporations. Coupled with the recommended redefinition of "distributing corporation" to mean "reporting issuer" under the *Securities Act*, this limitation on the Part's application would eliminate both overlap and gaps as between the ABCA and the *Securities Act*, which contains much more comprehensive rules for the

regulation of take-over bids in the context of reporting issuers.

"Going Private Transactions" – Section 193 of the CBCA is a very general authorization for newly defined "going private transactions". Distributing corporations are permitted to carry out going private transactions provided that they comply with applicable securities laws. This specific authorization has been added to the CBCA to eliminate any uncertainty over whether a distributing corporation may carry out this type of transaction, as there have been some infrequent decisions (see *Burdon v. Zeller's Ltd.* (1981) 16 BLR 59 (Que. SC) and *Carlton Realty Co. Ltd. et al. V. Maple Leaf Mills Ltd. (1978)* 4 BLR 300 (Ont. HC)) granting injunctions to prevent transactions broadly defined as such. However, I am concerned that authorization of "an amalgamation, arrangement, consolidation or other transaction" (CBCA Reg. SOR/2001-512 ss. 3(1)) to accomplish a going private transactions may some day be interpreted as authority beyond that provided under the pre-existing provisions of the CBCA for a new type of transaction, defined only by its result and the above noted requirement to comply with "applicable provincial securities laws".

Apart from the foregoing concern, because the position of the Edmonton Focus Group and other interested observers has been that the ABCA should leave the regulation of

reporting issuers to the *Securities Act*, we have not recommended that any such provision to be added to the ABCA.

Squeeze-out Transactions – As the non-distributing corporation counterpart to going private transactions, Section 194 of the CBCA introduces another generally worded section that provides express authority for "squeeze-out transactions". As, by definition, the scope of this category of transaction cannot be limited by securities legislation, Section 194 limits a corporation's ability to implement a squeeze-out transaction by requiring approval of any such transaction by ordinary resolution of each class of shares affected by the transaction, voting separately, whether or not they have voting rights. In this vote, affiliates of the corporation and holders of shares which following the squeeze-out would have an entitlement to consideration of greater value or superior rights and privileges to those available to other shareholders are disqualified from voting. The provision therefore effectively requires a "majority" of the minority approval.

As with "going private transactions", my first concern is that the very general definition of "squeeze-out transaction", when combined with the permissive language of CBCA s.194, may come to be interpreted as authorization for transactions which are outside the scope of a squeeze-out

transactions as currently understood, and which might contravene present corporate law principles.

In respect of both squeeze-out and going private transactions the CBCA amendments adopt definitions which perhaps have specific meaning to the drafters of the legislation, but which appear to me to be subject to much broader interpretation by less experienced members of the public, lawyers or judges.

Another reason for which it is not recommended that Alberta introduce corresponding legislation is dissatisfaction with the stipulated exclusion from the vote of shareholders entitled to consideration of greater value or superior rights. I believe there could be some considerably uncertainty in justifying the valuation of the property being given to the minority versus the value of shares taken by the continuing shareholders on the squeeze-out transaction.

Part 17 – Liquidation and Dissolution

Section 211 – Dissolution by Directors or Shareholders in Special Cases. It is currently fairly common practice on the dissolution of a wholly owned subsidiary for the parent corporation to enter into a conveyance agreement with the subsidiary, whereby all of the assets of the subsidiary are transferred to the parent and the parent assumes all liabilities. Thereafter, the provisions of subsection 211(2) are utilized to affect an immediate dissolution of the subsidiary.

There is concern that this practice is not authorized by the terms of subsection 211(2) unless, in conjunction with the assumption of the liabilities, releases are obtained from all parties to which the wound up corporation owes obligations. Despite this deficiency, where the wind up is into a solvent parent corporation there is no prejudice to creditors of the wound up corporation, as transfer of all assets and assumption of all liabilities functions in an equivalent manner to an amalgamation. Because of this functional equivalency, it is recommended that a windup be permitted where the parent corporation has assumed all of the liabilities.

Analogous to the circumstances of an amalgamation, the creditors of the corporation being wound up could be required to provide further comfort by way of Statutory Declaration from an officer or director of the parent, stipulating that no creditors will be prejudiced by the windup and assumption of liabilities. Since these windups are used predominantly in circumstances to which subsection 88(1) of the *Income Tax Act* apply, it might also be acceptable for the special provision to be accessible only where the distribution on the winding up is to a Canadian parent holding at least 90% of the issued capital of the corporation.

CBCA Part 19.1 - Proportionate Liability

Pre-Enron, the proportionate limitation of liability set out in Part 19.1 of the CBCA might have been adopted in Alberta

simply in order for conformity with the federal law. However, in light of Enron and other corporate scandals, it is unlikely that this provision will be viewed as politically attractive by legislators.

Part 20 – General

Section 270 – Errors in Certificates. The CBCA has provided expanded authority to the Director to correct errors in certificates or documents. There is a proposal that equivalent authority be given to the Registrar under the ABCA, to correct errors not only in certificates but also in other documents. This power would be in addition to the ability of the Registrar to alter documents with the authorization in writing of the person who sent the document, as currently provided by as s.269 of the ABCA.

Other Forms of Business Organization

The current initiative by Alberta Government Services does not address the issue of other forms of business organization.

Presently, there are enacted but unproclaimed amendments to the ABCA that will permit the registration in Alberta of limited liability companies ("LLCs"). Until these provisions of the ABCA are proclaimed, there is no authority for registration of an LLC in the Province of Alberta.

Historically in Canada only the members of corporations and companies created by a specific act of Parliament or Royal Charter could be assumed to have limited liability as shareholders. The earliest legislation for companies created by registration permitted the incorporation of a company with or without limited liability. Because statutory authority for companies whose members had unlimited liability appeared unnecessary and also, perhaps, due to the provisions of the Canada *Interpretations Act*, which created a presumption of the limitation of shareholders' liability, authority to incorporate an unlimited liability company was removed from the Alberta legislation sometime after 1922. My incomplete research places the amendment in either 1929 or 1941. Only Nova Scotia continued among Canadian jurisdictions in permitting the incorporation of companies whose shareholders had unlimited liability. In the 1990's a use was finally identified for unlimited liability companies and these companies have, of course, grown in popularity. Today, it is my experience that the majority of US investments in Canada involve Nova Scotia unlimited liability companies.

Given that one of the major objectives of the current reform of the ABCA is to ensure the competitiveness of Alberta's legislation with other Canadian jurisdictions, the next thrust in amendment to the legislation must be for the authorization of unlimited liability corporations which, similar to the Nova

Scotia legislation, meet the requirements of US law as non-recognition entities.

CCRA INTEREST DEDUCTIBILITY GUIDELINES

In conjunction with their presentation at the 2002 Canadian Tax Foundation Annual Conference, Canada Customs and Revenue Agency (CCRA) has posted a paper on the topic of Interest Deductibility on their website (www.ccra-adrc.gc.ca/tax/technical/incometaxpresentation-e.html).

The presentation and paper are significant events, as CCRA's administrative policies have essentially been in a state of suspension since the late 1980's when, after the Supreme Court of Canada decision in *The Queen v. Phyllis Barbara Bronfman Trust*, 87 DTC 5059 (SCC), the Department of Finance released a Notice of Ways and Means Motion proposing detailed amendments to the interest deductibility provisions of the legislation which would have confirmed Revenue Canada's then administrative policies on interest deductibility. The initiative stalled, as the high degree of artificiality in the administrative policy provoked significant commentary from tax practitioners and many rounds of consultation. Draft legislation was not introduced until December 20, 1991 and that draft legislation has never been enacted.

In the absence of highly specific legislative provisions, the Supreme Court of Canada has continued to define the Canadian law on interest deductibility, most notably in *Shell Canada v. The Queen*, 99 DTC 5669 (SCC) and the recent decisions in *Ludco Enterprises Ltd., et al v. The Queen*, 2001 DTC 5505 (SCC) and *The Queen v. John R. Singleton*, 2001 DTC 5533 (SCC). With the Supreme Court's decisions in *Ludco* and *Singleton*, the time was right for CCRA to revise its administrative policies.

In *Bronfman Trust*, the trust was denied interest deductibility in respect of money borrowed to make capital distributions to its beneficiaries. The trust's argument for deductibility was that the loan permitted the trust to retain income-producing capital assets, which, for market reasons, it did not wish to dispose of at that time. Had those income-producing assets been liquidated in order to fund the capital distribution and the proceeds of the loan been utilized to reacquire the income-producing properties, then the debt would have been deductible.

In *Bronfman Trust* the Supreme Court of Canada held that interest deductibility arose only where there was a *direct* and *current* income-producing purpose for the borrowed funds. This confirmed the tracing requirement for interest deductibility and also the principle (since modified

legislatively) that there must be a current source in order to sustain ongoing interest deductions.

The problem with *Bronfman Trust* arose from Chief Justice Dickson's *obiter* commentary in the last two paragraphs of the judgment, where he stated that had the trust undertaken a series of transactions involving the sale of income-producing asset, use of the proceeds to make capital allocations and a repurchase of the asset all within a brief time interval, then "the courts might well consider the sale or repurchase to constitute a formality or a sham designed to conceal the essence of the transaction, namely, that money was borrowed and used to find a capital allocation to the beneficiary" (87 DTC 5059 at 5068). Coming at the end of a judgment wherein the Court had ruled that borrowing to fund a direct, non-income producing distribution (which had a qualifying indirect use) was an insufficient purpose, this comment introduced an element of some considerable uncertainty.

The uncertainty arising from Chief Justice Dickson's *obiter* in *Bronfman Trust* was finally eliminated by the Supreme Court decision in *Singleton*. In *Singleton*, a lawyer had received a repayment of his capital contribution to his firm, which he used to purchase a house. On the same day, he borrowed money from the bank and replenished his capital account with the law firm. The Supreme Court confirmed that as the

direct use of the borrowed money was to make the capital contribution in respect of his income-producing partnership interest, interest on that loan was deductible.

CCRA's new guidelines fall into line with the Supreme Court of Canada's pronouncements in its series of decisions on interest deductibility and should serve to eliminate uncertainty within the business community as to whether the agency is prepared to conform its assessing practices with the Court's views. The following is review of some of CCRA's comments, having reference to the relevant paragraphs of the paper, on a number of general and specific rules for interest deductibility.

A. Tracing/Linking

The paper notes the requirement from *Bronfman Trust* for a direct tracing of the use for borrowed funds, but also observes that due to the fungible nature of money, *Shell* and *Ludco* have liberalized the rule slightly, such that linking of the borrowed funds to the eligible use will be sufficient. The Paper states that CCRA will permit interest deductibility where a taxpayer can demonstrate that the aggregate eligible expenditures from a co-mingled fund exceed the amount of borrowed money deposited to the account.

B. Borrowing to Acquire Income-Yielding Investments

In *Ludco*, the principal issue was that the borrowed money was used to acquire offshore securities which generated a small amount of income and were primarily designed to appreciate in a manner which would be taxable as capital gains in Canada. The Supreme Court held that, notwithstanding that the taxpayer's interest expense exceeded the amounts received and taxable as income, the full amount of that interest expense was deductible.

Following the decision in *Ludco*, CCRA's paper accepts that the use of borrowed money for an ancillary purpose of earning income will be sufficient to meet the test for income deductibility, provided that there is a reasonable expectation of some income from the investment.

C. Amounts Payable for Services Rendered

Under this heading, CCRA states that "Interest on accounts payable for service costs that are currently deductible is deductible under section 9." The policy paper makes no reference to the Federal Court of Appeal decision in *The Queen v. Thomas Gifford*, 2002 DTC 7197, and this statement is not consistent with the Court's conclusion in the *Gifford* decision. Despite his own views to the contrary, in *Gifford* Justice Rothstein determined that was bound by

decisions of the Supreme Court of Canada to rule that interest must always be considered to be a capital expenditure, and as such may not be deducted under the general rules provided by Section 9, but only in accordance with special rules for deductibility, such as paragraph 20(1)(c) (*Gifford*, pp.7204-5).

E. Borrowing to Acquire Common Shares

One of the most significant practical concerns arising subsequent to *Ludco* is whether interest on money borrowed to purchase shares traded on Canadian stock exchanges will be deductible, given that only a small percentage of the publicly traded shares ever return dividends. CCRA's policy paper states that interest borrowed for the purpose of acquiring publicly traded shares will be deductible where the corporation is silent with respect to its dividend policy or where the policy is that dividends will be paid when operational circumstances permit. However, where a public corporation has indicated that its policy is not to pay dividends, or that dividends are not expected to be paid, then, in CCRA's view, the *Ludco* purpose test will not be met and therefore the interest will not be deductible. This pronouncement may have some implication for the dividend policies of Canadian public corporations and must be borne in mind in crafting related prospectus disclosure.

G. Participating Interest

The paper outlines the following four tests to determine whether participating payments will be deductible by the debtor as interest:

1. the payments must be limited to a stated percentage of the principal;

2. alternatively, the facts must show that the participation payment are intended to increase the interest rate on the loan to the prevailing market rate;

3. the limiting percentage, if any, must reflect prevailing arm's-length commercial interest rates; and

4. there must not be any other factor to indicate the presence of an equity investment.

H. Debts Issued at a Premium or Discount

CCRA has stated that on repayment a full or partial deduction will be available for the amount of any discount on debt issued by a borrower, pursuant to paragraph 20(1)(f) of the *Income Tax Act*.

In respect of debt issued at a premium, the policy paper provides that receipt of the premium will be a non-taxable capital receipt to issuers other than those in the lending business. However, where the interest rate on the debt is

clearly in excess of commercial arm's-length rates, CCRA may challenged the reasonableness of the interest rate (and therefore the deductibility of the interest payments).

I. Borrowing to Redeem Shares or Return Capital

Consistent with CCRA's current policy, as set out in Interpretation Bulletin IT-80, paragraphs I through K confirm a number of principles first established in *Trans-Prairie Pipelines Ltd. v. M.N.R.*, 70 DTC 6351 (Ex. Ct.).

Interest on money borrowed by a corporation for the purpose of returning capital, by share redemption or otherwise, will be deductible to the extent that the debt replaces that capital. The policy paper also confirms the deductibility of interest in the analogous partnership context.

J. How is Capital Calculated

The CCRA policy paper states that corporate capital will usually be measured as the stated capital under the applicable corporate law and that accumulated profits "means retained earnings computed on an unconsolidated basis with investments accounted for on a cost basis."

K. Borrowing to Pay Dividends

In accordance with CCRA's policy following the *Trans-Prairie* case, use of borrowed money to fund dividends up to the

amount of accumulated profits will also be a qualifying purpose for interest deductibility.

L. Notes Issued to Redeem Shares

The paper cautions that where a corporation issues a note to a shareholder in order to satisfy a dividend, interest on the note will not be deductible, as no property has been acquired by the corporation on the transaction. A note issued in respect of the redemption of shares will not be denied interest deductibility, since the corporation does acquire the redeemed shares.

M. Borrowing to Make Interest-Free Loans

CCRA has indicated in its paper that the agency will accept the deduction of interest on money borrowed to make an interest-free loan to a wholly owned corporation where the proceeds will be used by the corporation to produce income. CCRA will also permit the deduction of interest where there is more than one shareholder, if each shareholder makes a loan in proportionate to its shareholding. The general rule is that interest on money borrowed to make interest-free loans will not be deductible, but there may be other exceptional circumstances where the general rule will not apply.

N. Employee and Shareholder Loans

Provided there is a reasonable expectation of income from the corresponding debt instrument issued by a shareholder or employee, a corporation should be permitted to deduct interest on money borrowed to make interest-bearing loans to its shareholder or employee. Interest on debt incurred for the purpose of making a loan to an employee in that capacity will also be deductible to the corporation, even if the loan is made without interest, since this type of loan can be viewed as a form of remuneration to the employee.

O. Borrowing to Contribute Capital

CCRA's policy, as disclosed by the paper, is to accept the deduction of interest on money borrowed to make capital contributions to a wholly owned corporation or to make *proportionate* loans in multiple-shareholder circumstances. It appears that if loans are made disproportionately (for example by a parent and children) CCRA may challenge the deductibility of interest paid on any disproportionate interest free loans.

P. Borrowing for Loss Utilization Purposes

CCRA has also provided their administrative approval for arrangements within a group of affiliated corporation, whereby money is lent by a corporation in a loss position to other affiliated corporations, in order to generate interest

income to the loss corporation, thereby effectively shifting losses within the corporate group. The plan typically requires the profitable corporation to return the amount borrowed to the loss corporation by way of an investment in preferred shares yielding lower-rate dividends.

Q. Borrowing to Honour Guarantees

CCRA's view is that generally borrowing in order to honour a guarantee is not an income-earning purpose and therefore the related interest is not deductible. However, CCRA is prepared to generally accept the deduction of interest on money borrowed to honour a guarantee of a loan to a wholly owned corporation, where the transaction serves to increase the potential dividends to be received. Again, where there are multiple shareholders, CCRA has stated that it will recognize deductibility only to the extent that all shareholders make guarantee payments in proportion to their shareholdings.

R. Leveraged Buy-Outs

Where money is borrowed by an acquiror that subsequently amalgamates with or winds up the target corporation, interest on that money will continue to be deductible, notwithstanding the merger of the acquiror and target.

SELECTED TAX PLANNING CONSIDERATIONS FOR PRIVATE BUSINESS

On December 20, 2002, subsequent to the topics for this paper being set, the Department of Finance released draft technical legislation to amend the *Income Tax Act*. Therefore, this part of the paper is more properly a review of some of the more significant recent developments in income tax than a discussion of broader tax planning considerations.

1. Reasonable Expectation of Profit

Over the past several years, CCRA has been increasingly aggressive in reassessment of taxpayers for the denial of expenses where the agency deems no reasonable expectation of profit to exist. These reassessments have often occurred in the unfortunate circumstances of a failed business, compounding the taxpayer's woes with the denial of deductibility for their losses based on CCRA's assessment (in hindsight) that the business venture was so poorly thought out that the unfortunate taxpayer could not have had any reasonable expectation of profit. After CCRA's initial successes, the agency stepped up their use of the reasonable expectation of profit (REOP) line of attack, notwithstanding that it did start to suffer some losses, in cases such as *Tonn et al v. The Queen* 96 DTC 6001 (FCA), where the court cautioned that the reasonable expectation of profit test was "not intended as a vehicle for the wholesale

judicial second guessing of business judgment" (*Tonn*, p. 6012) and that such errors did not prohibit deductibility of losses resulting from those errors.

In 2002, the Supreme Court of Canada dealt what now appears to be a fatal blow to the REOP test in its decisions in *Brian J. Stewart v. The Queen*, 2002 DTC 6983 (SCC) and *The Queen v. Jack Walls and Robert Buvyer*, 2002 DTC 6964 (SCC). In these decisions, which were released simultaneously by the court, the Supreme Court established a new test for the purpose of determining whether a taxpayer's activity constitutes a source of business or property income, such as to permit deductibility of losses incurred from that source under Section 9 of the *Income Tax Act*. In Income Tax Technical News No. 25, dated October 30, 2002, CCRA has confirmed that it will use the *Stewart* test in replacement of the REOP test:

The first element of the test is to ask whether the activity is undertaken in pursuit of profits, or whether it is a personal endeavour. If there is no personal element and the activity is clearly commercial, then no further inquiry is necessary. However, if some portion of the activity could be characterized as a personal pursuit, then further inquiry is required in order to determine whether or not the activity has been carried on in a sufficiently commercial manner to constitute a source of income.

The second stage test is to determine whether the source of income is a business or property for the purposes of the *Income Tax Act*. The element of the decisions in *Stewart* and *Walls* which CCRA seems most uncomfortable with at present is the inference which may be drawn, that this test may be met where the only hope of "profit" is to earn eventual capital gains on disposition of the capital property. The potential for such an inference arises from the fact that the Federal Court of Appeal determined that the taxpayer in *Stewart* did not have a realistic plan to produce profit and the following statement in *Stewart*:

> in our view, the motivation of capital gains accords with the ordinary business person's understanding of "pursuit of profit", and may be taken into account in determining whether the taxpayer's activity is commercial in nature. Of course, the mere acquisition of property in anticipation of an eventual gain does not provide a source of income for the purposes of section 9; however, an anticipated gain may be a factor in assessing the commerciality of the taxpayer's overall course of conduct.
>
> (*Stewart* at 6983).

Based upon the foregoing provisions of *Stewart*, CCRA's position as stated in Income Tax Technical News No. 25 is that the realization of capital gains will assist in determining the commercial nature of an activity (the first test) but is not in itself determinative of the second test being satisfied, so as to constitute the capital property a "business or property"

permitting deductibility of the expenses in accordance with section 9 of the *Income Tax Act.*

2. Partnership Dispositions and ACB Calculations

The December 20, 2002 draft technical legislation contains proposed amendments dealing with the calculation of the adjusted cost base (ACB) of partnership interests ACB and the calculation of losses arising to former partners in circumstances surrounding mid-year departures from a partnership.

New subsection 96(1.01) will provide that, where a partner leaves mid-year the stub year income allocated to the partner is to be included in calculating the ACB of the partnership interest at the time of departure. (96(1.01)) Absent this new subsection, the partner's draws against capital to the time of departure would reduce the adjusted cost base of the partnership interest and could result in a capital gain, where capital returned to the partner as of that time exceeded the year's opening ACB, so that ACB was a negative amount in consequence of those drawings. Instead, with the addition of income for the stub year to the date of withdrawal, a more normalized calculation of the partnership adjusted cost-base will occur.

Under subsection 100(5), where a former partner pays an amount to the partnership to compensate for any over-drawings in a year in which the person was a partner, the

payment will be deemed to be a capital loss from the disposition of property for the year, in order to permit that loss to be carried back to offset any capital gains arising in relation to the partnership interest in the year of disposition.

3. Interest Paid to Authorized Foreign Banks

Pursuant to paragraph 212(1)(b) of the *Income Tax Act*, an income tax withholding is generally required in respect of interest payable to a non-resident person. Paragraph 212(1)(b) contains various exceptions to this general rule, the one most often used being the exception under sub-paragraph (vii) for interest on obligations having a term of greater than five years in respect of which not more than 25% of the principal is repayable during that period under any circumstances. The 2001 amendments to the *Income Tax Act* added subsection 212(13.3) which, for the purposes of section 212 and the remainder of Part XIII of the *Income Tax Act*, deems an authorized foreign bank to be a resident of Canada for the purpose of amounts paid or credited to the bank in respect of its Canadian banking business. As a result, no withholding is required where the payee is an authorized foreign Bank under the *Bank Act*. However, there has been some uncertainty since the introduction of subsection 212(13.3) as to whether responsibility for determining a lender's qualification as an authorized foreign bank falls to the payer of the interest. The December 20, 2002 amendments to the *Income Tax Act* introduced

changes to the *Income Tax Regulations* which extend the rules applicable to registered non-resident insurers to authorize foreign banks, effectively exempting the payer of interest to a financial institution which has held itself out to be an authorized foreign bank from the obligation to withhold and placing the obligation to pay the tax on that financial institution (Regulations 800 through 805).

4. Split Charitable Receipts

The December 20, 2002 technical amendments amended subsections 110.1(1) and 118.1(1) of the *Income Tax Act* in order to permit charitable donation receipts to be issued for a portion of an amount received by a charity (the "eligible amount" as defined in subsection 248(30)) where the amount received is in part consideration for value transferred by the charity and in part intended as a "gift". The eligible amount is defined in subsection 248(30) as the difference between the fair market value of the property transferred to the charity and the advantage that accrues to the donor by virtue of the gift. Under subsection 248(32), provided that the advantage which the charity provides to the donor has a value of less than 80% of the total fair market value of the property transferred to the charity, a gift will be presumed.

Following from the above legislative changes, CCRA released Income Tax Technical News No. 26 on December 24, 2002. Technical News No. 26 sets out guidelines for

charities in relation to split receipting. The guidelines contain examples for various fundraising events such as charity auctions, dinners, golf tournaments and membership fees that appear to represent a much more workable approach than CCRA's prior administrative positions.

The new rules also provide that the charity may provide gifts or door prizes which will not reduce the value of the charitable receipt which may be issued, provided that the aggregate value of such gifts and door prizes does not exceed the lesser of 10% of the value of the property transferred to the charity and $75.00.