UTILIZATION OF TAX LOSSES AND DEBT RESTRUCTURING

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UTILIZATION OF TAX LOSSES AND DEBT RESTRUCTURING*

I. INTRODUCTION

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

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

II. TRIGGERING ACCRUED LOSSES – THE STOP-LOSS RULES

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

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

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

A. THE AFFILIATED PERSONS CONCEPT – SECTION 251.1

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

B. DEPRECIABLE PROPERTY – SUBSECTION 13(21.2)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

S is the number of items disposed at that time;

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

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

L is the loss on the disposition as otherwise determined.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

D. ELIGIBLE CAPITAL PROPERTY

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

E. ACCRUED LOSS ON DEBT INSTRUMENTS

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

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

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

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

F. ADVENTURES IN THE NATURE OF TRADE

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

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

G. SUPERFICIAL LOSSES

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

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

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

(d) the expiry of an option,

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

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

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

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

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

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

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

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

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

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

H. DIVIDENDS

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

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

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

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

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

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

A. DIVIDENDS

1. Amalgamations[60]

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

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

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

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

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

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

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

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

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

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