READING 5-1

Incorporated or unincorporated business

LEVEL 1

Many individuals carry on a business or own significant investments personally. The resulting income is often taxed at a high marginal tax rate. The income tax paid on such income may generally be reduced or deferred by using a corporation.

However, before incorporating a business, the individual should analyze the tax and other consequences of such a decision. For example, a professional wishing to carry on his activities through a corporation should review the provincial laws governing his profession because, in certain provinces, carrying on a profession through a corporation is not permitted. Similarly, carrying on a business through a family corporation may be advantageous for tax purposes but not practical from a "business" point of view.

Example 5-1 provides a summary of the main tax consequences of the incorporation of a professional practice.

EXAMPLE 5-1

Louis, a CGA who practises on his own, may decide to incorporate his professional practice if the practice is established in a province where this is permitted. He must take into account the FMV of the property that he wants to transfer to the corporation, consisting primarily of accounts receivable, work in progress (inventory), office equipment, and goodwill. Assume that Louis has acquired no clientele since he started his firm. The provisions of sections 22 and 85 may apply to the transfer of the property.

In addition to considering the other factors studied here, Louis would have to assess whether it is preferable to choose an agreed amount for the transfer that would be higher than the minimum limit permitted by section 85. He would have to check whether it is more advantageous to create business income on the transfer of the goodwill, or a capital gain on another transferred property. This would then enable him to receive a greater non-share consideration that he could monetize tax-free in subsequent years when the corporation has sufficient liquidity.

Louis would nevertheless have an immediate tax outlay that could amount to approximately 25% of the FMV of the goodwill or capital gain if he chooses an agreed amount higher than the minimum limit stipulated in section 85 and if he has no loss carryforwards or other deductions serving to reduce or offset the income created. On the other hand, Louis may choose an agreed amount such that he will not be subject to any tax consequences on the transfer of the property. The non-share consideration will then be lower, and he will instead receive dividends in subsequent years, which will cost him up to 35% at the maximum marginal rate. These may be reported real dividends or deemed dividends on the redemption of the preferred shares received on the rollover.

Suppose Louis decides to only transfer to the new corporation the goodwill that has an FMV of $125,000.

He has two main options:

1. Transfer under section 85 of the goodwill for an agreed amount of $1. For the consideration, he could receive only preferred shares having an ACB and a PUC of $1, being redeemable at $125,000. He would have no immediate tax consequences

and will pay income taxes only on a deemed dividend on the redemption of shares received on the transfer. He will choose the timing of the redemption.

His tax burden for the transfer of the goodwill will be a maximum of 35% of the deemed dividend he will receive sometimes later, that is, $43,750 ($124,999 × 35%). The redemption of shares could be done over a few years to take advantage of the progressive tax rates, if applicable.

2. Sale of the goodwill for an amount of $125,000. For the consideration, the corporation could issue a note of $125,000. There will be immediate tax consequences as an amount of $62,500 ($125,000 × 75% × 2/3) will be included in his business income for the year of the transfer. At the maximum marginal tax rate, it represents an amount of $28,125 of income tax payable ($62,500 × 45%).

Louis must therefore decide which situation is the most advantageous for him. For example, if he intends to take out the $125,000 in the near future, the second option is preferable since the amount of tax is lower and the benefit of the deferral in the payment of tax available in the first option would be minimal.

Often, a new business incurs losses in the initial years of operation. These losses, when incurred personally, are deductible from other sources of income. However, losses incurred by a corporation are deductible only against income earned by the corporation and, under paragraph 111(1)(a), may be carried forward for twenty years. It is therefore preferable from a tax standpoint to defer incorporation until the business becomes profitable.

Incorporation should also be postponed until the individual no longer requires all the income derived from the business to meet personal living expenses. It would not be advantageous from a tax point of view for an individual to incorporate if the entire corporate profits were paid out annually as salary or dividends only to himself.

An individual wishing to carry on business through a corporation should also consider these factors:

- description of the share capital
- involvement of family members as shareholders
- shareholders' agreement
- ownership of the assets used in the business

Description of the share capital stock

On incorporation, an individual should provide for sufficient flexibility in the description of the corporation's share capital. This will enable subsequent transactions to be undertaken without having to amend the articles of incorporation every time a share issue is required.

Thus, the capital structure should be determined taking into consideration both present and future and personal and business objectives. Some of the more frequent objectives are

- the complete or partial freeze of the accrued gain on the business
- income splitting with other family members
- retaining control over the business
- transfer of property
- deductibility of interest on money borrowed to subscribe for shares

Involvement of family members

To meet the cash needs of the principal shareholder and his or her family, distributing part of the corporation's income as salary or dividends to the spouse and/or children may be advantageous for tax purposes. Income from an unincorporated business may also be distributed to the spouse and/or children in the form of salary. If the spouse and children are taxed at a lower marginal tax rate than the principal shareholder, the net after-tax amount available to the family will increase. In such case, the income attribution rules should be considered. The amounts paid to family members must also be reasonable. The salary must be commensurate with the services rendered and comparable to the salary that would be paid to an unrelated third party for the same work.

Shareholders' agreement

If the shares are held by more than one shareholder, a shareholders' agreement should be prepared.

Where a shareholder leaves the corporation, such as on retirement or on death, such an agreement would ensure that the departing shareholder has a market for his shares, if the agreement provides that the shares must be purchased by the other shareholders or redeemed by the corporation. The remaining shareholders may also increase their interest in the corporation and prevent the admission of a third party.

To avoid disputes, the agreement should include a method of valuing the shares on departure. In addition, provisions to protect minority shareholders and a non-competition clause should also be included.

In case of death, the provisions may include several different types of clauses, including:

- a requirement for the deceased shareholder's estate to sell the shares to the remaining shareholders and a requirement for the remaining shareholders to purchase these shares
- the redemption of the deceased's shares by the corporation

To provide the cash required to purchase or redeem the shares owned by a deceased shareholder, the shareholders' agreement may require each shareholder to carry insurance for the value of the shares owned. Even though the premium is not deductible, the corporation generally owns the life insurance policy. Assuming that the corporation pays tax at a lower rate than its shareholder, the after-tax cost of the policy is less if it is paid for by the corporation instead of by the shareholder with after-tax dollars.

On the death of a shareholder, the insurance proceeds received by the corporation, less the ACB of the policy, are added to the corporation's CDA under paragraph (d) of the definition of capital dividend account in subsection 89(1). Non-taxable dividends may be paid to the shareholders from the CDA under subsection 83(2), thus providing the remaining shareholders with the cash required to acquire the deceased's shares. The price paid by the remaining shareholders increases the ACB of the shares acquired. They benefit from the accrued gain on the deceased shareholder's shares, often without having to make any outlay of funds other than the CDA received from the corporation.

Ownership of assets

Where a corporation carries on a business that was previously unincorporated, certain property owned by one or more of the individuals in the business will sometimes be used by the corporation. It should be determined whether the asset will be owned by the individual personally and leased to the corporation, or whether it will be transferred to the corporation. In the latter case, under subsection 69(1), the asset must be sold at FMV. However, the ITA contains provisions under which the resulting capital gain and/or recapture of CCA may be deferred. These rules are included in section 85.

If the individual decides to lease the property to the corporation, he will receive rental income. The most common situation is in the case of a building which is leased to the corporation. To avoid any presumption of appropriation of funds by the shareholder, the rent must be reasonable. If CCA is claimed by the shareholder, the net rental income will be reduced. However, under REG 1100(11), the shareholder may not create a loss through CCA to reduce income tax payable on his other income.

Sometimes, the corporation may make an addition or improvement to the building. If the addition or improvement vests in the owner of the building, a benefit is considered to have been conferred on the shareholder by the corporation under subsection 15(1). In computing the amount of the benefit, it is necessary to consider the particular facts of each case, such as the nature of the addition or improvement, the term of the lease, provisions for extension of the lease, provisions of the lease in respect of leasehold improvements and the amount of rent charged. IT-432R2 provides more assistance in evaluating the benefit. The amount included in income under subsection 15(1) is not added to the capital cost of the property for CCA purposes even though, under subsections 52(1) and 52(1.1), it is added to the capital cost of the capital property for capital gains purposes.

Advantages of incorporation

In addition to the possible tax deferrals resulting mainly from the fact that the corporate tax rate on active business income (ABI) is generally lower, incorporation may provide other significant tax benefits.

1. A corporation may be used to split income with family members who are often taxed at a lower tax rate than the individual managing the business.

   A business may pay reasonable salaries to family members, whether it is incorporated or not. However, if the business is incorporated, the spouse may subscribe for common shares of the company using his or her own funds. In this way, dividends paid to the shareholder-spouse result in income splitting. Such planning is particularly worthwhile if the spouse has a low income and cannot be paid a salary. However, consideration should be given to attribution rules that may apply, especially section 74.4, if the corporation is not a small business corporation.

   A corporation is also a very useful tool for freezing an estate for the benefit of family members whereby the increase in the value of certain property is transferred to other beneficiaries, enabling them to use the CGD provided for in subsection 110.6(2.1).

2. A corporation may offer certain non-taxable benefits to its employees. An unincorporated business owner may not take advantage of these benefits because he cannot be an employee of his business.

   Such benefits include disability insurance premiums, premiums to a private group health insurance plan, and interest-free loans, provided that certain conditions are met. In addition, a death benefit of up to $10,000 may be paid to the surviving spouse without any tax consequences. Other tax planning measures, such as the payment of a retiring allowance or the declaration of a bonus, are also possible.

3. The lower the tax rate is on income, the less cash is needed to pay non-deductible expenses, such as life insurance premiums often paid to provide for income taxes on death. For example, approximately $1,250 of before-tax income is required by a corporation eligible for the small business deduction (SBD) to pay a premium of $1,000. If the premium were paid by an individual taxed at the top marginal rate,

approximately $2,000 of before tax income would be required to pay the $1,000 premium.

4. Because the corporate tax rate is lower, the corporation's cash requirements are thus reduced, leaving more cash for operations, acquisitions, and expansion.

5. For an individual whose income fluctuates significantly from year to year, the use of a corporation allows for the accumulation of income in the corporation, which enjoys a reduced tax rate for the years in which the individual's needs are lower. The income is then paid to the individual in a year when his other income is not sufficient to meet his needs. In this way, the individual's income is consistent from year to year and income taxes may be minimized.

6. Some provinces offer tax holidays of up to five years for new corporations. However, certain conditions must be met to be entitled to the tax holidays. An existing unincorporated business is not entitled to this benefit.

7. Given that the $375,000 CGD (this was increased from $250,000 to $375,000 under the 2007 budget, for dispositions on or after March 19, 2007) is available for a gain on the disposition of qualifying small business shares, carrying on a business through a corporation could be more advantageous than carrying on the business personally. If a corporation were not used, the individual would be entitled to the CGD only if the property consists of qualified farm property or fishing property or if all or substantially all the assets used in the business by the individual in his capacity as owner or through a partnership were transferred to a corporation before the sale.

Disadvantages of incorporation

There are also disadvantages to incorporation.

1. Using a corporation entails some legal and accounting fees on incorporation, such as fees for obtaining the articles of incorporation, and each year thereafter, the preparation of financial statements and annual minutes.

2. Some provinces impose a capital tax (shareholders' equity and certain types of debt) at a rate that varies from one jurisdiction to another (from 0.2% to 0.5%). The level of taxable capital starting at which the tax is computed also differs from province to province (from $1,000,000 to $20,000,000).

3. To realize substantial tax savings, the profits of the corporation must accumulate within the corporation, except where income splitting is possible.

4. Losses incurred by a corporation that does not have sufficient income to absorb such losses cannot be used by the shareholders to reduce their own income.

Bonus

To defer income taxes for both the employer and the employee, bonuses are often declared just before the taxation year end. Small and medium-sized businesses often use this technique for the shareholder-employee. Thus, a bonus may be declared just before the end of the fiscal year, which is not paid before December 31. The employer is entitled to the deduction and the employee is not taxed until the bonus is received.

Such arrangements are a form of planning accepted by the tax authorities. However, to prevent some taxpayers from abusing these arrangements, provisions have been included in section 78 preventing, in most cases, a deduction for the employer and a tax deferral for the employee for any significant period of time.

Under subsection 78(4), where an amount in respect of a taxpayer's expense that is a superannuation or pension benefit, a retiring allowance, a salary, wages or other remuneration is unpaid on the day, that is, 180 days after the end of the taxation year in which the expense was incurred, it is deemed not to have been incurred as an expense in that year but in the taxation year in which it is paid. On this subject, refer to IT-109R2 (paragraphs 10 to 14).

Example 5-2 shows how subsection 78(4) applies.

EXAMPLE 5-2

On December 20, 2008, Patio Ltd., having a fiscal period ending December 31, 2008, declared a bonus of $20,000 to Lucy Taylor, an employee. Payment will be made at a later date.

If the payment is not made by June 28, 2009, the 180th day after the end of Patio's fiscal year, subsection 78(4) provides that Patio Ltd. may not deduct the $20,000 bonus for its fiscal period ending December 31, 2008.

If Patio Ltd. meets the conditions of subsection 78(4), it will be entitled to a deduction in 2008 and Lucy may defer income taxes on the bonus for one year, except for deductions at source which must be withheld when the bonus is paid to Lucy.

However, if the employer is tax exempt or in a loss position, deferring the deduction may not be an important consideration. For businesses in a loss position, the deferral of deductions is recommended so as not to lose the benefit of loss carryforwards. In such a case, an employee may have a tax deferral of up to three years. In the exceptions listed under salary deferral arrangements, an employee has up to three years following the end of the taxation year in which the services were rendered to receive a bonus if such a mechanism is agreed to with the employer, as illustrated in Example 5-3.

EXAMPLE 5-3

Assume that Patio Ltd. is in a loss position. The non-deductibility of the bonus declared to Lucy in 2008 does not involve any additional tax liability, given that the company does not have any tax to pay. If Lucy wishes, she may agree with Patio Ltd. to have the amount paid during the 2011 year, thereby deferring her tax liability for three years.

Deferring remuneration in this manner may be particularly advantageous for an individual nearing retirement who expects his marginal tax rate to decrease.

READING 5-2

Capital gains deduction

LEVEL 1

Every **individual** owning qualified small business corporation shares or qualified farm or fishing property likely to increase in value will probably one day use the CGD. Ultimately the CGD is available on death. Tax planning should be undertaken to ensure that the individual makes maximum use of the CGD taking into account section 245 and, more particularly, the anti-avoidance rules contained in section 110.6.

Small business corporation

A capital gain realized by an individual on the disposition of qualified small business corporation shares (QSBCS) may be eligible for the $375,000 CGD under subsection 110.6(2.1). This capital gains deduction was raised from $250,000 to $375,000 for transactions carried out after March 18, 2007. However, certain conditions contained in the definition of QSBCS in subsection 110.6(1) must be met:

a) At the **time of disposition**, the shares must be shares of a **small business corporation** (SBC) as defined in subsection 248(1), that is, shares of a corporation which, at that time, is a CCPC all or substantially all (90% or more, according to CRA) of the FMV of the assets of which at that time are attributable to assets that are:

- used principally in an active business carried on primarily in Canada by the corporation or by a corporation related to it. Thus, the total value of an asset used principally in a business will be taken into consideration [paragraph (a) of the definition in subsection 248(1)]
- shares of the capital stock of one or more SBCs connected with the corporation within the meaning of subsection 186(4) or debts incurred by such connected corporations [paragraph (b) of the definition in subsection 248(1)]
- assets described in paragraphs (a) and (b) [paragraph (c) of the definition in subsection 248(1)]

b) Throughout the 24 months preceding the disposition, the shares must not be owned by anyone other than the individual or a person or partnership related to the individual. Under paragraph 110.6(14)(f), treasury shares issued by a corporation are deemed to have been owned immediately before their issue by a person not related to the owner of those new shares.

c) Throughout the required 24-month period preceding the disposition, the shares were shares of a CCPC of which *more than 50%* of the FMV of the assets were used in an active business carried on primarily in Canada by the corporation or by a corporation related to it. For this purpose, shares or debts of connected corporations — within the meaning of subsection 186(4) — held by a corporation will be considered to be used in an active business carried on by it primarily in Canada provided that

- throughout that part of the 24-month period preceding the disposition, such shares or debts were not owned by anyone other than the corporation or a person or partnership related to it

and

- throughout that part of this period while the shares or debts were owned by the corporation or a person or partnership related to it, the connected corporations

were CCPCs more than 50% of the FMV of the assets of which were attributable to assets used by it principally in carrying on a business in Canada.

d) Where all or substantially all of a corporation's assets cannot be attributed to eligible assets at a given time during the 24-month period preceding the disposition, then all or substantially all of the assets (rather than more than 50%) of connected corporations must be assets used by the corporation principally in carrying on a business in Canada at that time. The purpose of this rule is to prevent the conditions from being met by the interposition of several holding companies.

The percentages set out in the above conditions apply to the **FMV** of the assets. It is therefore necessary to take account of the FMV of all assets, regardless of whether they are entered on the balance sheet or not. For example, the corporation may have a goodwill value that does not appear on the balance sheet because it was not purchased, but it must nevertheless be included in the assets so as to be able to verify whether the conditions regarding the percentage are met. Liabilities are not relevant in the determination of the percentages.

Where a parent corporation holds shares or debts of a connected subsidiary and the subsidiary holds shares or debts of the parent corporation, there could be a problem of circularity in determining whether a particular share qualifies as an SBC share. Paragraph 110.6(15)(b) eliminates this problem by establishing that the FMV of shares or debts of the parent corporation held by the subsidiary is nil. Paragraph 110.6(15)(b) applies where the parent corporation is connected with the subsidiary within the meaning of subsection 186(4), without taking into account subsection 186(2).

In applying the CGD under paragraph 110.6(14)(b), paragraph 251(5)(b), concerning buy-sell rights in determining control of the corporation, is not relevant. Furthermore, under paragraph 110.6(14)(a), the individual will be deemed to have disposed of shares that are identical properties in the order in which they were acquired. This presumption does not affect the computation of the ACB of the shares, but rather their order of disposition where they were acquired at different times. This presumption is necessary for purposes of determining the 24-month holding period.

There are three other exceptions to paragraph 110.6(14)(f) relating to the deemed ownership of shares before their issue. Shares are not deemed to have belonged to an unrelated person before their issue if

i) they are issued as consideration for other shares, for example, on amalgamation;
ii) as part of a transaction or series of transactions enabling a person or partnership to transfer all or substantially all the assets used in an active business carried on by the person or the members of the partnership. This exception is also valid for an interest in a partnership.
iii) they are issued as stock dividends. This exception comes from the fact that paragraph 248(5)(b) stipulates that any share received in payment of a stock dividend is deemed to be property substituted for that other share.

The second exception allows an individual whose business is not incorporated to claim the CGD if he wishes to dispose of a business carried on as a sole proprietorship or a business carried on by a partnership by carrying out certain transactions. He may first sell all the assets used in the business to a new wholly-owned corporation under the capital gains deferral rules contained in section 85. He may then dispose of the shares of the corporation. If all the conditions listed above are met except for the 24-month holding period, he may claim the CGD. In this respect, under section 54.2, where a person has disposed of all or substantially all of the assets used in an active business carried on by that person to a corporation, the shares are deemed to be capital property. Whether the business has been carried on for more or less than 24 months is not a criterion used in this case.

For the first and third exception, the effect of the presumption is that the 24-month holding criterion will be met if the substituted shares or the shares that entitled the holder to the share dividend met this criterion [subsection 110.6(1), definition of "qualified small business corporation share," paragraph e].

Purification

A corporation also may have held excess assets (assets not principally used in its active business) so that both the more-than-50% over 24-month rule and the rule requiring that, at the time of disposition, all or substantially all of the assets be qualified assets are not respected. It is generally accepted by CRA that all or substantially all of the assets means at least 90% of the assets. It is therefore very important to rid the corporation of its excess assets, or "purify" it, so as to make it eligible for the CGD in anticipation of a sale by an individual or death. Consideration should also be given to disposing of its ineligible assets. There are a number of ways in which excess assets may be removed from a corporation. Some of these methods will be analyzed using examples. Each case is unique and the same solution is not necessarily valid in all cases.

Before undertaking complicated and/or onerous solutions to meet the asset eligibility criteria, certain simple solutions using internal measures should be considered:

- A corporation having substantial liquid assets which do not earn business income could use these assets to repay liabilities. In certain cases, this could qualify a sufficient percentage of assets to make the corporation qualify as an SBC.
- A dividend or bonus could be paid to an individual shareholder, thereby removing ineligible assets from the corporation. Income taxes will be payable, but the situation could still be advantageous, depending on the circumstances. If the corporation has a CDA, a non-taxable dividend could also be paid.
- Reducing PUC by a payment to shareholders could sufficiently reduce ineligible assets in certain cases. The ACB of the shares is then reduced by the same amount and may give rise to an immediate capital gain if it becomes negative.
- Where a subsidiary with business assets has a high debt ratio and another subsidiary has substantial liquid assets that are not used in the business, an amalgamation of these two corporations could make the amalgamated corporation qualify as an SBC. The same procedure could be used for a parent corporation and its subsidiary, either through an amalgamation under section 87 or a winding-up under subsection 88(1). Example 5-4 illustrates such a situation.

EXAMPLE 5-4

Wapiti Ltd. has owned 100% of the shares of Zest Ltd. and Java Ltd. for more than 24 months. Below is a summary balance sheet at **FMV** of each of these corporations.

Java Ltd.

Assets used in the business	$500,000	Debt	$ 450,000
Goodwill	50,000	Shareholders' equity	100,000
	$550,000		$ 550,000

Zest Ltd.

Shares of public corporations	$ 50,000	Shareholders' equity	$ 50,000

Wapiti Ltd.

Shares — Java Ltd.	$100,000		
— Zest Ltd.	50,000		
	$150,000	Shareholders' equity	$ 150,000

If the shares of Wapiti Ltd. that are held by an individual are sold and there is a resulting capital gain, it would not qualify for the CGD because Wapiti Ltd. does not meet the test of 90% of the **FMV** of qualifying assets at the time of the sale. Approximately 1/3 of its assets do not qualify, being the shares of Zest Ltd., which are not shares of an SBC since 100% of the assets of Zest Ltd. are not used in an active business.

Two possible solutions that will qualify Wapiti Ltd. as an SBC are as follows:

1. Wind up Java Ltd. into Wapiti Ltd. under subsection 88(1), which applies automatically since the following conditions are met:

   - Both the subsidiary and the parent corporation are taxable Canadian corporations.
   - Wapiti Ltd. holds 90% or more (in this case, 100%) of the shares of each class of the capital stock of Java Ltd.

   Wapiti Ltd.'s balance sheet at **FMV** would then be

   Wapiti Ltd.

Shares — Zest Ltd.	$ 50,000	Debt	$ 450,000
Assets used in the business	500,000	Shareholders' equity	150,000
Goodwill	50,000		
	$ 600,000		$ 600,000

   Only 8.33% of the **FMV** of Wapiti Ltd.'s assets would be considered as ineligible, namely the shares of Zest Ltd. The test of 90% of the **FMV** of assets would be met.

2. Amalgamate Zest Ltd. and Java Ltd. The balance sheet of the new corporation (Zest & Java Ltd.) at FMV would then be

   Zest & Java Ltd.

Shares of public companies	$ 50,000	Debt	$ 450,000
		Shareholders' equity	150,000
Assets used in the business	500,000		
Goodwill	50,000		
	$ 600,000		$ 600,000

   Zest & Java Ltd. would qualify as an SBC because only 8.33% of the **FMV** of its assets would be ineligible, namely the shares of public corporations. Since Wapiti Ltd. would hold only shares of Zest & Java Ltd., an SBC, the shares of Wapiti Ltd. would qualify for the CGD provided that, during the 24 months preceding the sale, Wapiti Ltd. met the test of 50% of the **FMV** of qualifying assets and Zest & Java Ltd. met the test of 90% of the **FMV** of qualifying assets. At a minimum, therefore, for Wapiti shares to qualify for the CGD in this scenario, they could not be sold until 24 months after the Zest Ltd. and Java Ltd. amalgamation.

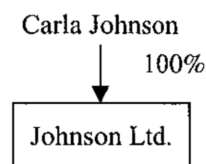
However, certain situations require more elaborate planning, as illustrated in Examples 5-5 to 5-7.

EXAMPLE 5-5

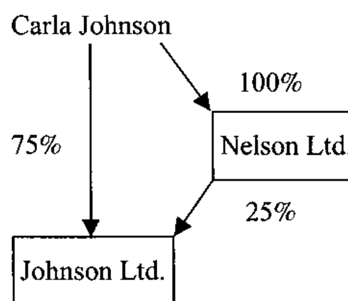
Carla Johnson owns 100% of the shares of Johnson Ltd., 75% of the **FMV** of the assets of which are attributed to the business and 25% of which are investments (ineligible assets). On a sale or on death, Carla would not be entitled to the $375,000 CGD even though she has met the more-than 50% over 24-month rule, because on the sale or on death, the 90% rule would not have been met. To remove the ineligible assets from Johnson Ltd., a new corporation, Nelson Ltd., should be formed. Carla may then transfer 25% of her shares in Johnson Ltd. to Nelson Ltd. under section 85 and receive shares having a low PUC. There would be no immediate tax consequences. Thereafter, Johnson Ltd. would redeem its shares held by Nelson Ltd. using its investments as the method of payment. Nelson Ltd. would be deemed to have received a dividend under subsection 84(3). As it is deductible under subsection 112(1), there is no Part I tax payable by Nelson Ltd. There would also be no Part IV tax payable if Johnson Ltd. did not receive a dividend refund. If the investments held by Johnson Ltd. have a sizable accrued gain, this alternative is less attractive, because, on the redemption of the shares, Johnson Ltd. is deemed to have disposed of its investments at FMV, resulting in a capital gain. However, if Johnson Ltd. has a balance of capital or non-capital losses to carry forward, this solution could also be used, provided the losses are sufficient relative to the capital gain realized on the transaction.

Steps

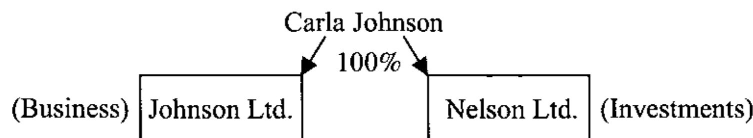
1. Actual situation



2. Transfer under section 85



3. Redemption of shares



A valuation of the shares of Johnson Ltd. would be required at the time of the transfer of the shares to Nelson Ltd. and a price-adjustment clause should be included in the contract of sale. Furthermore, if these transactions were part of a series of transactions for the purpose of disposing of the shares of Johnson Ltd. to a third party unrelated to Nelson Ltd., the provisions of subsection 55(2) would have to be taken into account. Subsection 55(2) might apply to the deemed dividend on redemption of the shares. A consequence of this could be that part or all of the deemed dividend would instead be considered as proceeds of disposition of the shares and give rise to a capital gain.

EXAMPLE 5-6

Using the same facts contained in Example 5-5, here is a different solution.

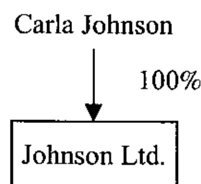
A reorganization of capital under section 86 could be carried out, thereby converting the shares of Johnson Ltd. owned by Carla into two new classes of shares:

- common shares representing the value of eligible assets
- voting preferred shares redeemable for an amount equal to the value of the ineligible assets

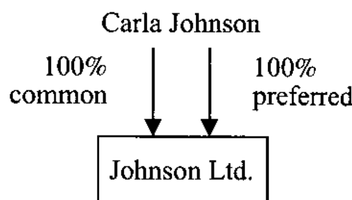
Thereafter, the preferred shares are transferred to Nelson Ltd. under section 85, in consideration for shares having a low PUC. They are then redeemed using the ineligible assets, thereby creating a deemed dividend under subsection 84(3), which is deductible under subsection 112(1). There is no Part I tax payable by Nelson Ltd. and if Johnson Ltd. did not receive a dividend refund there would be no Part IV tax payable either.

Steps

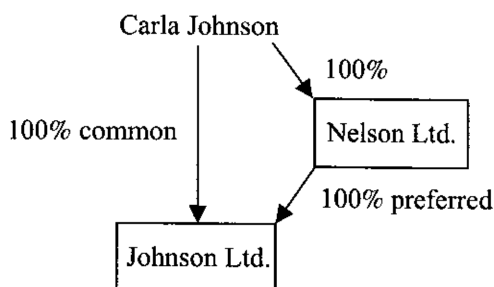
1. Actual situation



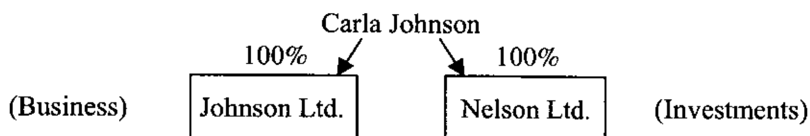
2. Reorganization of capital



3. Transfer under section 85



4. Redemption of preferred shares



In this example, Johnson Ltd. would also be deemed to have disposed of its ineligible assets at their FMV at the time of the redemption thereby resulting in a potential capital gain. This alternative should be avoided if there is a substantial accrued gain on the assets transferred or if Johnson Ltd. does not have a sufficient balance of losses to carry forward or losses in the year of the transaction to offset the capital gain. In such case, a transaction similar to the one proposed in the following example could be considered, after making any necessary changes to reflect the specific circumstances. As in Example 5-5, care must be taken not to overlook the possible application of the provisions of subsection 55(2) on the deemed dividend on redemption of the shares if the removal of ineligible assets is carried out as part of a series of transactions for the purpose of selling shares of Johnson Ltd. to a person unrelated to Nelson Ltd.

EXAMPLE 5-7

Patrick Labelle owns 100 Class A shares and 1,000 Class B shares of Paris Ltd.

Class A (participating)	
ACB	$ 100
PUC	$ 100
FMV	$ 1,800,000

Class B (non-participating)	
ACB	$ 10,000
PUC	$ 1,000,000
Redemption price	$ 1,000,000

Paris Ltd. owns 100% of the common shares of Rome Ltd.

Rome Ltd. has the following assets:

Property used in carrying on an active business:	
Cost	$ 500,000
FMV	$ 2,100,000

Rome Ltd. qualifies as an SBC, since 100% of its assets are eligible.

Paris Ltd. has the following assets (FMV):	
Shares of Rome Ltd.	$ 2,100,000
Shares of public corporations	$ 700,000

Consequently, Paris Ltd. does not qualify as an SBC because at least 25% of the **FMV** of its assets are ineligible, being shares of public corporations.

The following steps should be taken to remove Paris Ltd.'s ineligible assets:

1. A new company, Montreal Ltd., is formed and is wholly owned by Patrick.

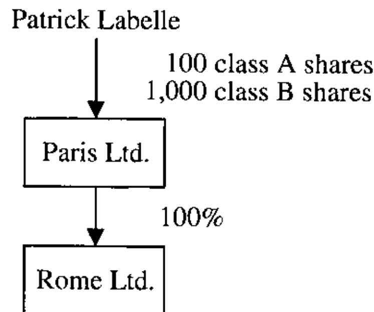
2. The FMV per Class A share is $18,000 ($1,800,000 ÷ 100). So the number of Class A shares required to represent the value of ineligible assets is 39 ($700,000 ÷ $18,000). Patrick may then transfer to Montreal Ltd. 39 Class A shares of Paris Ltd. under section 85 for $700,000 in consideration for common shares of Montreal Ltd.

3. Paris Ltd. then transfers its investments to Montreal Ltd. in exchange for shares redeemable for $700,000 under section 85.

4. Paris Ltd. redeems its shares held by Montreal Ltd. and Montreal Ltd. redeems its shares held by Paris Ltd. by a simple exchange of cheques.

Paris Ltd. now owns only shares of Rome Ltd., thereby qualifying as an SBC.

Steps



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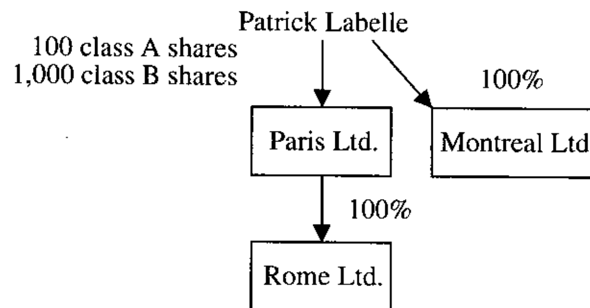

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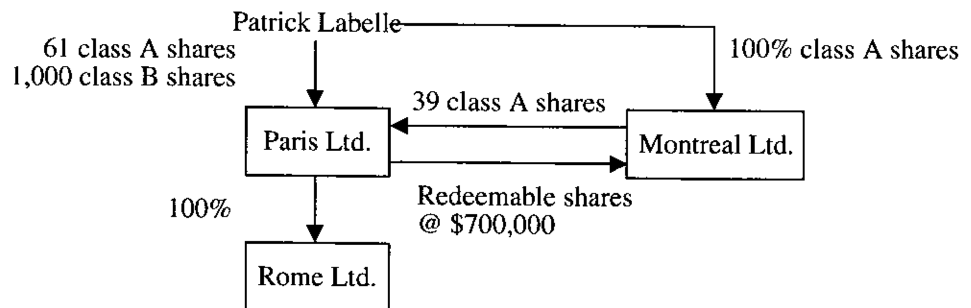

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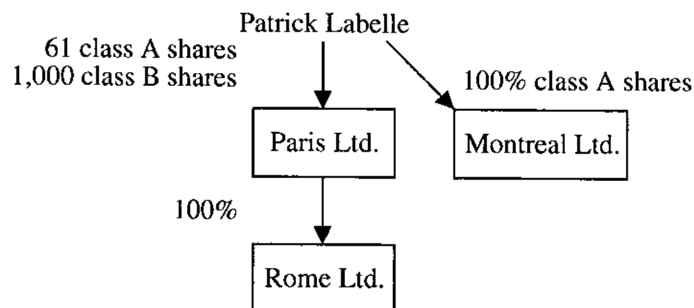


As in the previous examples, the deemed dividend on redemption of the shares may be subject to the provisions of subsection 55(2) if the removal of ineligible assets is carried out as part of a series of transactions for the purpose of selling shares of Paris Ltd. to a third party unrelated to Montreal Ltd.

Examples 5-5, 5-6, and 5-7 are not the only ways to remove ineligible assets from a corporation. Rather, these are the most common and a combination of these techniques may be considered. Each case should be reviewed independently and the resulting solution should rectify the specific problems at hand.

It is important to remember that, for the capital gain on the shares to be eligible for the CGD, a corporation must maintain its CCPC status for 24 months and be an SBC at the time of disposition. Removing ineligible assets from the corporation should be a constant concern, because on death, it is too late to plan. Even a sale of shares is not always anticipated 24 months in advance. In addition, depending on the amount of safe income available, subsection 55(2) may apply and all or part of the dividend may be deemed POD of shares if the shares are sold shortly after the ineligible assets are removed from the corporation.

As noted above, the possibility of claiming the CGD on death may be eliminated if the corporation does not meet the 90% criterion immediately before the time of death. Paragraph 110.6(14)(g) is intended to grant tax relief in such a situation. If there is a disposition of a share on death, this share is deemed to be an SBC share at the time of the disposition if it met the definition of such at any time in the 12-month period immediately preceding the disposition.

Identical properties

As noted earlier, when the shares are identical properties, the individual is deemed under paragraph 110.6(14)(a) to dispose of them in the order in which they were acquired. This presumption is significant in a number of situations, and it regularly arises where the shareholder has incorporated his business but not transferred to the corporation the building that houses the operations of the business, as illustrated in Example 5-8.

EXAMPLE 5-8

Yvonne Fong owns a building in which she operates a restaurant. Her business has become so profitable that her accountant suggests that she incorporate, since her profits greatly exceed her living expenses. This would enable her to defer taxes. Nevertheless, Yvonne, who is very cautious, prefers to retain personal ownership of the building, so that if the financial situation should deteriorate and she should be obliged to close the restaurant, the building could then be used for other purposes and would not be put at risk.

This type of decision is made very frequently and is usually justified.

The transfer of the business takes place in 2007, and there are no immediate tax consequences arising from the transaction, since Yvonne takes advantage of the rollover provisions of section 85. She receives 1,000 common shares of Totem Systems Ltd. on the rollover. Totem Systems Ltd. was constituted immediately before the transaction. Yvonne is the sole shareholder.

In 2009, Yvonne, seeing that Totem Systems Ltd. is realizing substantial profits, decides to transfer the building to it, and again takes advantage of the provisions of section 85. Yvonne intends to sell the restaurant and believes that the transaction will be simplified if all the elements of the business are brought together. She receives 400 common shares. In addition, she has been told that she would be entitled to a CGD of as much as $200,000 if she were to sell the shares, since she has already used some of the CGD in a previous transaction.

In 2010, Totem Systems Ltd. receives an offer of $700,000 which Yvonne decides to accept. Assume the ACB of the shares is $200,000, that is, $150,000 for the shares acquired in 2007 and $50,000 for those acquired in 2009. The shares being identical properties, an average ACB has to be calculated ($200,000 ÷ 1,400 = $142.857).

Totem Systems Ltd. is an SBC at the time of the transaction.

Tax consequences

Under paragraph 110.6(14)(a), Yvonne is deemed to dispose of the 1,000 common shares acquired in 2007, then the 400 common shares acquired in 2009.

1. 1,000 common shares:

POD ($700,000 × 1,000 ÷ 1,400)	$ 500,000
Less: ACB (1,000 × $142.857)	(142,857)
Capital gain	$ 357,143
Taxable capital gain (1/2)	$ 178,572
Less: CGD [110.6(2.1)]	(178,572)
	$ —

2. 400 common shares:

POD ($700,000 × 400 ÷ 1,400)	$ 200,000
Less: ACB (400 × $142.857)	(57,143)
Capital gain	$ 142,857
Taxable capital gain (1/2)	$ 71,429

Yvonne is not entitled to the CGD under subsection 110.6(2.1) on the 400 common shares acquired in 2009, since she does not meet the 24-month holding requirement set out in subsection 110.6(1), in paragraph (b) of "qualified small business corporation share."

Summary

Below is a summary of the conditions that must be met in order for the shares of a corporation to qualify as qualified small business corporation shares:

1. At the time of disposition
   - the corporation must be a CCPC
   - all or substantially all of the FMV of the assets of the corporation are used in an active business carried on primarily in Canada and/or are shares or debts of connected SBCs

2. Throughout the 24 months before the disposition
   - the shares were shares of a CCPC
   - the shares were not owned by anyone other than the individual or a related person or partnership
   - more than 50% of the FMV of the assets of the corporation was used in an active business that the corporation carried on primarily in Canada

Incorporated or non-incorporated business

There are various advantages and disadvantages for continuing a business through an incorporation. To the advantages may be added the CGD under subsection 110.6(2.1).

As noted earlier, an individual who carries on a business as its sole owner and who wishes to sell it has the option of transferring the business to a corporation before the sale, under the rollover provisions of section 85. These provisions also apply to a partnership. Following the transfer, there is a sale of the shares of the corporation that acquired the business. By virtue of paragraph 110.6(14)(f), the CGD under subsection 110.6(2.1) is claimed by the individual on

the sale of the shares, provided that the individual or the partnership has transferred all or substantially all of the assets used in the business at the time of incorporation.

An individual who is going into business and is deciding whether to do so as a sole proprietor or whether to incorporate should assess the probability that the business will be sold within 24 months. It would be fairly unusual for this to occur. If the business is incorporated from its inception, the shareholder will not be entitled to the CGD if the shares are sold within 24 months. If the business begins as a sole proprietorship, the owner can always take advantage of the provisions of paragraph 110.6(14)(f) to claim the CGD after transferring the business to a corporation, even if the business has not been in existence for more than 24 months.

Crystallization

The term **crystallization** is used when a transaction is planned for the purpose of enabling an individual to claim all or part of the CGD without there being a transfer of shares of an SBC to a third party. This transaction is usually carried out in order to claim the CGD if the individual prefers to do so before there is a "real" disposition. There are generally no immediate tax implications for the transaction except that alternative minimum tax (AMT) may apply. The individual must be able to pay AMT with liquid assets already on hand, since with the crystallization, although a capital gain eligible for the CGD is realized, no cash is received. Generally, only shares are issued on the transaction; otherwise, section 84.1 might apply and there would then be a deemed dividend.

The main reasons why an individual may want to carry out a transaction crystallizing a capital gain are

- The possibility that the shares of the corporation will not qualify as qualified small business corporation shares on their disposition and that no planning tool will correct the situation. This would be the case, for example, if the 50% test were not met during the 24 months preceding the disposition of the shares.
- Once the capital gain is crystallized, the corporation need no longer concern itself with meeting the criteria for being considered an SBC.

There are two main techniques for crystallizing a capital gain. They are presented in Examples 5-9 and 5-10.

EXAMPLE 5-9

Michel Caron holds 100% of the common shares of Michigan Ltd., the only shares issued by that corporation, which qualify as small business corporation shares for the purposes of subsection 110.6(1). Michel wishes to claim the CGD immediately (assuming he would be entitled to a CGD of as much as $250,000) and stop worrying about whether or not the shares are qualified small business corporation shares. The ACB and PUC of the shares of Michigan Ltd. are $10,000, and the FMV is $610,000.

Steps

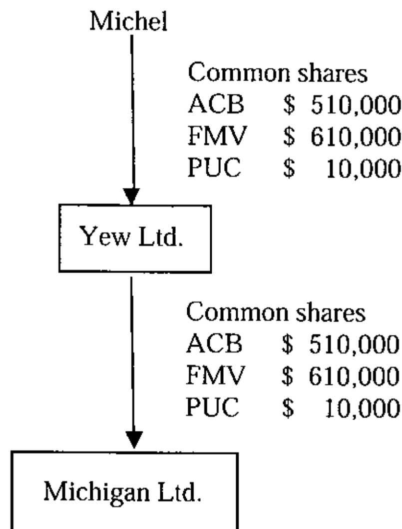
1. Incorporation of Yew Ltd.

2. Using the rollover provisions of section 85, Michel transfers the shares of Michigan Ltd. to Yew Ltd. in consideration of common shares of Yew Ltd. having an FMV of $610,000 and a PUC of $10,000. The agreed amount is set at $510,000.

POD (agreed amount)	$ 510,000
Less: ACB	(10,000)
Capital gain	$ 500,000

Taxable capital gain (1/2)	$ 250,000
Less: CGD	(250,000)
	$ —

After this step, the situation is as follows:



To benefit from the advantages of the capital gain crystallization, Michel must sell the shares that he holds in Yew Ltd. when he wants to sell the business that is carried on by Michigan Ltd.

3. (This step is optional.) Yew Ltd. and Michigan Ltd. are amalgamated under the provisions of section 87 or Yew Ltd. is wound up into Michigan Ltd., taking advantage of the provisions of subsection 88(1).

EXAMPLE 5-10

Return to the data in Example 5-9, but this time use an **internal rollover** to crystallize the capital gain. Provisions of section 85 can be used on behalf of the corporation issuing the shares to be transferred.

Steps

1. Under section 85, Michel transfers to Michigan Ltd. the common shares that he holds in that corporation. In consideration, he receives 10,000 preferred shares retractable at $610,000, having a PUC of $10,000 and an ACB of $510,000. The agreed amount is set at $510,000.

POD (agreed amount)	$ 510,000
Less: ACB	(10,000)
Capital gain	$ 500,000
Taxable capital gain (1/2)	$ 250,000
Less: CGD	(250,000)
	$ —

2. Michel subscribes to new common shares, for example 100 common shares for $100.

The crystallization of the capital gain could have been done in a single transaction if, for example, Michel had transferred the number of common shares corresponding only to an FMV of $510,000. He would have thus kept some common shares, and step 2 would not have been useful.

LEVEL 2

Qualified farm property

The disposition of qualified farm property by an individual may also qualify for the CGD. A **qualified farm property**, defined in subsection 110.6(1), includes

a. A real property that has been used by the individual, his spouse, child or parent, by a family farm corporation, a family farm partnership or a beneficiary of a trust for whom a designation is made, in the course of carrying on the business of farming in Canada.

   To be considered as used in the course of carrying on the business of farming in Canada at that time, the property or property substituted therefore, if acquired before June 17, 1987, must have been used by one of the above-mentioned persons or a family farm partnership either in the year the property was disposed of by the individual, or in at least five years during which the property was owned by one of these persons (other than a corporation) or the partnership.

   However, real property acquired by the individual or his family after June 17, 1987, is excluded unless throughout the period of at least 24 months preceding its disposition, the real property was held by the individual or one of the persons or entities mentioned above, and one of the following additional conditions was met:

   - for at least two years while the property was so owned, the gross revenue earned by the individual, his spouse, a child or parent from the farming business in which the property was principally used and in which such person was actively engaged on a regular basis must exceed his income from all other sources for the year

   or

   - the property must be used by a family farm corporation or a family farm partnership in the course of carrying on the business of farming throughout a period of at least 24 months during which time the individual, his spouse, child or parent, or a beneficiary of a trust was actively engaged on a regular basis in the farming business

b. A share of the capital stock of a family farm corporation of the individual or his spouse.

c. An interest in a family farm partnership of the individual or his spouse.

d. An eligible capital property (ECP), such as a milk quota, used by one of the persons listed in (a) or a family farm partnership in the course of carrying on the business of farming in Canada.

To multiply the CGD, an individual may transfer his shares of a family farm corporation to his children, grandchildren, or great grandchildren tax free under subsection 73(4). Following this type of transfer, every family member may be entitled to the CGD unless the transfer takes place in the three years preceding the sale with the goal of multiplying the CGD.

Qualified fishing property

Since May 2, 2006, other types of property have been added to the list of properties that qualify for the CGD upon disposal. These are qualified fishing properties, which are defined in subsection 110.6(1) and which consist primarily of the property of an individual, his spouse, or common-law partner, or of a partnership. Qualified fishing property includes

a. Real or immovable property or a fishing vessel that was used principally in the course of carrying on the business of fishing.

b. A share of the capital stock of a family fishing corporation.

c. An interest in a family fishing partnership.

d. An eligible capital property used in the course of carrying on the business of fishing in Canada.

Anti-avoidance and CGD

General considerations

Following the introduction of the CGD, it has become even more advantageous for an individual to realize capital gains rather than ordinary income or dividends. Parliament, therefore, believed that it was necessary to introduce measures to prevent tax planning abuses designed to take advantage of the CGD. The purpose of the anti-avoidance measures contained in the ITA is to prevent the following:

- the conversion of a capital gain of a corporation into a capital gain of an individual that is eligible for the CGD
- the conversion of ordinary or dividend income into a capital gain that is eligible for the CGD
- the manipulation of the PUC of the shares of a corporation for the purpose of distributing a corporate surplus as a capital gain rather than as a dividend
- the disproportionate distribution of capital gains to individuals by trusts, partnerships and certain types of investment corporations

Some of the provisions have already been covered and you should review them again.

Subsection 15(1.1): A stock dividend may be taxed at its FMV.

Section 84.1: The transfer of shares by an individual to a corporation with which he does not deal at arm's length may give rise to an immediate dividend or a reduction in the PUC of the shares received on the transfer.

Subsection 85(2.1): On the transfer of property under section 85, the PUC of the shares of the purchaser corporation may be reduced.

Unreported capital gains

Under subsection 150(1), an individual is required to file an income tax and benefit return for each year in which he has a taxable capital gain or has disposed of capital property. Under subsection 110.6(6), the CGD may be disallowed where a taxpayer who has realized a capital gain in a taxation year fails

- to file an income tax and benefit return for that year within one year after the day on which the return should normally have been filed

or

- to report the capital gain in his income tax and benefit return

The CGD will be disallowed only if, knowingly or under circumstances amounting to gross negligence, the individual has failed to file his return or report the capital gain. It is up to CRA to determine the facts justifying the disallowance of the deduction.

Conversion of a capital gain of a corporation into a capital gain of an individual

Subsection 110.6(7) deals with circumstances where a capital gain that would normally have been realized by a corporation is transferred to an individual, following

- a series of transactions that qualify as a "butterfly" transaction

or

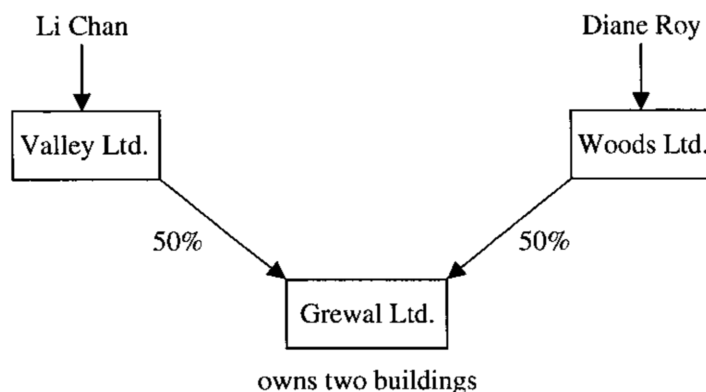
- a series of transactions in which a corporation or partnership acquires property for consideration that is significantly less than the FMV (not including less than FMV acquisitions following certain reorganizations, as discussed below in Example 5-12)

Capital gains transferred in this manner are not entitled to the CGD.

Example 5-11 illustrates one of the situations covered by these provisions.

EXAMPLE 5-11

Grewal Ltd. owns two buildings of equal value, which it wishes to sell to two different buyers. Grewal Ltd. is owned as follows:

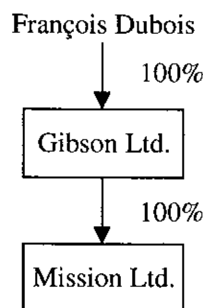


Using a "butterfly" transaction, Grewal Ltd. transfers one building to Valley Ltd. and the other building to Woods Ltd.

Subsequently, Li Chan sells the shares of Valley Ltd. to a purchaser and Diane Roy sells the shares of Woods Ltd. to another purchaser. Without subsection 110.6(7), Li and Diane could have claimed the CGD on the sale of the shares.

As mentioned, the CGD may also be disallowed if a capital gain is realized by an individual as part of a series of transactions in which a corporation or partnership acquires a property for consideration significantly less than FMV. The CGD will be allowed if the acquisition results from an amalgamation or merger, a winding-up of a corporation or partnership or a distribution of property by a trust in satisfaction of all or part of a corporation's capital interest therein, as illustrated in Example 5-12.

EXAMPLE 5-12



Immediately before François Dubois sells the shares of Gibson Ltd., Mission Ltd. is amalgamated with Gibson Ltd. François will be allowed to claim the CGD even if the assets of Mission Ltd. are transferred to Gibson Ltd. for POD less than FMV.

Unpaid dividends

Subsections 110.6(8) and 110.6(9) cover circumstances in which the CGD will be disallowed on the disposition of property where a significant portion of the capital gain is attributable to dividends that were not paid on a share (other than a prescribed share) of the share capital of a corporation.

Prescribed shares are defined in REG 6205 and include

- shares which have all the attributes of common shares, which are not convertible into non-prescribed shares and which are not guaranteed (read REG 6205 for more details)
- certain freeze shares (paragraph 2 of REG 6205)
- shares issued by a mutual fund corporation

Where the issued capital of the corporation that is the object of the transaction includes shares that are not prescribed, subsection 110.6(8) disallows the CGD with respect to the capital gain realized on the property if it may reasonably be concluded that a significant portion of the gain is attributable to the fact that

- dividends were not paid on shares other than prescribed shares

or

- dividends paid in the year or in any preceding year were less than 90% of the average annual rate of return

The **average annual rate of return** is defined in subsection 110.6(9). It is equal to the annual rate of return by way of dividends that a knowledgeable and prudent investor would expect to receive in that year, other than the first year after the issue in respect of the share, if the following conditions are met:

a. there is no delay or postponement of the payment of dividends and no failure to pay dividends in respect of the non-prescribed share

b. there was no variation from year to year in the amount of dividends payable on the non-prescribed share (other than where the amount of dividends payable is expressed as an invariant percentage of or by reference to an invariant difference between the dividend expressed as a rate of interest and a generally quoted market interest rate)

c. the proceeds to be received by the investor on the disposition of the non-prescribed share are the same amount the corporation received as consideration on the issue of the share

One situation contemplated by subsection 110.6(8) is where a share provides for a fixed cumulative dividend that is not paid. On the sale of the share, the selling price takes account of the unpaid cumulative dividend. If a significant part of the capital gain on the sale of the share is attributable to the unpaid cumulative dividend, subsection 110.6(8) applies, and the CGD will be disallowed with respect to the capital gain realized on the sale of the share.

Another situation that could trigger the application of subsection 110.6(8) is where a corporation has two classes of issued shares: common shares issued for $1,000 and preferred shares issued for $500,000. No dividend is paid on the preferred shares, with the result that the common shares increase in value more rapidly. Subsection 110.6(8) could apply to the sale of the common shares if a significant part of the capital gain realized on the sale may be attributable to the fact that no dividend was paid on the preferred shares.

Subsection 110.6(8) is worded in such a way that the CGD will be disallowed not only with respect to shares of the corporation that issued the share on which insufficient dividends have been paid, but also with respect to any property on which a significant part of the capital gain arising on the sale is attributable to the fact that insufficient dividends have been paid on the share, such as a share of a corporation holding shares of the corporation that paid insufficient dividends.

LEVEL 1

Cumulative net investment losses

A **cumulative net investment loss** (CNIL) for purposes of subsection 110.6(1) is defined as

a. the total of the individual's investment expense for the year or a preceding taxation year ending after 1987

less

b. the total of the individual's investment income for the year or a preceding taxation year ending after 1987

For the definition of **investment expense** and **investment income**, review the definitions contained in subsection 110.6(1).

Since a CNIL may postpone the availability of the CGD to an individual, planning should be undertaken to minimize CNIL.

Several methods are possible, depending on the taxpayer's annual situation and his accumulated CNIL balance:

- Defer deductions for exploration and development expenses, and earned depletion in respect of resources to a subsequent year.
- If the taxpayer claims interest expense on the cash basis, try to defer the interest payment to a subsequent year.
- If the individual is a shareholder/employee, choose dividend income or a salary-dividend combination rather than salary alone in order to increase investment income. However, do not forget to take into account the corporation's taxable income level and the shareholder's marginal tax rate.
- Since the interest deducted in computing business income is not considered an investment expense for the purposes of the CNIL, it is advantageous to borrow for a business and pay cash for investments that generate property income or tax shelters.
- If the individual is a shareholder in a corporation to which he made a non-interest bearing advance, a reasonable amount of interest could be charged to increase investment income.

- An individual who intends to dispose of a property during the year could decide to make the disposition at the beginning rather than at the end of the year, and invest the POD as early as possible in the year. In this way, the investment income entering into the CNIL computation would be increased.

Alternative minimum tax

The purpose of alternative minimum tax (AMT) is to prevent certain taxpayers from substantially reducing their income tax liability through certain deductions otherwise available.

This section is aimed at planning to reduce the impact of the AMT. The federal AMT rate is 15.5%, which is used as the basis for computing the income tax payable to a province. In your analysis, assume a combined federal and provincial tax rate of 25%.

Capital gain

In the year when a capital gain is realized and the CGD is used to reduce all or a portion of the capital gain, there may still be an income tax liability despite the belief that the capital gain is tax-free once the CGD is claimed.

Under subsection 127.52(1), in computing the taxable income for AMT purposes, 60% of the non-taxable portion of the capital gain in excess of the non-deductible portion of the capital loss must be added back to the taxable income.

EXAMPLE 5-13

In 2008, Patricia Blake makes a gift of qualifying small business shares to her daughter. The shares have an FMV of $500,010 and an ACB of $10. She believes that there will be no tax liability because she can claim the CGD. Patricia has no other taxable income in 2008.

Capital gain	$ 500,000
Taxable capital gain (1/2)	$ 250,000
CGD	$ (250,000)
Part I tax	—
Amount on which AMT is calculated ($250,000 × 60%)	$ 150,000
AMT [25% × ($150,000 — section 127.53 basic exemption of $40,000)]	$ 27,500

Patricia would be required to pay AMT in the amount of $27,500 because she does not have any Part I tax to reduce the impact of the taxable capital gain. Since she made a gift, no cash was received on the disposition and therefore she may have difficulty in paying her tax liability.

Except for gifts, one way of reducing the impact of the AMT where a capital gain eligible for the CGD is realized is to leave a balance of the sale price unpaid on the disposition of the property giving rise to the capital gain. The capital gains reserve allowed under subparagraph 40(1)(a)(iii) is also allowed in computing income for AMT purposes.

Recovering the AMT

To recover the AMT paid in a taxation year, an individual may, in a subsequent year, decide either not to invest in tax shelters or to reduce his investment in tax shelters, so that the AMT will be less than the standard tax in that year.

READING 5-3

Debt forgiveness and seizure of property

LEVEL 1

Seizure of property

It may happen that a mortgage creditor will take possession of a building as repayment for a debt that its owner cannot discharge. This constitutes seizure of real property. In cases of seizure of property, repossession of property covered by a conditional sales and similar agreements, there are tax consequences for the debtor (section 79) as well as for the creditor (section 79.1).

Surrender of property by the debtor

Subsections 79(1) and 79.1(1) provide several definitions that apply to section 79 and also to section 79.1, including:

- **Property:** sections 79 and 79.1 do not apply to money or to debt that either is owed by the government (savings bonds, for example) or is guaranteed by it.
- **Debt:** obligation to pay an amount under a mortgage or similar obligation or under a conditional sales agreement.
- **Specified amount:** the "specified amount" of a debt owed or assumed by a person means the unpaid principal amount of the debt and unpaid interest accrued on the debt.
- **Person:** this term is defined in subsection 248(1) but is expanded to include a partnership for the purposes of sections 79 and 79.1.
- **Specified cost:** the "specified cost" of a debt that consists of capital property of the creditor is the ACB of the debt. If the debt is not capital property, the specified cost is equal to its cost amount, minus such portion of the cost amount that represents unpaid interest.

Section 79 applies if property is surrendered by a debtor to a creditor and the ownership of the property is acquired or reacquired from the debtor by the creditor and the acquisition or reacquisition was in consequence of the debtor's failure to pay debt owing by the debtor to the creditor. This also includes a situation where the creditor acquires or reacquires property from a third party to whom property was previously transferred by a debtor of the creditor, only if the third party becomes *directly liable* to the creditor and fails to pay an amount to the creditor.

Where property is surrendered at any time by a debtor to a creditor, the property is disposed of, and the POD of the property are determined under subsection 79(3) by the following formula:

$$(A + B + C + D + E - F) \times \frac{G}{H}$$

For the purposes of the course, elements D, E, and F, which are important but are seldom encountered in practice, will not be studied.

The formula thus becomes

$$(A + B + C) \times \frac{G}{H}$$

where

A = the total of all debts (principal amount and interest) owing, immediately before that time, by the debtor to the creditor in connection with properties surrendered to the creditor

B = the total of all debts (principal amount and interest) owing, immediately before that time, by the debtor to someone other than the creditor to whom properties are surrendered, if such amounts cease to be owing by the debtor as a consequence of that surrender

C = the total of all debts (principal amount and interest) which are owing, immediately before that time, by the debtor to third parties and which are assumed by the creditor, since they take precedence over the debt owing to the creditor at the time of surrender of the property. For example, if the debtor surrenders property secured by a first and second mortgage, due to defaulting on the second mortgage, a debt under the first mortgage in respect of the same property is included in computing the debtor's POD.

G = the FMV of the property surrendered

H = the FMV of all properties surrendered by the debtor to the creditor

Where a debt is denominated in a foreign currency, the POD are determined with reference to the historical foreign exchange rate at the time the debt was issued, as required by subsection 79(7). Fluctuations in the exchange rate are not taken into account in determining the POD.

Example 5-14 illustrates the tax consequences for a debtor who has had real property seized.

EXAMPLE 5-14

During the year, Zodiac Ltd. had to turn over to the second mortgagee the warehouse that it had acquired a few years earlier, since it could no longer make the required payments. The warehouse, consisting of land and a building, was security for a first and a second mortgage. Zodiac Ltd. and the mortgagee deal with each other at arm's length.

<u>Land</u>

ACB	$250,000
FMV at the time of surrender	$180,000

<u>Building</u>

Capital cost	$160,000
FMV at the time of surrender	$210,000

No CCA has been claimed since the acquisition.

<u>Mortgages</u>

First: $250,000 plus accrued unpaid interest of $18,000

Second: $100,000 plus accrued unpaid interest of $25,000

Tax consequences

For Zodiac Ltd.:

Under subsection 79(3), the deemed POD are determined as follows:

$$(A + B + C) \times \frac{G}{H}$$

where

A = $125,000 ($100,000 + $25,000)

B = 0 (the amount owing does not cease to be owing as a consequence of the surrender)

C = $268,000 ($250,000 + $18,000), the amount of the first mortgage that the second mortgagee must assume in order to take possession of the properties

G = for the land: $180,000
for the building: $210,000

H = $180,000 + $210,000 = $390,000

Land

POD $\left(\$393{,}000 \times \frac{\$180{,}000}{\$390{,}000} \right)$	$181,385
Less: ACB	(250,000)
Capital loss	$ (68,615)

Building

POD $\left(\$393{,}000 \times \frac{\$210{,}000}{\$390{,}000} \right)$	$211,615
Less: Cost	(160,000)
Capital gain	$ 51,615

The result of the surrender of the properties by Zodiac Ltd. is thus a net capital loss of $17,000 ($51,615 – $68,615).

If the debtor subsequently settles a debt, the amount of which had already been included in calculating the POD of the surrendered property, subsection 79(4) provides for treating such a payment as a capital loss to the extent that it relates to non-depreciable capital property. In most other cases, the amount of the payment is deductible under paragraph 20(1)(hh), or 3/4 of the amount in the case of ECP under paragraph 20(1)(hh.1).

Seizure of property by the creditor

The operative rules regarding the tax consequences for the creditor in connection with acquisitions or reacquisitions of property from debtors are contained in section 79.1. They apply only where property is seized by a creditor in respect of a debt and in general there are no immediate tax consequences.

Under subsection 79.1(2), ownership of property is acquired or reacquired in consequence of another person's failure to pay the debt to the creditor. Subsection 79.1(2) may apply to the creditor even when there is no direct liability between the third party debtor and the creditor.

Under subsection 79.1(6), the cost of seized property to a creditor that is acquired in consequence of the failure to pay debt is the sum of:

a. $\text{specified cost of the debt} \times \frac{\text{FMV of the property seized}}{\text{FMV of all the property seized}}$

and

b. the total expenses incurred by the creditor before the acquisition, other than expenses that would otherwise be taken into account for purposes of the ITA and other than the portion of expenses that relate to other property, and the specified amount of debt assumed by the creditor to protect the creditor's interest in the property,

less

c. any reserve claimed for the preceding year with respect to the property, or the POD reduction determined under subsection 79.1(5) (explained below), in the event that the property is being reacquired by the creditor. This element is found only where the creditor was also the vendor of the property, that the terms of the sale were such that the vendor was entitled to claim a reserve for tax purposes, and that the creditor/vendor retained the right to seize the property in the event of a default in payment.

Under subsection 79.1(1), the specified cost of a debt for a creditor is equal to its ACB where the debt is capital property, and to its cost amount in other cases.

As mentioned in (c), in calculating the cost of the property seized, subsection 79.1(5) provides relief for a creditor who seizes capital property in the same taxation year in which it was previously disposed of by the creditor.

The new POD for the creditor of the seized property are then equal to the lesser of:

- the real POD of the property
- the greater of:

  a. the amount by which the actual POD exceed the unpaid principal amounts of debt immediately before the seizure

  or

  b. the cost amount to the creditor of the property immediately before the previous disposition

Since the reserves for capital gain or business income mentioned in paragraph 79.1(6)(c) serve to reduce the cost of the property seized, they do not have to be added back in computing the creditor's income in the year of the seizure, as provided for in subsections 79.1(3) and 79.1(4). In this way, the taxation of the capital gain or business income is carried forward until the creditor disposes of the property seized. However, if the prior year reserve exceeds the cost of the seized property, the excess is added back into income for the year of the seizure.

The amount received by the creditor on account of the debt is deemed under subsection 79.1(7) to be equal to the ACB of the debt or, if the debt is not capital property, its cost amount. This measure ensures that there will be no income or loss resulting from any recovery in respect of debt, unless the creditor recovers further amounts in respect of the debt if the debt is not entirely settled following the seizure. Any further recovered amounts would be a capital gain or income of the creditor, depending on whether or not the debt is capital property. Under paragraph 79.1(7)(d), the creditor may deduct as a bad debt any interest unpaid as of the date of the seizure.

Below is an example of the tax consequences for the creditor on seizure of property.

EXAMPLE 5-15

Using the data from Example 5-14, determine the consequences for the creditor assuming that legal costs of $15,000 were incurred in recovering the properties and that the creditor had never previously owned the warehouse.

Tax consequences

For the creditor:

Determination of the cost of the seized property under subsection 79.1(6)

Land

The sum of

a.	$\$100{,}000 \times \dfrac{\$180{,}000}{\$390{,}000}$	$ 46,154	
and			
b.	$(\$250{,}000 + \$18{,}000 + \$15{,}000) \times \dfrac{\$180{,}000}{\$390{,}000}$	130,615	$176,769
less			
c.	0		—
			$176,769

Building

The sum of

a.	$\$100{,}000 \times \dfrac{\$210{,}000}{\$390{,}000}$	$ 53,846	
and			
b.	$(\$250{,}000 + \$18{,}000 + \$15{,}000) \times \dfrac{\$210{,}000}{\$390{,}000}$	152,385	$206,231
less			
c.	0		—
			$206,231

In addition, regarding the unpaid interest, $25,000 may be deducted as a bad debt under paragraph 79.1(7)(d).

Debt forgiveness

The rules on debt forgiveness, contained in sections 80 to 80.04, are highly complex, and they cover some situations not often encountered. Thus you will only examine the more common situations. Various new definitions will be introduced and analyzed as they become relevant. However, it should be noted that these definitions are mainly contained in subsection 80(1).

Although the rules on debt forgiveness are complex, the related concepts are quite simple. In simplified terms, a tax gain is triggered when a debt forgiveness occurs. The underlying rationale for the tax gain is that the debt enabled the debtor to acquire property or make expenditures that gave rise to deductions in computing taxable income. When the debt in

question has been forgiven, the debtor has in effect not had to pay for the cost of the expenditures, and therefore they should not be recognized for tax purposes.

The purpose of these sections is to determine the rules that apply when a debt is settled or extinguished and the debtor has made no payment or has paid an amount less than the principal of the debt.

Rules of application

In cases of debt forgiveness, debtors who in any way receive a benefit as a result of not repaying their debt in its entirety will be affected by the reduction or elimination of some of their tax benefits and/or the inclusion in their income of part of the amount of the debt thus extinguished (forgiven amount).

Subsection 80(2) contains the rules that apply for the purposes of section 80. The most important ones are as follows:

- 80(2)(a): An obligation incurred by a debtor is considered to be settled when it is settled or extinguished other than by way of a bequest or inheritance, which implies that the creditor must confirm that the debt is in fact erased either in whole or in part, as the case may be.

- 80(2)(b): Interest that is deductible or that may be capitalized is added to the amount of the debt.

- 80(2)(c): Subsections 80(3) to 80(13) apply in numerical order to the "forgiven amount" in respect of a commercial obligation. A "commercial obligation" is a "commercial debt obligation" or a "distress preferred share." The rules concerning these type of shares are not studied in this course.

  A "commercial debt obligation" is a debt on which interest payable is deductible in computing income or would have been so deductible if interest had been payable.

- 80(2)(d) and (e): The reduction of capital losses, including business investment losses, is determined on the basis of the year in which these losses originate, meaning that it is necessary to take into account the deductible portion, namely 1/2, 2/3, or 3/4 (see Example 5-16).

- 80(2)(f): The CEC reduction takes into account the fact that only 3/4 of capital expenditures are added in computing CEC. This rule is parallel to the rule for capital losses.

- 80(2)(g) and (g.1): Where shares of a corporation are issued to a person as full or partial consideration for the cancellation of a debt of the corporation, the debt is considered to be settled for an amount equal to the total of:

  a. the FMV of the shares issued, and
  b. the increase, resulting from the settlement of the debt, in the value of other shares of the corporation owned by that person

  "Person" has the meaning assigned to it in subsection 248(1) and also includes a partnership.

- 80(2)(k): Where a debt is denominated in a foreign currency, the "forgiven amount" is determined with reference to the exchange rate at the time that the debt was issued. Gains or losses on exchange are not considered in determining the forgiven amount.

- 80(2)(l): Where a guarantor is obliged to make payments under the terms of a guarantee to a creditor, an obligation is deemed to have been created at the same time for the guarantor.

"Forgiven amount" on a commercial obligation, which appears several times in subsection 80(2), basically corresponds to the amount of the debt erased by the creditor for the debtor, and the definition is set out in subsection 80(1):

A – B

where

A = the lesser of the principal amount of the obligation and the amount for which it was issued

B = the total of the following amounts, among others [certain paragraphs of this definition found in subsection 80(1) are not considered for the purposes of this course]:

a. the amounts paid in satisfaction of the principal amount of the obligation

f. such portion of the principal amount of the obligation as is included in the POD for the debtor in the surrender of property [79(3)]

i. the principal amount of the obligation where the debtor is a bankrupt at that time

l. consideration given by the debtor to another person for the assumption by that person of the obligation

Order of application of the gain in debt forgiveness

The debtor, no longer having to repay the debt, in whole or in part, must face the tax consequences. The reduction of various tax benefits is provided for, with some reductions being mandatory and others optional. A person who wishes to take an optional reduction must file Form T2154, which must be appended to the income tax return.

Thus the forgiven amount in respect of a debt must reduce, in the following order:

1. the balance of losses carried forward from prior years

    - non-capital loss carryforwards, without taking account of business investment losses [80(3)(a)]
    - farm loss carryforwards [80(3)(b)]
    - restricted farm loss carryforwards [80(3)(c)]
    - business investment loss carryforwards [80(4)(a)]
    - net capital loss carryforwards [80(4)(b)]

    This reduction is mandatory. Within each of the above categories of losses, a loss for an earlier taxation year is reduced before a loss for a later taxation year. Thus the oldest losses are reduced first, following the order of presentation of the categories.

    Where the forgiven amount is decreased by the application of subsection 80(4), the decrease is not equal to the reduction of the loss; rather it is equal to twice this reduction. For example, if the balance of net capital losses carried forward that were incurred after October 16, 2000, is reduced by $6,000, the forgiven amount is decreased by $12,000 ($6,000 × 2). The reduction multiplier used to determine the decrease in the forgiven amount varies depending on the taxation year in which the loss was incurred.

2. capital costs of depreciable properties without exceeding the CC and the UCC (prescribed form required) [80(5) and 80(6)]. The balance of the UCC of a class cannot become negative. The choice of the class is left to the discretion of the debtor.

3. the CEC (prescribed form required) [80(7)]. The portion of the forgiven amount that is considered to have been applied represents 4/3 of the reduction

4. undeducted resource expenditure balances (prescribed form required) [80(8)]

5. the ACB of certain capital properties (prescribed form required) [80(9)], except for the following:

   - depreciable properties, unless the cost has not been reduced to zero under subsection 80(5) because of specific circumstances. In such a case, only the capital cost is reduced, and not the UCC
   - "excluded properties," that is, properties of a non-resident that would not qualify as taxable Canadian property if disposed of
   - personal-use properties
   - shares of a corporation and debts issued by a corporation of which the debtor is a specified shareholder as defined in subsection 248(1), namely a shareholder who owns, directly or indirectly, not less than 10% of the issued shares of any class of the capital stock of the corporation or a related corporation
   - interests in partnerships that are "related" to the debtor. In order to determine whether a partnership is related to one of its partners, it is necessary to refer to paragraph 80(2)(j). A partnership is deemed to be a corporation having a capital stock divided into 100 voting shares. The partners are deemed to be owners of 100 shares in proportion to their interest in the partnership. The proportion represented by a partner's interest is based on the FMV of that interest.

     This reduction is allowed only if the maximum reduction was used under subsections 80(5), (7), and (8).

6. the ACB of a capital property (prescribed form required) that is a share or a debt of a corporation not qualifying for a reduction under subsection 80(9), except for the following [80(10)]:

   a. a share of a corporation related to the debtor
   b. a debt issued by a corporation related to the debtor
   c. an excluded property

   This reduction is allowed only if the maximum reduction was used under subsections 80(5), (7), (8), and (9).

7. the ACB of a capital property (prescribed form required) that is a share of a related corporation, a debt issued by a related corporation or an interest in a related partnership [80(11)]

   This reduction is allowed only if the maximum reduction was used under subsections 80(5), (7), (8), (9), and (10).

8. current year capital losses. Under subsection 80(12), the lesser of the following two amounts is then considered to be a capital gain for the year:

   a. the unapplied balance of the forgiven amount after the application of subsections 80(3) to 80(11)

b. net capital losses for the taxation year that includes the time of the settlement of the debt, except for capital losses resulting from the disposition of excluded properties and specified personal properties

This reduction is allowed only if the maximum reduction was used under subsections 80(5), (7), (8), and (9).

Under subsection 80(13) and paragraph 12(1)(z.3), if an unapplied balance remains after the application of subsections 80(3) to 80(12), half the balance is added in computing the debtor's income. The source of this income is deemed to be the source in connection with which the obligation was issued.

Example 5-16 provides an illustration of the application of paragraph 80(2)(d) in conjunction with subsection 80(4). Paragraph 80(2)(d) and subsection 80(4) are complementary provisions.

EXAMPLE 5-16

A few years ago, Mak Inc. received a loan which it used in its business operations. Since Mak Inc. could not put up collateral, Julius Ltd. agreed to guarantee the loan. The loan was to be repaid in full in 2005. When Mak Inc. was unable to meet the deadline, the creditor asked Julius Ltd. to honour its guarantee. Julius Ltd. paid the balance owing on the loan.

In 2008, Mak Inc. reached an agreement with Julius Ltd. to settle its debt for $10,000 less than the payment Julius Ltd. had made to the creditor in 2005. Mak Inc. has a net capital loss carryforward of $6,000 at the beginning of the 2008 taxation year, and this loss was incurred in 1994, when the deduction rate was 3/4 under paragraph 38(b).

Tax consequences

1. When Julius Ltd. paid off the loan to the creditor of Mak Inc. in accordance with the guarantee, Mak. Inc. became a debtor of Julius Ltd. Under paragraph 80(2)(l), this commercial obligation is deemed to have been issued at the same time and in the same circumstances as the first obligation.

2. As a consequence of subsection 80(4) and paragraph 80(2)(d), no more than $7,500 (3/4 × $10,000) may be applied to reduce the loss carryforward.

3. While the amount required to eliminate the loss carryforward is $6,000, the portion of the forgiven amount that is considered to have been applied is $8,000 (4/3 × $6,000). The unapplied portion of the forgiven amount is thus $2,000. Under subsection 80(13), if Mak Inc. has no other items that can be reduced, an amount of $1,000 (1/2 × $2,000) will be added to its 2008 income.

Example 5-17 illustrates the effect of subsections 80(3) to 80(13).

EXAMPLE 5-17

The principal amount of a debt issued by Thériault Ltd., namely $50,000, is settled in 2008 with no payments by the corporation. At the time the debt is extinguished, Thériault Ltd. has the following tax balances:

CEC	$ 1,200
UCC — class 10	$ 18,000
Land — ACB	$ 16,000
Balance of losses carried forward	—

Two properties are included in class 10, having respectively a capital cost of $8,000 and $12,000.

Tax consequences

1. The forgiven amount of $50,000 may first be applied under subsection 80(5) to reduce the CC of the properties included in class 10, without exceeding the UCC. For example, the CC could be reduced to nil for the first property, and to $2,000 for the second property. At the same time, the UCC of the class is reduced by $18,000, an amount equal to the reduction of the CC of the properties included in it. The UCC is now zero. The unapplied balance of the forgiven amount is $32,000.

2. Subsection 80(7) provides that the unapplied balance of the forgiven amount is multiplied by 3/4 and then applied to reduce the CEC. So the CEC may be reduced by a maximum of $24,000 ($32,000 × 3/4). An amount of $1,200 is applied to reduce the CEC to nil. Under paragraph 80(2)(f), the forgiven amount is reduced by $1,600 (4/3 × $1,200). The unapplied balance is $30,400 ($32,000 – $1,600).

3. An amount of $16,000 may then be applied under subsection 80(9) to reduce the ACB of the land to nil. The unapplied balance is then $14,400 ($30,400 – $16,000).

4. Under subsection 80(13) and paragraph 12(1)(z.3), an amount of $7,200 (50% × $14,400) is added to the income of Thériault Ltd. in 2008.

LEVEL 2

Reserve for debt forgiveness

Section 61.2 provides relief to individuals resident in Canada who might face financial hardship as a consequence of the application of subsection 80(13), allowing them to claim a reserve.

The deduction allowed is equal to the total of

- the amount added under subsection 80(13) for the year

and

- the amount deducted under section 61.2 for the preceding year

less

- 20% of the excess of the individual's income for the year which exceeds $40,000

Over the years, then, individuals will be taxed only up to 20% of their income in excess of $40,000.

Under section 56.2, the amount thus deducted for a taxation year is added in computing income for the following year and a new deduction is calculated under section 61.2. The effect of section 80 is thus carried forward to a taxation year, with no time limit, during which the individual's income from other sources will enable the individual to absorb the addition of an amount under subsection 80(13).

Example 5-18 illustrates how sections 56.2 and 61.2 apply.

EXAMPLE 5-18

Under subsection 80(13), Carlos Reid included $20,000 in his income in 2008. Carlos' income before any adjustments resulting from the debt forgiveness is $30,000 in 2008 and $50,000 in 2009. Carlos wishes to claim the maximum deduction permitted by section 61.2 in order to spread out the income tax payable as a result of the debt forgiveness.

Tax consequences

For Carlos:

2008

Income	$ 30,000
Plus: Additional income [80(13)]	20,000
Less: Deduction [61.2][1]	(20,000)
	$ 30,000

[1] Deduction under 61.2

Amount added under 80(13)	$ 20,000
Less: 20% ($30,000 – $40,000)	—
	$ 20,000

2009

Income	$ 50,000
Plus: Deduction under 61.2 for 2008 [56.2]	20,000
Less: Deduction [61.2][2]	(18,000)
	$ 52,000

[2] Deduction under 61.2

Amount deducted in 2008 under 61.2	$ 20,000
Less: 20% ($50,000 – $40,000)	(2,000)
	$ 18,000

The reserve of $18,000 claimed by Carlos for 2009 will be added to his income for 2010. Carlos may claim a reserve for 2010 and subsequent years, depending on his income.

Relief is also provided for in subsection 61.3(1) for an insolvent corporation resident in Canada with respect to the amounts added to its income under subsection 80(13). The deduction allowed is such that the corporation is taxed only to the extent of twice its net assets, as defined below. This deduction is not a reserve and does not have to be included in computing income for the subsequent year.

The deduction is equal to the lesser of the following amounts:

a. the amount included in income under subsection 80(13)

b. A – 2 (B – C – D – E)

where

A = the amount included in the income of the corporation under subsection 80(13)

B = the total of the following amounts:

- the FMV of the corporation's assets at the end of the year
- the current year's federal and provincial taxes payable paid during the year under Parts I, I.3, II, VI, and XIV
- all amounts which are paid in the 12-month period preceding the end of the year by the corporation to a person with whom it does not deal at arm's length, and which are

a. dividends other than stock dividends
b. amounts relating to a reduction of the corporation's PUC or a redemption of its shares
c. amounts considered to be an appropriation for the benefit of the shareholders of the corporation

C = the total liabilities of the corporation at the end of the year, determined in accordance with generally accepted accounting principles, without regard to income tax payable for the year under Parts I, I.3, II, VI, and XIV and similar provincial taxes

D = the principal amount of all distress preferred shares issued by the corporation as of the end of the year (this concept is not studied in the course)

E = 50% of the amount by which the corporation's income for the year, before the deductions of sections 61.3 and 61.4, exceeds the amount included in income under subsection 80(13)

In addition, section 61.4 allows a corporation resident in Canada to spread the inclusion in income over five years. When an amount is included under subsection 80(13), the net result after the deduction allowed under subsection 61.3(1) entitles the taxpayer to claim a reserve. A minimum of 1/5 of the amount must be taxed each year. Under section 56.3, the reserve claimed is included in income for the subsequent taxation year, and a new reserve is then calculated.

Example 5-19 illustrates how section 61.3 applies.

EXAMPLE 5-19

The following data apply to Renault Ltd. at the end of 2008:

Amount included in income under 80(13)	$100,000
FMV of total assets	$ 70,000
Liabilities excluding tax payable	$ 67,000
Income for the year	$101,000
Tax payments made during the year	—

Tax consequences

Application of subsection 61.3(1)

1. Calculation of the deduction
   The lesser of the following amounts:

   a. $100,000
   or
   b. A = $100,000
      B = $70,000 + 0 = $70,000
      C = $67,000
      E = 50% ($101,000 – $100,000) = $500

      $100,000 – 2 ($70,000 – $67,000 – $500) = $95,000

   Under subsection 80(13), Renault Ltd. must include $100,000 in its income, but that amount is reduced by a deduction of $95,000 allowed under subsection 61.3(1).

2. Under section 61.4, the balance of $5,000 to be included in the income of Renault Ltd. in 2008 may be spread over five years.

READING 5-4

Anti-avoidance rules

LEVEL 2

Section 245

The general anti-avoidance rule (GAAR) was introduced in 1988. It was a number of years before the courts rendered decisions with respect to it. These include

- *McNichol et al. v. The Queen*, [1997] DTC 111: surplus stripping
- *Equilease Corporation v. The Queen*, [1997] DTC 302: surplus stripping
- *Husky Oil Limited v. The Queen*, [1999] DTC 308: terminal loss
- *Lyse Nadeau v. The Queen*, [1999] DTC 324: surplus stripping
- *JABS Construction Limited v. The Queen*, [1999] DTC 709: gifts
- *OSFC Holding Limited v. The Queen*, [2001] DTC 5471: transfer of loss
- *Canadian Pacific Limited v. The Queen*, [2002] DTC 6742: interest on foreign loan

And in 2005, the Supreme Court of Canada (SCC) rendered its first judgments on the GAAR. These decisions provide guidelines for determining whether or not a situation constitutes tax avoidance. *Canada Trustco Mortgage Co. v. Canada* (2005 SCC 54) concerns CCA and *Mathew v. Canada* (2005 SCC 55) deals with the transfer of losses through a partnership.

The decisions concern various types of transactions, but they most often deal with surplus stripping and transactions involving losses. CRA has also stated its position at various conferences and in Information Circulars. Section 245 is a general anti-avoidance rule intended to prevent abusive tax avoidance transactions and arrangements. (See IC 88-2 and Supplement 1.) It is not intended to interfere with legitimate commercial and family transactions.

Transactions that comply with the objective and spirit of other provisions of the ITA, read as a whole, will not be affected by the application of this general anti-avoidance rule.

Subsection 245(1) contains certain definitions:

A **tax benefit** means a reduction, avoidance or deferral of tax or other amount (penalties, interest) payable under the ITA, or an increase in a refund of tax or other amount under the ITA.

The term **tax consequences** is defined in such a way as to allow the adjustment of income, taxable income of a person or tax or other amount payable by or refundable to the person under the ITA, or any other amount, such as the ACB of property or the PUC of a share, that is relevant for the purposes of computing income or such other amount as mentioned previously.

A **transaction** includes an arrangement or event.

Subsection 245(3) defines an **avoidance transaction** as:

a. a transaction that, but for section 245, would result, directly or indirectly, in a tax benefit, unless the transaction may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit

or

b. a transaction that is part of a series of transactions, which series, but for section 245, would result, directly or indirectly, in a tax benefit, unless the transaction was undertaken primarily for purposes other than tax benefits

Subsection 245(2) states that, in an avoidance transaction, the tax consequences to a person shall be determined as is *reasonable* in order to deny a tax benefit resulting from the transaction. Subsection 245(5) provides a list of measures that may be taken to obtain this result. In many cases, however, the result will be evident or specified in the ITA.

Where a transaction is undertaken both for bona fide purposes other than for tax purposes and also for tax avoidance purposes, the principal objectives should be determined. If CRA considers that a transaction meets the non-tax purpose criterion, it will not be considered to be an avoidance transaction, even if a tax benefit also results or tax considerations were a significant but not primary motive of the transaction.

The majority of commercial or family transactions and investment transactions should not be affected by section 245, because they are undertaken primarily for bona fide purposes other than to obtain a tax benefit.

Subsection 245(4) specifies that a transaction that may reasonably be considered not to result directly or indirectly in a misuse of the provisions of the ITA read as a whole does not fall within the rule set forth in subsection 245(2).

Example 5-20 illustrates a transaction not covered by the provisions of section 245, unlike the transaction shown in Example 5-21, which with respect to those provisions is not in keeping with the spirit of the ITA.

EXAMPLE 5-20

A person owns a capital property having an accrued gain, which he or she wishes to sell to a third party. An affiliated corporation has a net capital loss carryforward. Rather than selling the property to the third party and realizing a capital gain, the person transfers the property to the affiliated corporation under subsection 85(1), thereby deferring the gain. The affiliated corporation then sells the property to the third party and reduces tax on the resulting capital gain by offsetting its capital loss.

Subsection 69(11) does not allow the tax-deferred transfer of property to an *unaffiliated* corporation where it is expected that the corporation will sell the property and offset the gain by the losses to which it is entitled. Therefore, subsection 69(11) explicitly allows transfers to *affiliated* corporations for tax deferral purposes. Consequently, the transaction described above would be acceptable because the transfer to an affiliated corporation complies with the spirit of the ITA. It is acceptable from an ethical standpoint for a CGA to suggest it to a client.

EXAMPLE 5-21

A taxpayer owns a capital property the disposition of which would give rise to a capital gain. The taxpayer and another taxpayer (purchaser) who wishes to purchase the property form a partnership. The taxpayer transfers the property to the partnership under subsection 97(2) (rollover to a partnership) and defers tax on the capital gain. The purchaser contributes capital to the partnership in the form of cash equal to the FMV of the property transferred by the taxpayer. The taxpayer withdraws all the cash from the partnership. This withdrawal reduces the taxpayer's interest in the income and losses of the partnership which continues to carry on business.

Using a partnership constitutes an attempt to circumvent the provisions under which the POD of a property must be recorded when received. It does not comply with the objective of the ITA read as a whole. Consequently, subsection 245(2) would apply to this situation. Since the

transaction goes against the spirit of the ITA, it is not acceptable from an ethical standpoint for a CGA to suggest it to a client.

LEVEL 1

Ethics

In these examples, it is essential to determine whether there is a genuine business purpose for the transaction apart from the desire to obtain a tax benefit. It is not ethically acceptable for an accountant either to suggest to a client or to facilitate a transaction that is designed *solely* to avoid taxation, for example, to suggest the formation of the partnership as in Example 5-21. However, it would be perfectly acceptable for an accountant to suggest a transaction such as the one described in Example 5-20.

Acting ethically requires two things:

1. Knowing the ITA in order to determine whether or not a transaction is in the spirit of the ITA;

and

2. Suggesting to clients only transactions that are in the spirit of the ITA.

Since the ITA and its interpretation change frequently, accountants are required to keep their knowledge of the ITA current. In addition, they must maintain their professional integrity, and this includes resisting pressure from clients wishing to carry out inappropriate transactions or seeking the accountant's assistance in order to facilitate such transactions. Furthermore, the civil penalties provided for in section 163.2 might apply to such situations.

In this area an accountant will face three types of situation:

1. "White" situations in which transactions have legitimate purposes and so are legitimate tax reducing strategies;
2. "Black" situations in which transactions are contrary to the spirit or letter of the ITA and so are clear cases of tax avoidance; and
3. "Grey" situations in which it is simply not clear if the transaction falls under the anti-avoidance rules.

The question is: "What should the accountant do in the third grey zone situation?"

In these "grey" zone situations, the responsibility of the accountant is to inform the client that in view of the uncertainty, CRA may try to apply the anti-avoidance rules. The accountant can then offer the client a reasoned opinion of whether or not the client would be in a good position to appeal a negative ruling from CRA. The client (and perhaps his legal counsel) can then make an informed choice whether or not to take the risk of an adverse ruling from CRA.

In cases of legal uncertainty, it is legitimate for a taxpayer to "test the waters" by proceeding with the transaction as long as he does so in an open and honest way. It is then up to CRA to challenge the transaction and ultimately the courts to decide the matter. In advising the client that this is a grey zone situation, the accountant discharges his ethical responsibility of acting within the spirit of the ITA.

Where subsection 245(2) applies to a transaction and a taxpayer has been assessed with respect to subsection 152(1.11), under subsection 245(6), another person who was party to the avoidance transaction may request the Minister to apply subsection 245(2) to him, thereby adjusting the same transaction to his benefit. This request must be made in writing within 180 days following the date of mailing of the notice of assessment to the first taxpayer. This provision, therefore, prevents double taxation where subsection 245(2) applies to an avoidance transaction.

One criticism that may be made regarding the request under subsection 245(6) is that it must be made within a time limit that is determined from the mailing date of a notice of assessment to another taxpayer. Consequently, there may be some concern that certain taxpayers will not be able to make the request because they will not have been informed that an assessment was sent to the other taxpayer.