A Selection of Income Tax Issues in the Downsizing and Restructuring of an Insolvent Company

by Joan E. Jung, Tax Partner
Minden Gross LLP, a member of MERITAS Law Firms Worldwide.

(First presented at the Ontario Bar Association program, "A Selection of Income Tax Issues in the Downsizing and Restructuring of an Insolvent Company", June, 2005.)

INTRODUCTION

This paper will discuss the application of certain provisions of the *Income Tax Act* (Canada) (the "ITA")[1] to the scenario of a corporation facing some financial challenges. The choices and methods of restructuring, both on a legal entity and on an enterprise basis, will have different tax consequences and indeed, may also lead to potential personal liability issues for those involved. It is assumed that the corporation will have been in operation for some period of time or, at least, one taxation year and thus, the corporation may have non-capital loss carryforwards and other assets. In this scenario, the goal is to preserve the tax attributes and tax accounts of the corporation. The business may revive and the tax attributes may effectively provide shelter against future income or there may be some opportunity to monetize same.

This paper will discuss in particular:

- Debt forgiveness
- Loss utilization
- Liability considerations

This paper will not be a technical treatise on various income tax matters and is intentionally written in a non-technical manner. Some details of the actual provisions of the ITA may be found in the footnotes.

A PRIMER OF TERMS

Non-capital loss

The term "non-capital loss" is a defined term in the ITA.[2] In the context of a corporation carrying on a business, a "non-capital loss" is essentially the corporation's operating losses from carrying on the business and therefore is sometimes colloquially referred to as an "operating loss" or "business loss". A "non-capital loss" is to be distinguished from a "net capital loss"[3]. Whereas a non-capital loss can be deducted from all sources of income, i.e., income from business or property or employment or capital gains, a "net-capital loss" can only be applied against a taxable capital gain. A non-capital loss may be carried forward for ten (10) taxation years and carried back for three (3) taxation years[4].

Control

Subject to a number of anti-avoidance rules, control for purposes of the ITA generally refers to *de jure* control as opposed to *de facto* control. Specifically, control has been interpreted by the courts to mean the ownership of enough shares carrying a majority of votes in the election of the directors of the corporation[5]. As a result of the Supreme Court of Canada decision in Duha Printers (Western) Ltd. v. The Queen[6], it is generally understood that for purposes determining control, one looks not only at the share register but also any constating documents of the corporation including a unanimous shareholders agreement.

The concept of control is relevant for the purposes of the ITA because of the tax consequences upon the acquisition of control of a corporation and the effect of same upon the existing non-capital loss and net capital loss balances of the corporation. For this purpose, it should be noted that although the phrases "acquisition of control" and "change of control" are sometimes used interchangeably in common parlance, for income tax purposes, the relevant phrase is an acquisition of control.

Debt forgiveness rules

The debt forgiveness rules[7] have the effect of reducing or "grinding" tax attributes where a debt is settled or extinguished for less than its principal amount. For this purpose, it should be noted that technically, not all debts may be subject to these rules. Specifically, it is only the forgiveness of a "commercial obligation"[8] that may have adverse tax consequences. A "commercial obligation" means either a "commercial debt obligation" or a distress preferred share. Distress preferred shares shall not be discussed herein as those rules are beyond the scope of this presentation.[9] In general terms, a "commercial debt obligation" is a debt obligation in respect of which interest is deductible in computing income or, where the debt obligation is non-interest bearing, such interest would have been deductible. In the case of a corporation carrying on business, if it is assumed that the debt obligations arise from an operating line of credit or specific project financing facilities, such obligations most likely constitute "commercial debt obligations".

Debt parking

Prior to the significant changes to the debt forgiveness rules in 1994, these rules could be avoided by arranging for the debt to be purchased by a related entity at a discount. This was often referred to as "debt parking". However, this planning technique has largely been made ineffective under the current rules.

Debt parking[10] is a subset of the debt forgiveness rules and, if applicable, causes the debt forgiveness rules to apply notwithstanding that there may not have been any formal extinguishment, waiver or settlement of an outstanding commercial debt obligation. Rather, the debt parking rule is predicated upon a change in relationship between the debtor and the debt holder (typically a change to a non-arm's length relationship) including ownership of shares of the corporate debtor, and requires that the debt holder have acquired the debt at a discount of greater than 20%.

Non-arm's length

For purposes of the ITA, persons can be non-arm's length (sometimes referred to as "not dealing with each other at arm's length") by virtue of deeming rules[11] or as a question of fact. For example, individuals may be deemed to be non-arm's length by virtue of a connection by blood relationship, marriage or adoption. However, a corporation and a shareholder or any two corporations may be deemed to be non-arm's length because of control circumstances. The relevant rules are beyond the scope of this discussion but suffice it to state that a corporation and the person who controls the corporation are deemed to be non-arm's length and any two corporations which are controlled by the same person are also deemed to be non-arm's length.

WHAT HAPPENS IF A CORPORATION BECOMES A BANKRUPT?

For purposes of the ITA, the term "bankrupt" is as defined in section 2 of the *Bankruptcy and Insolvency Act* (the "BIA")*[12]*:

"Bankrupt" means a person who has made an assignment or against whom a receiving order has been made or the legal status of that person.

The consequences of a corporation becoming a bankrupt are set out in section 128 of the ITA which specifies the following[13]:

(a) The trustee in bankruptcy is deemed to be an agent of the bankrupt for all purposes of the ITA.

(b) While there are special rules in the ITA relating to the taxation of a trust or estate, those rules do not apply to the estate of the bankrupt[14]. Rather, the ITA deems any act performed in carrying on the business of the bankrupt estate by the trustee in bankruptcy as having been done as an agent on behalf of the bankrupt. Thus, any income of the trustee from carrying on the business of the bankrupt is considered to be income of the bankrupt and therefore not income from a trust or an estate for tax purposes.

(c) The taxation year of the corporation is deemed to have ended on the day immediately before it became a bankrupt and a new taxation year is deemed to have commenced on the day that it became a bankrupt. The foregoing accelerates compliance obligations as corporate returns are typically due six (6) months after year end. It should be noted however, that although paragraph 128(1)(d) deems the taxation year of the corporation to have ended as described, the corporation is not thereafter free to choose a new fiscal period.[15]

(d) Although a taxation year end is triggered as described above, the ITA treats the property of the bankrupt as remaining vested in the bankrupt and not passing to the trustee in bankruptcy. This prevents a deemed disposition of assets and resultant changes to the depreciable cost of assets. In contrast, upon a corporation becoming a bankrupt, the BIA provides that “a bankrupt ceases to have any capacity to dispose of or otherwise deal with their property, which shall. … immediately pass to and vest in the trustee …”[16]

(e) The corporation is deemed not to be associated[17] with any other corporation in any taxation year ending during the period in which the corporation is a bankrupt. Associated corporation status is relevant to the sharing of the small business limit for purposes of the small business deduction[18] .

(f) During the period in which the corporation is a bankrupt, if income tax payable by the corporation is not paid, then the trustee in bankruptcy is jointly and severally liable in respect of same but only to the extent of the property of the bankrupt in his possession. However, the responsibility for filing an income tax return for a taxation year ending during this period is that of the corporation.[19] The trustee in bankruptcy is however required to file returns for past years which have not been filed.[20]

Section 128 of the ITA as described above, continues to apply until such time as an absolute order of discharge is granted. Such an order may have undesirable tax consequences. Specifically, paragraph 128(1)(g) provides that where an absolute order of discharge is granted, any losses of the corporation for preceding years cannot be deducted in computing income in the taxation year in which the order is granted or in subsequent taxation years. Thus, to the extent that the corporation may have had non-capital loss carryforward or net capital loss carryforward balances, these may not be applied in taxation years subsequent to the granting of the absolute order of discharge. Under the BIA, a bankruptcy may be annulled, if in the opinion of the court, the receiving order ought not to have been made or the assignment made. [21] A bankruptcy may also be annulled if a proposal is made under Section III of the BIA which is approved by the court.[22] Since section 128 of the ITA applies only during a period of bankruptcy, if the bankruptcy is converted into a proposal, this appears to preserve the loss carryforwards of the corporation, in contrast to the result if an absolute order of discharge were granted.

RESTRUCTURING DEBT

The primary tax consideration when restructuring debt in a commercial enterprise is the potential application of the debt forgiveness rules. In general terms, the debt forgiveness rules in section 80 apply where debt of a taxpayer is forgiven or settled for payment of an amount that is less than the principal amount. The forgiveness causes a reduction in various tax accounts or tax attributes or ultimately, an income inclusion.

As a policy matter, the rationale for the debt forgiveness rules seems to be that as interest in respect of the debt was deductible in computing income, if the debtor is not required to pay the debt in full, then such forgiveness of the debt should reduce the losses which were effectively funded by the debt or the cost of property whose acquisition was funded by the debt because the taxpayer did not truly bear the cost of acquisition nor the burden of the losses. The debt forgiveness rules were very substantially revised in 1994 and have been criticized for being unduly complex.[23]

Debt forgiveness rules

The basic parameters of the debt forgiveness rules are:

- there must be a “commercial obligation”
- there must be a debtor
- the “commercial obligation” must be settled
- there must be a “forgiven amount”

(a) There must be a “commercial obligation”.

It should be noted that a "commercial obligation" includes more than a loan or borrowed money. The term "obligation" is itself effectively defined[24] to include not only the circumstance where a person becomes liable to repay money previously borrowed but also includes the circumstance where a person is liable to pay an amount as consideration for property or services acquired by the person. It should also be noted that the interest component of debt is deemed to be a separate obligation with a principal amount equal to the amount of interest that was deductible.[25] Thus, the debt forgiveness rules may potentially apply not only to the "typical" circumstance of a loan, but also to outstanding amounts in respect of purchased goods or services[26] and may apply separately in respect of the interest relating to any obligation.

As noted earlier in this paper, a "commercial obligation" comprises a "commercial debt obligation" and "distress preferred shares". A "commercial debt obligation " is an obligation in respect of which interest is deductible, or if the obligation is not interest bearing, an obligation in respect of which interest would have been deductible if charged.

(b) There must be a debtor.

The debt forgiveness rules may apply to a corporation, an individual, a partnership[27] or a trust.

(c) The commercial obligation must be settled.[28]

The concept of settlement is not defined in the ITA but clearly requires a final resolution between debtor and creditor who are *ad idem*. In Central City Financial Services Ltd. v. The Queen[29], the Tax Court of Canada stated:

> … in order for the debt to be settled there must be more than an abandoning of the debt or inaction on the part of the creditor to pursue the debt. Further, mere assignment of the debt does not settle the debt.

In this case, the taxpayer corporation had issued a debenture to a bank, secured by the corporation's assets and guaranteed by the individual shareholder. Rising interest rates left the taxpayer in financial difficulty. Litigation ensued and the bank claimed on the guarantee. The matter proceeded to trial and was settled during the process on the basis of a handwritten agreement. Under the agreement, the individual shareholder paid an amount to the bank in full settlement of the bank claim under the guarantee, the taxpayer corporation agreed that it "would not pursue" the bank for any claims and the bank agreed that it "would not pursue" the taxpayer corporation for any claims. Although the taxpayer corporation argued that the agreement was merely a "standstill agreement" or a form of interim agreement[30], the Tax Court of Canada did not accept this argument. Rather the Court found that the parties had intended to settle the litigation; it was a final agreement with respect to the liability of the debtor for the original debt.[31]

The finality of settlement was described thus by Bowman, J.T.C.C. in Carma Developers Ltd. v. R.[32]:

"The term "settle" has a variety of meanings, some of which are colloquial in the sense that a problem is resolved one way or another. The terms "settle" or "compromise" are used in some of the documents. In the context of section 80, however, "settle" connotes a final and legal resolution of a taxpayer's obligation whereby that obligation is reduced or brought to an end. It must be considered from the point of view of the taxpayer who would be affected by section 80, not the creditor. Moreover, it must be a final and legally binding termination or reduction of the debtor's obligations."

Carma Developers Ltd. was a wholly owned subsidiary of Carma Corporation. Carma Developers was heavily indebted to three classes of lenders: operating lenders; project lenders; and debenture holders. The indebtedness was secured ranging from a floating charge to specific charges on property of Carma Developers or its parent corporation. Carma Developers began suffering financial difficulties in the early 1980's. It had difficulty servicing its debts. One creditor commenced foreclosure action. Ultimately, Carma Developers sought protection under the *Companies Creditors Arrangement Act* and a plan was worked out and filed with the court.

Under the plan, Carma Developers agreed to make certain minimum repayments on its operating loans over a period of three years and some payment was immediately made to the other two classes of lenders being a cash payment to the debenture holders and the quit claim of certain property to the project lenders. Each of the lenders agreed to assign Carma Developer's indebtedness to it to the parent corporation in return for shares of the parent corporation. The plan expressly provided that any claims assigned to the parent corporation by a creditor "shall not be extinguished".

Bowman, J.T.C.C. held while the lenders and the Carma group of corporations might view the implementation of the plan as a resolution of the debt issues and a "settlement" in the colloquial sense, as long as the obligations remained enforceable and there was the possibility that they may be paid in accordance with their terms, then the restructuring could not be considered a reduction of the debt. As a result, the debts had not been settled or extinguished.[33]

(a) There must be a "forgiven amount".

The "forgiven amount" is determined according to a formula in subsection 80(1) being the difference, if any, between the principal amount of the obligation[1] and the total of a number of items, the most common ones being:

- the amount paid at the particular time in satisfaction of the principal amount of the obligation
- any amount included in income as a benefit from employment or a shareholder's benefit[2]
- where the debtor is a bankrupt, the principal amount of the obligation
- the amount paid by the debtor to another person as consideration for the assumption of the obligation
- the principal amount of an "excluded obligation"[3] being, generally, an obligation whose proceeds were otherwise included in income such as a trade debt, or certain non-arm's length obligations not paid by the end of the second taxation year following the year in which the obligation was incurred.[4]

While the amount paid in satisfaction of the principal amount of the obligation may seem obvious in the case of a cash payment, there are specific deeming rules which apply where shares are issued in payment of debt or a new debt obligation is issued. Where shares are issued in payment of debt, the amount paid is deemed to be equal to the fair market value of the share at the time of issuance.[5] Where a new obligation is issued in settlement of a particular debt obligation, an amount equal to the principal amount of the new obligation is deemed to have been paid at that time by the debtor. [6]

Assuming that the above prerequisites are met and a "forgiven amount" has been calculated, then in general terms, the "forgiven amount" is applied by the debtor in the following order to reduce its tax accounts or the tax attributes of its property:[7]

- non-capital loss carryforwards,
- net capital loss carryforwards,
- capital cost of depreciable property,
- cumulative eligible capital,
- resource pool balances,

- adjusted cost base of capital properties (other than shares and debts of corporations in which the debtor is a “specified shareholder”[8] and interests in partnerships which are related to the debtor),
- adjusted cost base of shares and debts of corporations in which the debtor is a “specified shareholder” (other than shares and debts of corporations which are related to the debtor),
- adjusted cost base of capital properties that are interests in, or debts of, related persons.

Provided that the debtor has applied the forgiven amount to reduce its tax accounts and the tax attributes of its properties to the maximum (other than the last item noted in the list above, being the adjusted cost base of capital properties that are shares, interests or debts of a related corporation or partnership), the debtor may transfer the remaining unapplied portion of the forgiven amount to an “eligible transferee” so that the “eligible transferee” may apply same to reduce its tax accounts or the tax attributes of its properties in the order set out above, subject to certain limitations.[9] An “eligible transferee” will include a taxable Canadian corporation[10] which is related to the debtor.[11] A debtor’s rationale for transferring the unapplied portion of the “forgiven amount” to an “eligible transferee” is linked with the ultimate income inclusion consequence of the debt forgiveness rules.

The ultimate consequence of the debt forgiveness rules to the debtor is an income inclusion. The income inclusion is based on 50% of the remaining unapplied portion of the forgiven amount.[12] However, if the debtor chose to apply any portion of the forgiven amount to reduce the adjusted cost base of shares or debt or an interest in a related corporation or related partnership rather than transfer such remaining forgiven amount to an “eligible transferee” and at that time, there was:

- an “eligible transferee” who was controlled by the debtor; or who controlled the debtor; or was controlled by the same person or group of persons who controlled the debtor[13]
- such “eligible transferee” had “gross tax attributes” being the first seven items in the list above against which a forgiven amount may be applied[14]

then, there is effectively an add-back to the remaining forgiven amount for purposes of the income inclusion calculation. The add-back is equal to the lesser of the portion of the forgiven amount applied to reduce the adjusted cost base of the interest in a related person and the “gross tax attributes” of the particular “eligible transferee” as described above. Effectively, to the extent that the debtor chose to apply forgiven amount to reduce the adjusted cost base of shares or debt or an interest in a related person rather than transfer same to an eligible person, the income inclusion calculation forces an add-back and therefore an increase in the income inclusion from what would otherwise have been simply 50% of the remaining unapplied portion of the forgiven amount.

A reserve may be claimed by the debtor corporation in respect of the income inclusion. Section 61.4 permits the debtor corporation to claim a five year reserve with a mandatory recognition of 20% of the income inclusion in each year. In the case of an insolvent corporation, greater relief may be available pursuant to section 61.3.

Specifically, a reserve may be claimed to the extent that the income inclusion under section 80(13) exceeds two times the net fair market value of the corporation's assets[15] (i.e., net of liabilities[16]). The effect of section 61.3 is to effectively limit the income inclusion to two times the fair market value of the debtor corporation's net assets.[17]

Debt parking

The debt parking rules were introduced to prevent the avoidance or deferral of the debt forgiveness rules by "parking" the debt in friendly hands. In order for the debt parking rules to apply, the debt obligation must be a "specified obligation" and a "parked obligation".

The obligation is a "specified obligation"[18] if:

- previously, the person who owned the obligation was arm's length with the debtor and did not have a "significant interest"[19] in the debtor, meaning generally the ownership of shares representing at least 25% of the "votes and value" of the debtor corporation; or
- the obligation was acquired by the holder from an unrelated person; or
- the debtor had taken the position that the obligation was a bad debt and made an election under subsection 50(1).[20]

An obligation becomes a "parked obligation"[21] where it is a "specified obligation" and either the holder is non-arm's length with the debtor, or the holder has a "significant interest" (as described above) in the debtor.[22]

In circumstances where the obligation has become a "parked obligation" and the cost of the obligation to the holder is less than 80% of the principal amount, then the debt parking rule deems the obligation to have been settled and the forgiven amount is calculated as if the amount paid was equal to that cost.[23]

The following is a simple example of the circumstances in which the debt parking rules would apply:

- Debtor Co is a wholly owned subsidiary of Parent Co
- Debtor Co is indebted to a financial institution and the funds had been borrowed to fund its operating activities
- The loan is restructured and Parent Co acquires the loan from the financial institution for payment of less than 80% of the principal amount

In this example, the loan was a "specified obligation" because the debt holder was an arm's length financial institution and became a "parked obligation" when Parent Co acquired same.

If a debtor subsequently makes a payment on account of an obligation which had been deemed settled under the debt parking rules, there may be a limited deduction from income available in that subsequent year.[24]

Simplified conceptual examples of restructuring transactions

A debtor corporation in financial difficulty may seek to restructure its debt. This may involve:

- deferral of payment or forgiveness of accrued interest and/or some portion of principal, including change of interest rate, extension of maturity date and other payment terms

- Note that as the interest component is deemed to be a separate obligation, the forgiveness of accrued interest can trigger the application of debt forgiveness rules as described above.

- There may be disposition issues, i.e., a risk that the change in terms resulted in the disposition of the "old" debt with resultant tax consequences. It was the previous administrative position of the Canada Revenue Agency (the "CRA") that changes in terms of the debt obligations could result in a disposition of the debt by the holder.[25] After a lengthy review, a more lenient position was announced so that the CRA effectively accepted that a disposition would only occur based on the intention of the parties to effect a novation and substitute new debt.[26]

- debt for debt exchange

- Where a new debt is issued in exchange for another debt, for purposes of the debt forgiveness rules, the amount paid in satisfaction of the old debt is deemed to be the face amount of the new debt regardless of its fair market value. Thus, a debt for debt swap should not, in and of itself, result in debt forgiveness.

- equity for debt exchange

- Where shares are issued in exchange for debt, the amount paid in satisfaction of the debt is deemed to be the fair market value of such shares.

- Subject to certain limited exceptions, if shares with typical preferred share type attributes are issued in satisfaction of debt, they may be "taxable preferred shares" or "short term preferred shares"[27]. The issuer (i.e., the debtor) may be liable to pay tax (pursuant to Part VI.1 of the ITA) at a rate ranging from 25% to 50% of dividends paid on such shares in the year in excess of a $500,000 dividend allowance[28]. There is a deduction available which operates as a full offset provided that the issuer (debtor) is taxable at the top corporate rate.[29] However, where the issuer (debtor) is in a loss position and not taxable in the particular year, such deduction merely creates additional losses available for carryover and the Part VI.1 tax would therefore be a true tax cost in the particular year.

LOSS UTILIZATION

As the financially troubled company is assumed to have non-capital loss carryforwards, consideration should be given to the ability to continue to utilize same and/or the ability to monetize, perhaps by selling the company to a more profitable company. However, an acquisition of control of the company shall restrict the utilization of its losses.

Where there is no acquisition of control

Absent an acquisition of control of the corporation, the restrictions on loss utilization are limited to:

- Carryover periods[30]:

Loss	Carry - forward	Carry - back
Non-capital loss	10 taxation years	3 taxation years
Net capital loss	Unlimited	3 taxation years

- Certain losses may be applied against certain income only. Specifically, a net capital loss may only be applied against taxable capital gains and there are also rules resulting in limited utilization of restricted farm losses and limited partnership losses.

Where there is an acquisition of control

If there is an acquisition of control of the corporation, significant restrictions apply, notably:

- limitation of carryforward of non-capital losses by virtue of “loss streaming”
- no further carry forward of net capital losses
- where the fair market value of capital property is less than its adjusted cost base at the time control of the corporation is acquired, such property is deemed to have been disposed of at fair market value immediately before that time, thereby triggering a capital loss[31]
- where the fair market value of depreciable property is less than its undepreciated capital cost at the time control of the corporation is acquired, such property is deemed to have been disposed of at fair market value immediately before that time, thereby triggering a terminal loss which effectively becomes a non-capital loss subject to “loss streaming” after the change of control
- a year end of the corporation is deemed to have ended immediately before the acquisition of control[32]

These restrictions may be found in subsection 111(4), (5) and (5.1) of the ITA. Consideration of these provisions in OSFC Holdings Ltd. v. The Queen resulted in the Federal Court of Appeal holding that there is a clear and unambiguous policy in the ITA against the trading of losses by corporations, subject to the limited circumstances contemplated in section 111.[33]

For purposes of these restrictions, control means *de jure* control rather than *de facto* control. The principles applicable in determining control of a corporation were succinctly summarized by Iacobucci, J. in the Supreme Court of Canada decision in Duha, *supra*, as follow[34]s:

It may be useful at this stage to summarize the principles of corporate and taxation law considered in this appeal, in light of their importance. They are as follows:

> (1) Section 111(5) of the Income Tax Act contemplates *de jure*, not *de facto*, control.
> (2) The general test for *de jure* control is that enunciated in Buckerfield's, *supra*: whether the majority shareholder enjoys "effective control" over the "affairs and fortunes" of the corporation, as manifested in "ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the board of directors".
> (3) To determine whether such "effective control" exists, one must consider:
> (a) the corporation's governing statute;
> (b) the share register of the corporation; and
> (c) any specific or unique limitation on either the majority shareholder's power to control the election of the board or the board's power to manage the business and affairs of the company, as manifested in either:
> (i) the constating documents of the corporation; or
> (ii) any unanimous shareholder agreement.
> (4) Documents other than the share register, the constating documents, and any unanimous shareholder agreement are not generally to be considered for this purpose.
> (5) If there exists any such limitation as contemplated by item 3(c), the majority shareholder may nonetheless possess *de jure* control, unless there remains no other way for that shareholder to exercise "effective control" over the affairs and fortunes of the corporation in a manner analogous or equivalent to the Buckerfield's test.

The loss utilization restriction rules in subsections 111(4) and (5) apply where "control of a corporation has been acquired by a person or group of persons". The term "group of persons" is not defined in the ITA but is generally considered to mean more than simply any aggregation of persons who own shares in the same corporation. Rather, there must be a common link or interest among those persons such that they may be considered to act in concert to achieve certain purposes.[35]

There are anti-avoidance provisions in the ITA relevant to the concept of an acquisition of control of a corporation. In particular, the interaction of paragraph 251(5)(b) and subsection 256(8) need to be considered in any circumstance where parties are dealing with the shares of a corporation with non-capital loss carryforwards. Pursuant to subsection 256(8), where a taxpayer acquires a right referred to in paragraph 251(5)(b) and "it can reasonably be concluded that one of the main purposes of the acquisition" is to avoid any limitation on the deductibility of any non-capital loss[36], then for purposes of determining whether control of a corporation has been acquired, any such right is treated as if it had been exercised. The rights referred to in paragraph 251(5)(b) are very broadly worded – being a "right under a contract, in equity or otherwise, either immediately or in the future and either absolutely or contingently" to acquire shares (for example)[37] and thus in the simplest form, would include an option to purchase shares. For example, if a taxpayer acquired less than 50% of the voting shares of a corporation which has non-capital loss carryforwards but also acquires an option to purchase the balance of the voting shares, the interaction of paragraph 251(5)(b) and subsection 256(8) may treat the taxpayer as having acquired control of the corporation assuming that "it can reasonably be concluded that one of the main purposes" of the taxpayer acquiring the option is to avoid the loss streaming rules.

It should also be noted that there are certain mitigating provisions which deem control of a corporation to not be acquired. In particular, control of a corporation is deemed not to have been acquired by virtue of an acquisition of shares from a related person.[38] This generally facilitates the transfer of shares among a family or corporate group without impairing the ability to utilize non-capital losses. There are also specific deeming rules applicable to amalgamations, reverse takeovers and share exchanges.[39]

The non-capital loss streaming rule in subsection 111(5) may generally be summarized as follows:[40].

- There must be a loss(es) from a business.
- "That business", i.e., the business in which the losses were realized (sometimes colloquially referred to as the "loss business") must be carried on for profit or with a reasonable expectation of profit throughout the particular taxation year after the acquisition of control in which the non-capital losses are being deducted.
- the non-capital losses carried forward may only be applied against:
    - income from the "loss business", or
    - where properties were sold, leased, rented or developed or services were rendered in carrying on the "loss business", income from another business "substantially all the income of which derived from the sale, leasing, rental or development of similar properties or the rendering of similar services" – the so-called "same or similar business" requirement.

The following provides more detail with respect to the requirements of subsection 111(5) and the above points.

(a) There must be a loss or losses from a business.

Although losses from property and losses from employment also fall with the definition of "non-capital loss" in subsection 111(8), it is only losses from a business that may be carried forward to taxation years ending after control of the corporation has been acquired, subject to the loss streaming restrictions.

(b) The "loss business" must be carried on for profit or with a reasonable expectation of profit throughout the particular taxation year after the acquisition of control in which the non-capital losses are being deducted.

The "loss business" is the very business which was carried on by the taxpayer and gave rise to the losses in question. Thus, it must the "same business" which is being carried on after the acquisition of control. In other words, the "loss business" must be continued after the acquisition of control. Whether it is the "loss business" which continues to be carried on after the acquisition of control or whether it is a "separate business" is a question of fact. The seminal UK case of Scales (Inspector of Taxes) v. G. Thompson & Co.[41], held that question was the degree of "interconnection, any interlacing, any interdependence, any unity at all embracing"[42] the two businesses. In this case, the issue was whether the operation of a fleet of ships was the same business or a separate business from insuring or underwriting shipping risk. It was held that these were separate businesses.

Factors which may be considered in the above analysis include[43]:

- Whether the operations are carried on from the same premises[44]

- Do the operations involve the manufacture and/or sale of similar goods of services? If the subject matter seems similar, is the similarity tangential as in the Scales case, i.e., shipping business and insuring shipping risk?

- Are the operations integrated such that one operation supplies the materials for the other?[45]

- Do employees and management of the loss company continue?[46]

- What is the degree of integration of the operations? Is there separate accounting, separate branding, separate payroll?[47]

(c) Income from the "same or similar business"

To paraphrase subparagraph 111(5)(a)(ii), the non-capital losses may only be applied against income (in a post-acquisition of control year) from the same business (i.e., the "loss business") or a business where substantially all[48] of the income was derived from a similar business. The determination of whether there is a similar business largely applies the same criteria as the "same business" analysis.[49]

There is a similar loss streaming rules in the winding-up provisions of the ITA[50]. Thus, it is possible to wind-up a subsidiary[51] and thereby effectively "move" its non-capital losses to the parent corporation.[52] However, where control of the subsidiary has been acquired and the subsidiary is thereafter wound-up, loss streaming rules apply.

LIABILITY CONSIDERATIONS

There are two key potential liability provisions in the ITA to be considered in dealing with a financially troubled corporation: section 160 and section 159.

Section 160 contemplates a non-arm's length transfer of property for less than fair market value consideration. Where section 160 applies, the transferee becomes jointly and severally liable to pay any amount which the transferor is liable to pay under the ITA for the taxation year of transfer and preceding years (i.e., therefore including interest on unpaid taxes in addition to tax), to the extent that the fair market value of the transferred property exceeds the consideration therefor. Although a taxpayer can typically only be reassessed by the CRA within 3 years after the date of mailing of the notice of original assessment, this limitation does not apply to section 160.

Section 160 may apply to the declaration of a dividend in a non-arm's length situation. The case of Algoa Trust v. The Queen[53] held that the payment of a cash dividend constituted a "transfer of property". The possibility of a section 160 assessment may lead to shareholder liability for the corporation's unpaid taxes.

Section 159 applies to a "legal representative" (as defined)[54]. A "legal representative" is jointly and severally liable with the taxpayer to pay any unpaid amount under the ITA for which the taxpayer is liable, to the extent that the "legal representative" is in possession or control of property belonging to or held for the benefit of the taxpayer. Further a "legal representative" should obtain a clearance certificate from the CRA prior to distributing property in its possession or control. Otherwise, the "legal representative" may be personally liable for any amount which the taxpayer is or can reasonably be expected to become liable, to the extent of the value of the property distributed.

The term "legal representative" is defined as follows:

> legal representative" of a taxpayer means a trustee in bankruptcy, an assignee, a liquidator, a curator, a receiver of any kind, a trustee, an heir, an administrator, an executor, a liquidator of a succession, a committee, or any other like person, administering, winding up, controlling or otherwise dealing in a representative or fiduciary capacity with the property that belongs or belonged to, or that is or was held for the benefit of, the taxpayer or the taxpayer's estate

There is limited jurisprudence relating to section 159. It seems to be accepted that directors, acting in their capacity as such, do not constitute "like persons" so as to fall within the "legal representative" definition and therefore should not be held liable under section 159[55] The issue is whether a person could be considered to be acting in a like fashion to a liquidator and thus be considered a "de facto liquidator" potentially subject to personal liability pursuant to section 159. In one reported case, Malka v. The Queen[56], an individual was held to be a "de facto liquidator".[57] The title or office of the individual is unclear from the facts of the case although he was a shareholder. The case involved a loss utilization arrangement where two individuals acquired the common shares of a loss company but not voting control as the existing shareholder subscribed for voting preferred shares. The loss company acquired a profitable shoe manufacturing business whose profits were sheltered by the pre-existing non-capital losses. The shoe business was thereafter sold and the profits distributed to the shareholders. In this context, the Court held that one individual was acting as *de facto* liquidator.

SUMMARY

A restructuring of an insolvent corporation will almost inevitably have debt forgiveness issues. The above should provide an overview of the application of these complex rules. A restructuring which results in the introduction or change of shareholders may require a determination of whether there has been an acquisition of control of the corporation for tax purposes. An acquisition of control results in restrictions in the utilization of losses of the corporation as described above.

---

[1] The "forgiven amount" formula recognizes that an obligation may be issued at a discount. Technically, the calculation is based on the difference between the lesser of the principal amount of the obligation and the amount for which the obligation was issued.

[2] If an employee loan is forgiven, such forgiveness results in an employment benefit which is included in income pursuant to subsection 6(15) and paragraph 6(1)(a). Forgiveness of shareholder debt also results in an income inclusion pursuant to subsections 15(1) and (1.2) rather than the application of the debt forgiveness rules.

[3] See definition in subsection 80(1). See also discussion in footnote 26 regarding trade debts.

[4] Subsection 78(1) would apply rather than the debt forgiveness rules. Subsection 78(1) causes an income inclusion where a deductible expense is incurred by a taxpayer which is payable to a non-arm's length person (e.g., interest, fees, royalties) but which is not paid by the end of the second taxation year following the year in which such expenses were incurred.

[5] Pursuant to paragraph 80(2)(g) which reverses earlier case law to the effect that the amount paid upon issuance of shares in satisfaction of debt was equal to the addition to stated capital at the time.

[6] Pursuant to paragraph 80(2)(h).

[7] Pursuant to subsections 80(3) to (11).

[8] See definition in subsection 248(1). In general terms, a taxpayer is a “specified shareholder” of a corporation where he owns not less that 10% of the shares of any class of shares of capital of the corporation or a related corporation. Certain look through and deeming rules also apply. For example, for purposes of this definition, a taxpayer is deemed to own those shares which are owned by a non-arm’s length person.

[9] For example, the “eligible transferee” may not apply the forgiven amount to reduce the adjusted cost base of shares or debt of related persons.

[10] Defined in subsection 89(1). In general terms, a “taxable Canadian corporation” is a corporation resident in Canada for income tax purposes, was incorporated in Canada and is not exempt from tax under the ITA.

[11] “Eligible transferee” is defined in subsection 80.04(2) and incorporates the concept of a “directed person” which is defined in subsection 80(1). An “eligible transferee” includes a taxable Canadian corporation which controls or is controlled by the debtor, or which is controlled by the debtor and persons related to the debtor, or which is controlled by the same person or group of persons which control the debtor. A partnership, all of whose members are residents of Canada for income tax purposes, may also be an “eligible transferee” using a deeming rule in paragraph 80(2)(j) which analogizes a member’s interest in the partnership to shares of a corporation based on proportionate fair market value.

[12] Pursuant to subsection 80(13). The income inclusion is 100% of the remaining unapplied forgiven amount in the case of a debtor which is a partnership.

[13] Such an “eligible transferee” is a “directed person” as defined in subsection 80(1).

[14] See subsection 80(14.1). The “gross tax attributes” are essentially all of the tax attributes which may be reduced by a forgiven amount other than an interest, share or debt in or of a related person.

[15] Pursuant to the formula in subsection 61.3(1), the fair market value of assets is reduced by certain amounts paid in the preceding 12 months to non-arm’s length persons as a dividend, reduction of paid-up capital in respect of any shares, or redemption or cancellation of shares.

[16] Calculated on an unconsolidated basis.

[17] If a debtor claims a reserve pursuant to either section 61.2 or 61.3 and has not made designations to reduce its tax accounts or tax attributes to the maximum extent possible, the Minister of National Revenue has the discretion to do so pursuant to subsection 80(16). Thus if a debtor plans to offset the income inclusion from a debt forgiveness using the reserve provisions and has not made the maximum discretionary tax account reductions, the ITA gives the Minister discretion to make such designations.

[18] See subsection 80.01(6).

[19] See paragraph 80.01(2)(b). For this purpose, a person is deemed to own those shares which are owned by non-arm’s length persons.

[20] This technically results in a deemed disposition of the debt at Nil and reacquisition at same. A debtor might make such an election to trigger a capital loss in respect of the debt.

[21] See subsection 80.01(7).

[22] *Supra*, footnote 52, provided that such acquisition of debt occurred after July 12, 1994.

[23] See subsection 80.01(8). If the debt parking rule has applied and the loan is subsequently repaid, some relief is available pursuant to subsection 80.01(10) in the form of a deduction in computing income.

[24] Pursuant to subsection 80.01(10). In general terms, the deduction is equal to 50% of the amount by which the subsequent payment exceeds the forgiven amount, subject to adjustments if reserves were claimed pursuant to section 61.3.

[25] The CRA had an administrative position that the changes in terms of a debt obligation may result in a disposition of the debt itself and gave the following examples in Interpretation Bulletin IT-448, “Dispositions – Changes in Securities”:

7. The following changes in respect of the debt obligation itself (unless carried out pursuant to an authorizing provision in its original terms) are considered to be so fundamental to the holder's economic interest in the property that they almost invariably precipitate a disposition:

> (a) a change from interest-bearing to interest-free or vice versa,
>
> (b) a change in repayment schedule or maturity date,
>
> (c) an increase or decrease in the principal amount,
>
> (d) the addition, alteration or elimination of a premium payable upon retirement,
>
> (e) a change in the debtor, and
>
> (f) the conversion of a fixed interest bond to a bond in respect of which interest is payable only to the extent that the debtor has made profit, or vice versa.

The above administrative position was the subject of much criticism. Case law, Quincaillerie Laberge Inc. v. The Queen, 95 DTC 155 (TCC) also suggested that the above position was not correct, at least in terms of the effect of an extension in the maturity date.

[26] This change in administrative position was announced in Income Tax Technical News No. 14 (December 9, 1998):

> Interpretation Bulletin IT-448, Disposition — Changes in Terms of Securities, comments on whether or not there has been a disposition of a debt obligation and the creation of a new debt when there are changes in its terms. Paragraph 7 particularly provides examples of changes that are considered to be so fundamental to the holder's economic interest in the property that they almost invariably precipitate a disposition. This position has created some controversy and confusion. The Department has indicated at various tax conferences that the settlement, extinguishment or disposition of a debt obligation was primarily a matter of law and that the Department was reviewing its position expressed in paragraph 7 of Interpretation Bulletin IT-448.
>
> As a result of the review, it is now our position that if a debt obligation is renegotiated otherwise than as provided for in its original terms, the determination of whether a change in its terms is a substitution of a debt obligation for another should be made in accordance with the law of the relevant jurisdiction.
>
> If, in accordance with the relevant contract law in Quebec, the changes in the terms of the original debt obligation have resulted in a novation (where the original debt obligation is discharged and substituted by a new obligation), it is appropriate to view the original obligation as having been disposed of for income tax purposes.
>
> In the other provinces, a rescission of a debt obligation will be implied when the parties have effected such an alteration of its terms as to substitute a new obligation in its place, which is entirely inconsistent with the old, or, if not entirely inconsistent with it, inconsistent with it to an extent that goes to the very root of it. In such a case, it is appropriate to view the original obligation as having been disposed of for income tax purposes.
>
> This position applies for the purposes of the Act and will be reflected in the next revision of IT-448.

[27] The preferred share regime in the ITA is complex. The terms, “taxable preferred share” and “short term preferred share” are defined in subsection 248(1). As a gross over-simplification, a fixed dividend rate is an attribute of a “taxable preferred share”. The limited exceptions referred to require the shareholder to have a “substantial interest” in the corporation which generally requires the shareholder to be “related” to the corporation (as that concept applies for purposes of the ITA) or to hold shares representing greater than 25% of the “votes and value” of the corporation, including 25% of the shares in the capital of the corporation which are not “taxable preferred shares”.

[28] Subject to a clawback (and therefore effective reduction in the dividend allowance) on a dollar for dollar basis to the extent of dividends paid by the corporation and its associated corporations in excess of $1,000,000 on “taxable preferred shares” or “short term preferred shares”. See subsection 191.1(4).

[29] Paragraph 110(1)(k) provides for a deduction in computing taxable income equal to three (3) times the Part VI.1 tax. This deduction approximates the income that would have generated sufficient income tax equal to the Part VI.1 tax and therefore implies a tax rate of 33.3%.

[30] Carryover periods in respect of restricted farm losses; limited partnership losses and allowable business investment losses are not reproduced in the above table.

[31] It is possible for the corporation to make a designation pursuant to paragraph 111(4)(e) in respect of capital property to effectively trigger a capital gain where the fair market value of a particular property exceeds its adjusted cost base. Pre-change of control net capital losses could then be applied against the resultant capital gain.

[32] Pursuant to subsection 249(4).

[33] 2001 DTC 5471 at paragraph 98. OSFC is, thus far, the highest court decision on the General Anti-Avoidance Rule in section 245.

[34] *Supra*, footnote 6 at p. 6350. Duha was essentially a loss utilization case which focused on subsection 256(7), a related party mitigating provision.

[35] See Interpretation Bulletin IT-302R3, “Losses of a corporation – The effect on their deductibility of changes in control, amalgamation and winding-up”, paragraphs 3-6.

[36] There are other “main purposes” referred to in subsection 256(8). For example, subsection 256(8) may also apply where it can reasonably be concluded that one of the main purposes of the acquisition of the paragraph 251(5)(b) right is “to affect the application of section 80”. Section 80 comprises the debt forgiveness rules.

[37] Paragraph 251(5)(b) contemplates such a right not only to acquire shares but also such a right to control the voting rights of shares; to cause a corporation to redeem shares held by anther person; to acquire voting rights in respect of shares; or to cause the reduction of voting rights in respect of shares held by another person.

[38] See subsection 256(7)(a). The concept of “related persons” is found in section 251.

[39] See paragraphs 256(7)(b) – (e).

[40] Paragraph (a) of subsection 111(5) is reproduced below with emphasis added to certain words illustrating the points summarized above:

> Where, at any time, control of a corporation has been acquired by a person or group of persons, no amount in respect of its non-capital loss or farm loss for a taxation year ending before that time is deductible by the corporation for a taxation year ending after that time and no amount in respect of its non-capital loss or farm loss for a taxation year ending after that time is deductible by the corporation for a taxation year ending before that time except that
> (a) such portion of the corporation's non-capital loss or farm loss, as the case may be, for a taxation year ending before that time as may reasonably be regarded as its loss from carrying on a business and, where a business was carried on by the corporation in that year, such portion of the non-capital loss as may reasonably be regarded as being in respect of an amount deductible under paragraph 110(1)(k) in computing its taxable income for the year is deductible by the corporation for a particular taxation year ending after that time
> (i) only if that business was carried on by the corporation for profit or with a reasonable expectation of profit throughout the particular year, and

(ii) only to the extent of the total of the corporation's income for the particular year from that business and, where properties were sold, leased, rented or developed or services rendered in the course of carrying on that business before that time, from any other business substantially all the income of which was derived from the sale, leasing, rental or development, as the case may be, of similar properties or the rendering of similar services;

Paragraph (a) of subsection 111(5) applies to the carryforward of non-capital losses to taxation years following the acquisition of control. Paragraph (b) of subsection 111(5) applies to the carryback of non-capital losses to taxation years prior to the acquisition of control.

[41] [1927] 13 TC 83

[42] Supra, at p.89.

[43] See also Interpretation Bulletin IT-206R, "Separate Businesses" for the CRA's administrative view.

[44] See Canadian Dredge and Dock Company Limited v. M.N.R., 81 DTC 154 (TRB) where there was a scale down of operations in the Maritimes and apparent relocation to Ontario.

[45] See Manac Corp. v. The Queen, 98 DTC 6605 (FCA) where a loss corporation carried on a panel manufacturing business and was acquired by a truck trailer manufacturing corporation. The panels became part of the truck trailers.

[46] The hiring of one employee, albeit the key individual was held insufficient to show that the loss business continued to be carried on in Garage Montplaisir Ltee v. M.N.R., 2001 DTC 5366 (FCA).

[47] For example, in Gaz Metropolitan v. M.N.R., [1999] 2 CTC 2116 (TCC), the acquired business had been merged so extensively with the parent's enterprise that the operations could not be easily distinguished. See also DuPont Canada Inc. v. the Queen, 2001 DTC 5269 (FCA) where the Court held that explosives manufacturing was not a "separate business" from the business of manufacturing chemicals and plastics and reviewed numerous examples of integration of the operations.

[48] Although it has long been accepted that the CRA administratively considers "substantially all" to mean greater than 90%, recent cases have suggested that a lower threshold may suffice. In Manac, *supra*, at paragraph 13, the Court noted that 50% "is quite clearly not a percentage corresponding to 'substantially all'. Watts v. The Queen, 2004 DTC 3111 (TCC) was an informal procedure case and therefore of limited precedent value. This was not a case relating to the loss streaming rules but rather the eligibility of a non-resident to claim certain tax credits. However, the Tax Court of Canada reviewed a growing body of case law (including GST cases, US and UK) as to the meaning of "substantially" and "substantially all" and concluded on the facts in the case that greater than 80% met the "substantially all" requirement

[49] See IT-302R3, *supra*, paragraph 14 where the CRA states: "The word 'similar' in the context of subsection 111(5) is generally interpreted as "of the same general nature or character".

[50] See subsection 88(1.1).

[51] The rules in subsections 88(1) and (1.1) require that at least 90% of the shares of each class of the subsidiary were owned by the parent corporation immediately before the winding-up.

[52] Timing considerations apply. Although a winding-up does not trigger a year end of the subsidiary for tax purposes, the non-capital losses of the subsidiary may only be applied to taxation years of the parent commencing after the winding-up.

[53] 93 DTC 405 (TCC)

[54] See definition in subsection 248(1).

[55] M.N.R. v. Parsons, 83 DTC 5329 (FCTD).

[56] 78 DTC 6144 (FCTD).

[57] The CRA seems to acknowledge this possibility. In Information Circular IC 82-6R, “Clearance Certificate”, paragraph 3, the following statement is made:

> The reference to any other like person includes any person acting as a liquidator, whether or not the person was formally appointed. For instance, in a voluntary dissolution, there may be no formally appointed liquidator and the responsibility may be assumed by an auditor, director, officer, or other person. The facts of each particular case will determine whether a person is a legal representative.