Tax Planning in a Downturn (Part II)

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This article – my second in recent months devoted to this topic[1] - is based on a number of recent presentations by the Minden Gross tax group to members of the accounting profession.

Asset Securitization

Asset securitization procedures, which often accompany other tax and estate planning structures[2], are one of the most important planning strategies in a downturn. One of the biggest problems is timing: the more acute creditor issues have become by the time these strategies are undertaken, the less successful they are likely to be. In fact, some eleventh-hour procedures might even expose professional advisors to liability. So the best time to implement asset protection strategies is long before there are potential concerns - and the longer the structure is in place before a potential problem, the greater chances of success.

The typical strategy will be to interpose a Holdco (if necessary), pay a large dividend to it, and lend it back to the operating company on a secured basis. Some advisors think that the size of this dividend and loan-back is restricted to the operating company's retained earnings, so that deficits cannot be created. In fact, corporate solvency tests are typically based on the net realizable value of the company's assets (so as the company grows in value, additional dividends could be paid). Having said this, one issue for many businesses is that this procedure will wreak havoc on a company's balance sheet, which could be particularly problematic where financial information is required by third parties. In addition, the dividend will usually render Holdco liable for unpaid income taxes of the operating company. However, multiple holding company structures may alleviate these issues.

Refreezes – The "Reset Button"

One of the most important elements of an estate and succession plan is an estate freeze, a manoeuvre that limits the shareholder's death tax exposure to the value of the corporation at the time of the freeze, with future growth in value passing to the next generation.

If the value of the company has decreased relative to the freeze value, it is possible to "refreeze" at the lower value. If this is done, the death tax exposure will be "reset" at this lower value; otherwise, the original freeze value will prevail if the value of the company "reflates" to the freeze value[3]. So a refreeze can be a simple manoeuvre that can save considerable tax.

If the growth shares have been held by a family trust, it will usually be advisable to distribute these shares before the 21st anniversary of the trust in order to avoid adverse tax consequences. While not necessary, a refreeze can involve the formation of a new family trust, so that the 21-year period is also "reset".[4]

Accessing Losses

A company or its shareholders may have made loans that have gone bad. More often than not, such losses will be treated as capital losses, so that tax relief is restricted to situations where there are capital gains, including in the previous three taxation years.

In some cases, allowable business investment loss (ABIL) status may be available – where one-half of the actual loss is deductible against all sources of income, not just capital gains. This can arise where the bad investment has been made in a "small business corporation" – basically, a Canadian-controlled private corporation whose assets have been devoted to Canadian active business activities[5]. While ABIL treatment will not be available to non-arm's length inter-company loans, it could be available to other bad loans or equity investments. (An ABIL can be triggered either by a disposition to an arm's length person, or where subsection 50(1) of the Act applies in respect to bad debts or worthless shares[6].) It is also possible to take an ABIL for a guarantee of a small business corporation's indebtedness[7]; however, where guarantor is not a shareholder of the corporation at least[8], it is advisable to ensure that adequate guarantee fees or other consideration are received.

If ABIL claims are to be made, it is important that there is no undue delay. Generally, a corporation must qualify as a small business corporation within the twelve months preceding the time at which the investor triggers the ABIL claim. This timeframe could be problematic for investors, especially since information from companies which are in financial difficulty - and typically in various stages of winding down - may not be readily forthcoming.[9]

As many readers will be aware, ABIL claims are regularly followed by a detailed questionnaire from the CRA. It is a good idea to review the questionnaire before a claim is made, in order to ensure that satisfactory answers can be given (most accountants have copies of the questionnaire). Remember also that ABILs claimed in the year or prior years will block capital gains exemption claims[10].

Besides ABILs, there may be circumstances where a fully-deductible business expense can be claimed for a bad loan. One of these is by a taxpayer whose ordinary business includes money lending; however, meeting this requirement is unusual. Otherwise, the case for fully-deductible expense claims will be "factually driven" – i.e., considering the circumstances and purpose of the loan. For example, a bad loan to a subsidiary or related company could perhaps be deductible if the purpose is to protect or preserve existing goodwill or maintain a continuing source of revenue[11]. While these opportunities may be unusual, they should not be overlooked.

Tax Loss Selling

As the triggering of tax losses is usually done at year-end, I discussed this topic in the November and December issues of *Tax Notes.* For this year's tax season in particular, the big issue may be whether the losses can be filed as fully deductible. As mentioned in my December article, one possibility is an investor with a managed account, where the manager makes a great many trades. Fully-deductible loss treatment may also be available to a person whose trading activities amount to a business (e.g., a day trader); it may also be possible for stockbrokers and other professional investment advisors. Interested readers should obtain a copy of Interpretation Bulletin IT-479R[12], which delineates the CRA's policies on securities trading (available on the CRA's website www.cra-arc.gc.ca). Among other things, the CRA suggests that transactions may be presumed to be on income account (i.e., fully deductible) if it is apparent that the taxpayer has used special information not available to the public[13]. It is also suggested that gains and losses made by a corporation whose "prime activity" is trading in securities will be considered to be on income account[14]. As I mentioned in the fall, taxpayers who wish to claim fully-deductible losses should be prepared for a possible review by the CRA, as well as being held to income treatment if there are future gains, and even the possibility of a reassessment for prior years.

Another possibility for tax-loss selling relates to real estate investments that have declined in value. Even if the investment is "on capital account", it may be possible to trigger a terminal loss on a building. Because of applicable "stop-loss" rules, the sale must be to a non-affiliated transfereee[15]. Also, land transfer tax should be considered where applicable. In Ontario, for example, the land transfer tax may be quite material in relation to the tax benefits (particularly within Toronto)[16].

If real estate is held as inventory, it may be possible to simply write it down[17]; however, if a property increases in value, it will be necessary to write the property back up to its original cost; this can be prevented if the loss is triggered by transferring the property to another entity[18].

Default Procedures

One of the most overlooked tax planning opportunities relates to default proceedings, and more specifically, minimizing the adverse tax effects that may occur. In many cases, debtors may have no control over how creditors exercise their default remedies; however, a creditor may often be willing to work together with the debtor; after all, if the debtor's tax liabilities are minimized, there may be more assets available to the creditor.

Basically, there are two regimes for defaulting debtors, which can have very different tax results. Foreclosures and other procedures involving the actual surrender of property to a creditor result in proceeds of disposition of the surrendered asset based on the amount of debt. These rules (in section 79 of the Act)) are intended to sweep-in related debt in respect of the surrendered asset, for example, debts having priorities, as well as debts to third parties if they cease to be owing.

The other regime relates to powers of sales and similar remedies, e.g., where a creditor causes a sale of the secured asset to a third party and scoops the proceeds. In this case, the proceeds of disposition of the asset is based on the actual sale pricee[19]. Generally, powers of sale are preferable to foreclosures if the value of the asset is less than the associated debt. Under power of sale, the excess of the debt over the sale proceeds is not necessarily forgiven, so that the debt forgiveness rules (see below) may not apply.

Most default proceedings are based on power of sale rather than foreclosure. However, the "foreclosure rules" can apply if the debtor surrenders the property to the creditor as a consequence of failure to pay part or all of a debt, e.g., he or she makes a deal with the creditor to transfer over the asset, or there is a "quit claim".

Another group of tax rules come into play when a debt is forgiven by a creditor (i.e., settled or extinguished). These rules are among the most complex in the *Income Tax Act.* Basically, though, they reduce various tax accounts, and there are ordering rules as to which tax accounts are reduced[20]. The highest on the list are loss carry-forwards. Next in the pecking order are so-called "elective deductions": undepreciated capital cost, as well as resource and eligible capital balances. It may be possible to "manage" these accounts in order to minimize the effect of the debt forgiveness rules. For example, tax losses can be used up by transferring assets at a profit in the taxation year before the debt is forgiven[21]. Similarly, assets which involve "elective deductions" can be moved around prior to the time of forgiveness. Other planning opportunities relating to debt forgiveness that come to mind include the utilization of the deduction for insolvent corporations[22], and strategies to avoid the "debt parking rules"[23], which may otherwise result in debt forgiveness. The latter may arise, for example, where debt of a company is acquired at a discount of more than 20%, e.g., on a takeover[24].

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[1] See "Tax Planning in a Downturn", *Tax Notes* No. 550, November 2008.

[2] As well as sometimes having certain tax advantages.

[3] If it doesn't, the lower value should prevail. However, practically speaking, it is possible that the CRA might be tempted to take the position that the higher freeze value is operative – i.e., because this amount could

readily be identified as the redemption/retraction amount of the freeze shares – leaving the decedent's estate with an "uphill battle" to establish a lower value.

[4] See also "The Big Freeze", Grant Thornton, March 2009. The release also points out that a refreeze may increase the ability to pay dividends, because the freeze documentation, if properly implemented, will limit the ability to pay dividends if this impairs the ability to redeem or retract the freeze shares themselves.

[5] This may include a corporation the shares of which are traded over-the-counter.

[6] I.e., debts established to be bad debts, per paragraph 50(1)(a), or shares, where the conditions of paragraph 50(1)(b) are met.

[7] See subsection 39(12), which deems amounts owing by the corporation to the taxpayer honouring the guarantee, to be debt owing to the taxpayer by a small business corporation. The provision requires that the corporation be a small business corporation both at the time the debt was incurred, as well as any time within the 12 months before the time an amount first becomes payable by the taxpayer under the guarantee. In addition, the payment must be made to an arm's length person.

[8] Subsection 39(12) deems there to be an amount owing by a small business corporation; however, it is still necessary to deal with subparagraph 40(2)(g)(ii), which denies capital losses for non-income producing loans. Historically, the CRA has not applied this provision in respect of loans or guarantees by shareholders, provided that certain conditions are satisfied (see paragraph 6 of IT-239R2, now archived by the CRA). Per paragraph 14 of IT-484R2, a taxpayer may also be entitled to claim losses on a guarantee in the circumstances outlined in paragraph 6 of IT-239R2.

[9] There appears to be little case law as to when an otherwise active business has ceased to be so. An example, however, is *Vogel* v. *The Queen*, 96 DTC 1321 (TCC), which seems to illustrate some judicial sympathy for these issues. It involved a corporation which had carried on an active business in 1985. On its April 30, 1987 federal corporate income tax return, the company indicated that its operations were "in suspense". On the company's balance sheets dated April 30, 1986, and April 30, 1987, assets of $1,000 were reported which included incorporation costs of $792 and office furniture of $208, and there were total liabilities of $97,130. The Tax Court of Canada indicated that the evidence showed the company, albeit "in suspense", was still active. There were assets, liabilities and contracts to pursue. Further, during the period of time in question some minimal expenses were incurred as the company tried to negotiate contracts. The company as an "active business" did not cease until October 31, 1988. The final date was confirmed by a letter from the vice president of the company to the appellant dated November 30, 1988. Thus, up to November 30, 1988, the company was a "small business corporation" as all or substantially all of the assets were used in an "active business" carried on in Canada.

Other cases in which the timing of business cessation has been in issue relate to the requirements in subparagraph 50(1)(b)(iii), particularly the requirement in clause 50(1)(b)(iii)(D) that it is reasonable to expect that the corporation will not commence to carry on business. See *Hopmeyer* v. *The Queen*, 2007 DTC 5216 (FCA); *Jacques St. Onge Inc. v. The Queen,* 2001 DTC 487 (TCC); and *Turner v. The Queen*, 2000 DTC 6442 (FCA) (this case is somewhat similar to *Vogel*, involving the "extension of life" of a business).

[10] Previous years' capital gains exemption claims block ABILs.

[11] See, for example, *Valiant Cleaning,* 2008 DTC 5112 (TCC)*; L. Berman* 61 DTC 1150 (Ex. Ct.)*; Excell Duct Cleaning* 2006 DTC 2040 (TCC)*;* and *Laviguer,* 73 DTC 5538 (FCTD). If the loan is considered to be working capital of the subsidiary, this factor seems to lead to capital loss status; evidence of direct payment to third parties on behalf of a subsidiary may assist full-deductibility status.

[12] "Transactions in Securities."

[13] See paragraph 17. In paragraph 18, it is stated that the gain or loss on the short sale of shares is considered to be on income account.

[14] Notwithstanding that the corporation does not hold itself out to the public as a trader or dealer in securities. See paragraph 15.

[15] In *Landrus* v. *The Queen*, 2008 DTC 3583 (TCC), it was held that GAAR did not apply to a transaction which skirted the stop-loss rules.

[16] This may not be an issue in some situations where land is “jointly” held.

[17] This will not apply to an adventure in the nature of trade – i.e., an isolated property held as inventory – see subsection 10(1.01). Furthermore, stop-loss rules apply to transfers of such property; see subsection 18(14) *et seq*.

[18] Other than the provisions of subsection 18(14) *et seq*. relating to property held as an adventure in the nature of trade, there are no stop-loss rules in this situation, so that the transfer could be to an affiliated corporation in order to defer Ontario land transfer tax.

[19] See paragraph (g) of “proceeds of disposition”, section 54.

[20]As follows:

A. Non-capital losses, net capital losses (mandatory – limited to the "relevant loss balance")

B. Depreciable property, cumulative eligible capital, resource balances (elective)

C. Capital property (other than below) (if maximum designated in B)

D. Shares/debt where specified shareholder (if maximum designated in B, C)

E. Current year capital losses (if maximum designated in B, C)

F. Shares/debt of related corporations, interests in related partnerships (see paragraph 80(2)(j)). (This is added back to the “income hit”, unless the forgiveness is “laid off” to “directed persons”. The add-back is the lesser of F and the “residual balance” – the remaining tax accounts available to “directed persons”.)

The remainder, net of amounts "laid off" to eligible transferees under section 80.04, is an "income hit" (there is also a reduction for certain capital losses denied under stop-loss rules). One-half of this amount is included in income (100% if the debt forgiveness relates to a partnership).

[21] The forgiven amount reduces the carryforward otherwise available for the year in which the amount is forgiven. See, for example, description D.2 of the definition of non-capital loss is subsection 111(8).

[22] Section 61.3 of the Act.

[23] These rules potentially apply where a "specified obligation" becomes held by a person non-arm’s length with the debtor or who has "significant interest" (25% or more of shares), provided that the cost of the debt is less than 80% of principal thereof.

A "specified obligation" arises where debt was: (i) previously owned by person arm’s length to debtor with no "significant interest"; (ii) acquired from a non-related person; or (iii) there has been a subsection 50(1) election to treat the debt as a bad debt.

[24] In this case, one strategy which may be advisable is "ATR-66 type planning", where a vendor of shares and underwater debt of an Opco transfers the latter to a Newco prior to sale.