# Reality Bites: Tax News from the Summer

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*(*This release is based on an article published in Tax Notes #524, September 2006, CCH Canadian Limited)*

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I am still enjoying my annual summer journey to Maui; but by the time you read this, it will all be over for another year. If it is also your time to get back to reality, this rundown of summer tax news may be of interest.

## Technicals

Let's start with something easy - a couple of technical interpretations that may be of interest, the first indicating that leasehold improvements can qualify as replacement property for a building[1]. Perhaps more interesting is another technical[2], which canvasses the question of whether refundable tax is considered to be an eligible asset for the purpose of the capital gains exemption. This depends on whether this tax account is an "asset . . . used principally in an active business carried on primarily in Canada". While not completely clear, the technical seems to suggest that the RDTOH account itself may not be an asset to begin with, stating that refundable dividend tax on hand is a "notional account that is required to be calculated based on the applicable law in the Income Tax Act." The technical goes on to indicate: "Generally, the CRA is of the opinion that a dividend refund receivable by a corporation as a result of paying taxable dividends to shareholders constitutes an eligible asset that is used by the corporation in a business." So while the technical itself is reassuring, similar questions might be raised for other tax accounts, e.g., loss carryforwards. Are these also mere "notional accounts"? If not, when would they be considered to be eligible?[3] Remember, in the eyes of the CRA, it only takes 10% of non-eligible-asset value to put a company offside.

## Cases

In late June, the Tax Court of Canada came out with the *Grant* case[4]. This involved a sort of "interest straddle" by a couple who were about to become non-resident. A very large amount was borrowed from a bank and put on deposit with its subsidiary. On the last day of the year (just after the ceased Canadian residence), the taxpayers paid the interest, claiming a large deduction to shelter the departure tax exposure. The interest on the funds on deposit would be received after the couple ceased to be resident. At issue was whether the interest was deductible under subsection 114(c), which allows "any other deduction permitted for the purpose of computing taxable income". The CRA argued that this provision applies only to deductions pertaining to the calculation of taxable income itself (i.e., Division C), as opposed to the Division B (computation of income), which contains the deduction for interest. Woods, J. held that the CRA's interpretation of s. 114(c) was the correct one, thus striking down the scheme. This conclusion was based on a "textual, contextual, and purposive interpretation" of the legislation – i.e., per the *Canada Trustco* GAAR case[5], rather than GAAR itself[6]. An earlier Federal Court of Appeal case, *Stapley*[7] took a similar approach to statutory interpretation, but in this case, the Federal Court of Appeal declined to confine the 50% disallowance of food, beverage and entertainment expenses in section 67.1 to situations involving personally-consumed items. (Although the purposive approach supported the taxpayer in that the provisions of section 67.1 were originally intended to be reflective of the element of personal consumption, the context and text prevailed.)

In case there was any doubt, these cases enshrine textual, contextual, and purposive interpretation as a rule of statutory interpretation which is not confined to GAAR[8]. As stated in *Canada Trustco* itself:

> The interpretation of a statutory provision must be made according to a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole. When the words of a provision are precise and unequivocal, the ordinary meaning of the words play a *dominant* [not conclusive] role in the interpretive process. On the other hand, where the words can support more than one reasonable meaning, the ordinary meaning of the words plays a lesser role[9].
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> . . ..

> Even where the meaning of particular provisions may not appear to be ambiguous at first glance, statutory context and purpose may reveal or resolve latent ambiguities.[10]

As for GAAR itself, *Ceco*[11] continues the streak of recent taxpayer losses which had occurred earlier in the year, with notable defeats in *Lipson*[12] (interest deduction strategies) and *Desmarais*[13] (strips). *Ceco* involved a transfer of business assets by a vendor corporation into a purchaser partnership on a subsection 97(2) rollover basis. If cash in excess of the cost base of the transferred assets had been received as consideration for the transfer, there would, of course, have been a taxable gain. Instead, nearly $19M of cash was injected by the partnership into a sister corporation of the vendor in return for a class of shares, the rights of which were effectively neutralized vis-à-vis the purchaser (the proceeds of the subscription were in turn used to capitalize six holding companies). The court held that the transactions were a "patent abuse" of subsection 97(2).

A Federal Court of Appeal case, *La Survivance*,[14] illustrates how a "sleeper" provision – subsection 256(9) – might affect the status of a corporation at the precise time of a share sale. It provides that a change of control takes place at the commencement of the day in which control is acquired, rather than the actual time (an election to the contrary can be filed). The case involved a public company that sold shares of a sub to a private corporation and claimed an ABIL based on this provision; of course, an ABIL would not be available if, at the point of sale, the target corporation was controlled by the public company. The argument put forward: since control was acquired at the commencement of the day of sale of the sub, at the *actual time of the sale,* the sub was a no longer controlled by the public company. By that time, the sub had therefore changed its status so that it qualified as a small business corporation; accordingly, the public company could claim an ABIL in respect of the sale. The Federal Court of Appeal bought this argument, overturning the Tax Court of Canada[15]. Practitioners should consider subsection 256(9) carefully where tax consequences of a share sale depend on the status of a corporation.

## Legislation

The most noteworthy development of the summer was the end-of-June federal release of draft legislation pertaining to eligible dividends,[16] which fleshed out the details of a rather hasty announcement by the former Liberal government in November 2005.[17] (For further discussion, see "Eligible Dividends – The Good, The Bad and the Ugly", by the author, in last month's issue of *Tax Notes.*.) Barely a month later, [18] the Ontario government weighed in, announcing that it was following the proposals, with details of the provincial dividend tax credits.

The Ontario announcement features a phase-in of the enhanced provincial dividend tax credit for eligible dividends, from 6.5% this year, to 7.7% when the proposals are fully phased-in, in 2010, compared to a 5.13% credit for ineligible dividends.[19] Our calculations indicate that, compared to a top-bracket Ontario taxpayer earning income personally, the degree of underintegration (i.e., extra combined corporate and personal tax payable where income is earned corporately and distributed to an individual as a dividend) will drop from nearly 6% this year to less than 2% in 2010 (ignoring EHT which would reduce underintegration even further). For corporations qualifying for the M&P rate, underintegration would disappear by 2010.

Unfortunately, however, there's a fly in the ointment. The foregoing ignores the Ontario "clawback" of the provincial small business deduction, which may undermine this result, as it increases corporate tax by 4.67% between $400,000 and the clawback income ceiling (about $1.1M). The effect of the clawback is to increase corporate rates to about 40.8% in 2006, dropping to about 37.7% in 2010, compared to top personal rates of about 46.4%. Therefore, in the income zone where the clawback applies, the approximate tax deferral available where corporate income is not distributed to individual shareholders will drop from 10.3% to 5.6%, for 2006, and from 13.4% to about 8.7% in 2010, when the federal corporate rate decreases are phased-in. Where the clawback applies, underintegration is in excess of 9.2% this year, dropping to about 5.2% in 2010.

Thus, even when the system is fully phased-in, there could eventually be a tax cost of over 5% to enjoy a deferral of almost 9% in the meantime. But as corporate profits increase over the clawback ceiling, these effects will become less and less important. In other words, deferral by retaining profits at the corporate level is a good option for modestly profitable companies (i.e., under the small business limit) and very profitable companies. But those in the middle may have to think twice. Does this make sense?[20]

## Addendum

On August 18th, the Tax Court of Canada released *MIL (Investments) S.A.* v. *The Queen*[21]. I expect that this case will receive a great deal of commentary in coming weeks, so I will be brief. A non-resident individual transferred shares of Diamond Field Resources ("DFR", a public company incorporated in Canada) into MIL, a Cayman company. In July of 1995, MIL was continued into Luxembourg. On its face, Article 13(4) of the Canada-Luxembourg treaty provided that capital gains from the sale of the DFR shares by MIL, a Luxembourg resident, would be exempt from Canadian tax if less than 10% of the shares were held by the resident and related persons. Although the Appellant's holding had exceeded 10%, certain recent transactions had reduced its holdings below this threshold[22]. After several rejected offers from Inco, in the spring of 1996 the DFR shareholders approved the Inco offer, with the closing in August of that year.

The CRA attacked on the basis that GAAR should apply to deny the treaty exemption on the capital gain from the sale to Inco (in excess of $425M); alternatively that it was possible to deny the treaty benefits based on an anti-abuse rule inherent in the treaty itself. In respect of GAAR, Bell, J. found that the sale and the preceding transactions[23] were not avoidance transactions (and that actual the sale of shares DFR shares by the Appellant were not part of the same series of transactions as the previous transactions); it was therefore not necessary to deal with whether the transactions constituted an abuse. However, Bell J. nevertheless indicated that "The Appellant's reliance on a treaty provision as agreed on by both Canada and Luxembourg cannot be viewed as a misuse or abuse"[24], thus rejecting the CRA's argument that treaty shopping, *per se*, is subject to GAAR. Bell, J., also held that, in the light of OECD commentary[25] and the lack of an explicit reference to anti-avoidance rules in the treaty, there was no ambiguity in the treaty provision permitting it to be construed as containing an inherent anti-abuse rule. Therefore, the "ordinary meaning" of the treaty allowing the Appellant to claim the exemption must be respected.

***Thanks to Guy Dubé of BCF (Montreal), a member of MERITAS, as well as to Joan Jung and Michael Goldberg, Minden Gross partners.***

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[1] 2005-0156171E5.

[2] 2006-0174131C6.

[3] The situation with a recoverable non-capital loss could be somewhat analogous to a trade account receivable; the CRA has indicated that eligible status may depend on whether the receivable arose from sales by the corporation pursuant to its active business. See Technical Interpretation Nos.. 9301993, February 9, 1993, and 9219125, August 25, 1992.

[4] *Grant, D. et al*. v. *The Queen*, 2006 TCC 373.

[5] *The Queen* v. *Canada Trustco Mortgage Company*, 2005 DTC 5523, SCC.

[6] GAAR was argued, but it was not necessary to deal with this issue.

[7] *The Queen* v. *Mark Stapley*, 2006 FCA 36.

[8] Other recent cases in which this approach was used include *Humphrey* v. *The Queen*, 2006 TCC 168; *GKN Sinter Metals - St. Thomas Ltd.* v. *The Queen*, 2006 DTC 325 (TCC); and *Fenner* v. *The Queen*, 2006 TCC 396.

[9] Paragraph 10. For a discussion of Supreme Court cases on statutory interpretation following *Canada Trustco,* see "SCC on Interpretation", Evy Moskowitz, *Canadian Tax Highlights*, August 2006 (CTF).

[10] Paragraph 47.

[11] *Ceco Operations Ltd.* v. *The Queen,* 2006 TCC 256.

[12] 2006 DTC 2687 (TCC).

[13] *Desmarais* v. *The Queen*:, 2006 TCC 44.

[14] 2006 DTC 6288.

[15] The court concluded that at the first moment of the date of sale, the public company vendor was deemed to have relinquished control, and the private company purchaser was deemed to have acquired control of the target. For further discussion, see “Subsection 256(9): Deemed Change in Control”, John McClure, *Tax for the Owner-Manager*, July (Canadian Tax Foundation).

[16] *Legislative Proposals and Explanatory Notes Relating to Income Tax - Dividend Taxation*, released on June 29th.

[17] Department of Finance News Release 2005-082, November 23, 2005, available at www.fin.gc.ca.

[18] August 3rd. The News Release, Backgrounder and Tax Information Bulletin on the announcement are available at www.fin.gov.on.ca.

[19] The rates below are a percentage of the grossed-up dividend. The provincial dividend tax credit is as follows:

| Year | 2006 | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|---|
| Dividend tax credit | 6.5% | 6.7% | 7.0% | 7.4% | 7.7% |

[20] Some other summer developments: In *Ford Credit Canada Limited* v. *The Queen* (Docket: 2005-4286(IT)G, TCC), the characterization of retractable preferred shares for LCT followed GAAP - i.e., classified as debt.
On June 30th the Joint Committee released a grab bag of proposals for technical amendments. For particulars see www.cba.org/CBA/Sections/Tax.

*Henley* v. *The Queen,* 2006 TCC 347 involves an individual whose employer was issued share warrants by a client in partial payment of the employer's fees. A portion of these share warrants had been allocated to the appellant by his employer as part of his remuneration for his services on that client's file (note that section 7 was inapplicable). The court found that the benefit conferred upon the employee by the employer was taxable as an employment benefit at the time of the grant and not when the warrant was exercised. The difference between share value and exercise price was a capital gain capital gain rather than a benefit from employment. This distinugished an earlier case, *Robertson* v*. The Queen* 90 DTC 6070 (F.C.A.). Distinguishing factors include that the value of the warrant (and thus the benefit) at time of allocation could be ascertained, and the right to the warrant was unconditional.

Back in June, the Quebec government shut down the now-infamous Quebec Shuffle, a Quebec trust gambit involving non-Quebec-resident beneficiaries. Of course, the most controversial aspect of this legislation is its apparent retroactivity. (See “Uncertain Times”, *Tax Notes* #521, June 2006; the Quebec government claims that the legislation is not retroactive because of general statements in a previous provincial budget.). An article in the August 16 National Post (“Companies hit by Quebec’s retroactive tax vow not to pay”) lists a dozen publicly-traded companies who together owe $287 million in taxes as a result of the legislation.

[21] Docket 2004-3354(IT)G

[22] In June of 1995, a block of DFR shares were exchanged for Inco shares pursuant to section 85.1. The Inco shares were sold in August 1995, with the Appellant claiming the treaty exemption. This sale was not reassessed by the CRA. The facts indicate that MIL’s holdings in DFR were in excess of 29% in 1993; therefore the DFR shares that were the subject of the CRA reassessment would have been taxable Canadian property, as would also have been the case with the Inco shares, per section 85.1.

[23] I.e., including the continuance and the reduction of DFR shareholdings below 10%.

[24] Bell, J. indicated that, rather than relying on GAAR, Canada should renegotiate selected treaties.

[25] Bell, J. indicated that the OECD commentary should be interpreted without reference to revisions subsequent to the treaty.