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Alter Ego and Joint Partner Trusts: Some Issues – Part II

This article is based on a section of *Tax and Family Business Succession Planning*, Second Edition, by David Louis and Samantha Prasad, to be published by CCH later this fall.

This is a continuation of last month's article, in which we surveyed some issues pertaining to alter ego and joint partner trusts, including amending formulae, reversionary trust rules,[1] loss of low brackets and the capital gains exemption, and so on. This month's article concludes our survey.

Charitable Donations

A charitable donation made in one's will can be applied against the tax exposure due to deemed dispositions on death. In addition, the donation limit for the year of death is increased from 75% to 100% of income and qualifies for a carryback.[2] Assuming that an alter ego or joint partner trust contains a power of encroachment, the ability to use a charitable tax credit against the deemed realization on death is available only if a gift is made to the charity in the taxation year in which death occurs.[3] (Unlike the special treatment available for a donation made in a will, the charitable tax credit in an alter ego or joint partner trust cannot be carried back – it can only be carried forward; because of the basic requirements of alter ego/joint partner trusts, donations cannot be made prior to the death of the settlor/surviving spouse.) Further, depending on the drafting of the trust, issues may arise as to whether the transfer to the charity is voluntary, or is a distribution in satisfaction of the charity's capital interest in the trust – governed by subsection 107(2), rather than treated as a charitable donation.[4]

It has been stated that, in view of these issues, charitable gifts should be made by will, rather than in an alter ego or joint partner trust; however, this is not advantageous if an objective of the donation is to shelter the deemed disposition on death of assets placed in these trusts.

Inside

(If an alter ego or joint partner trust does not contain a power of encroachment, it might qualify as a charitable remainder trust; however, the lack of a power of encroachment may not be acceptable. In addition, the taxation of a charitable remainder trust differs from a normal *post-mortem* gift in that the charitable donation is current and is subject to a present-value calculation.)

Trustee Issues

Where it is desirable to have third-party trustees (e.g., where there are creditor considerations), the settlor may lose effective control of the assets. This could especially be the case if the trustees are concerned with their fiduciary duties to other beneficiaries of the trust. For example, if the trustees are given the power to make discretionary distributions of capital to the settlor, they may be concerned that making such distributions could put them in jeopardy of proceedings against them by other beneficiaries. While the settlor may provide an indemnity, query whether his or her assets will be sufficient, especially if the capital distributions are made to meet personal and living expenses. Unless the settlor can revoke the trust, similar considerations could apply if the settlor desires that the trustees unwind the arrangement, e.g., by distributing the assets of the trust and transferring them to a new alter ego/joint partner trust with different beneficiaries.

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Acquisition of Control Issues – Change of Trustees

As discussed in Chapter 3, a change of trustees could result in an acquisition of control of a corporation if control is held by the trust, particularly if the new trustee is unrelated to the previous trustee.[5] If so, loss streaming rules would apply, there would be a deemed year end, and so on. This could be particularly problematic with respect to alter ego and joint partner trusts, where the original trustee is the settlor and/or spouse: when the original trustees pass away, the appointment of an unrelated trustee would appear to be problematic.

Post-Mortem Planning

In respect of *post-mortem* tax planning procedures, an alter ego or joint partner trust is similar to a spouse trust: rather than the mechanism of subsection 164(6) applying (i.e., a "one year carryback" from the estate to the decedent), the mechanism for triggering a *post-mortem* capital loss in such a trust relates to a single entity (i.e., the trust itself) and is the normal three-year carryback. In view of this, it is suggested that the trust should be drafted to allow for the possibility of the trust continuing after the death of the settlor so as to enable such a carryback.

In addition, *post-mortem* procedures themselves may differ. Similar to the discussion in Chapter 12, at time of writing, the subsection 40(3.61) exemption to the stop-loss rules has not been amended to deal with these trusts. Therefore, the affiliation rules are relevant and considerations similar to those discussed in Chapter 12 in respect to spouse trusts may apply. Furthermore, unless special provisions are made in the trust,[6] the use of the paragraph 88(1)(*d*) bump may be greatly restricted: paragraph 88(1)(*d*.3) does not apply to deem control to have been acquired from an arm's length individual on the death of the beneficiary under an alter ego, or joint partner trust. Instead, in determining the adjusted cost base of shares of a corporation held by these trusts, one must look to when control was last acquired from an arm's length person; this could be a very modest amount (if any).

Stop-Loss Grandfathering

Shares transferred to an alter ego or joint partner trust will no longer qualify for grandfathering from the stop-loss rules in section 112 pertaining to the capital dividend account (i.e., relating to qualifying pre-April 27, 1995 arrangements).

Principal Residence Exemption

The principal residence exemption can be claimed by a trust, including an alter ego or joint partner trust. However, if such a designation is made, there are restrictions on beneficiaries and related persons claiming separate

exemptions, which should be reviewed carefully. Each beneficiary who "ordinarily inhabits" the home, or has a spouse, former spouse, or child who so uses it will be a "specified beneficiary". If the exemption is claimed by the trust, a specified beneficiary will not be able to claim a second exemption.[7]

Also restricted from claiming a separate exemption are a specified beneficiary's spouse (unless legally separated) or single child under 18. Further, it seems that if a specified beneficiary has not attained the age of 18 and is single, a second principal residence exemption will not be available to the beneficiary's parents,[8] i.e., if the exemption is claimed by the trust.

Association Rules – Deemed Ownership by Surviving Spouse

The ownership of shares by the surviving spouse may often be advantageous in respect of the association rules. In this respect, it should be noted that there is a special rule which applies in the case of a testamentary spouse trust[9] whereby the surviving spouse is deemed to own the shares in the trust, provided that the spouse's share of income or capital depends on the exercise (or failure to exercise) of any discretionary power. However, this rule does not appear to apply to an alter ego or joint partner trust.

Debt Forgiveness

For the purpose of the debt forgiveness rules, a settlement of indebtedness will not occur by way of "bequest or inheritance".[10] It is not clear whether debt forgiveness in an alter ego or joint partner trust will qualify for this exception.

Rights or Things

An alter ego or joint partner trust will not be eligible for the special treatment relating to "rights or things" in subsection 70(2) *et seq.* Although some qualifying items are germane only to individuals (e.g., unpaid bonuses, unused vacation leave credits), others could be applicable to such trusts, e.g., unpaid dividends or unmatured bond bonus coupons.

GST

The transfer of property from a decedent to an estate is not a supply, and therefore GST does not apply. However, section 268 of the *Excise Tax Act* provides that, where property is settled by a person on an inter vivos trust, for GST purposes, the transfer is treated as a supply of the property by the person to the trust, and that the consideration for the sale is equal to the amount determined for income tax purposes to be the proceeds of disposition of the property. Since there will typically be a rollover into an alter ego or joint partner trust, this would appear to be based on the cost amount of the property to the transferor. Of course, the transfer may well be an exempt supply, such as the transfer of shares or other financial instruments, or certain used residential complexes.

U.S. Issues

Certain double-tax issues may result if such trusts are used as an estate planning tool for a Canadian resident who is also a U.S. citizen.[11] In addition, there are a number of traps for U.S. situs assets. For example, it does not appear that the foreign tax credit for US estate taxes (allowed to the extent of the Canadian federal taxes arising on US source income in the year of death) per paragraph 6 of Article XXIX B of the Canada–U.S. Treaty will be available. Therefore US property on which estate tax may be exigible should not be transferred to such trusts.

Two Pots of Assets?

Either deliberately or otherwise, it is possible that the settlor will have personal assets/income. If so, there could be added complexities. For example, the settlor may have terminal period losses, and the trust may have gains resultant from the deemed disposition.[12] It is also possible that there could be similar issues prior to death; however, normally income and loss would be attributed to the settlor pursuant to subsection 75(2).

Other Tax Disadvantages

An alter ego or joint partner trust must select a calendar year end; this is not the case with a testamentary trust. These trusts must make quarterly tax instalments; again, this is not the case with a testamentary trust. Unlike a testamentary trust, an alter ego or joint partner trust is not entitled to the $40,000 alternative minimum tax exemption.[13]

Accounting, Legal, and Trustee Fees

An alter ego or joint partner trust will entail keeping accounting records for the trust. As discussed last month, the CRA's position is that annual T3 tax returns are required even if all of the income is taxable to the settlor pursuant to subsection 75(2). There will also be trustee fees if a professional trustee is used. There will be legal fees in establishing the trust, which will vary with the degree of customization required. As can be seen by the foregoing discussion, alter ego and joint partner trusts can raise some intricate and difficult issues, especially when marital, creditor protection, *post-mortem* planning, charitable donations, and the like are in play. It is suggested that these issues would be commonplace in the milieu of succession planning for the successful business.

The X Factor

For some clients, there may be a very real possibility that the relationship between the settlor and the alter ego/joint partner trust may become hopelessly muddled because the client does not respect or understand the significance of creating and maintaining the trust. As mentioned earlier, a client may forget to register new assets. If it is not clear that the assets are held by the alter ego/joint partner trust, will they end up in the estate of the individual, rather than the trust? If so, perhaps a will should nonetheless be prepared, e.g., as a failsafe mechanism to guard against an intestacy. Worse still, could the assets end up being governed by a will which the individual thought was replaced by the trust – e.g., with the "wrong beneficiaries"? As noted previously, the CRA's position is that, even if subsection 75(2) applies to the trust, T3 returns must be filed annually and it has indicated that penalties will apply if this is not done. This might not become apparent until income is to be reported by the trust, e.g., on death. In the end, will probate fees be replaced by tax penalties?

In Ontario, at least, in view of the fact that the *Granovsky* case specifically sanctions the use of multiple wills, the above-mentioned technical deficiencies, along with problems with respect to avoiding dependents relief legislation have made alter ego and joint partner trusts something of a rarity. (In other provinces, e.g., British Columbia, these will substitutes may be more popular.) However, they may be used where there is a specific advantage over wills. It is also submitted that they may be helpful in the succession planning process because of protection against family law claims. However, the drafter will have to become familiar with a myriad of tax pitfalls and traps.

Notes:

[1] In late August, STEP released the text of the round table at its 2007 STEP national conference. In question 6, the CRA indicated that, where a trust pays foreign tax on foreign source income which is attributed to an individual (the "transferor") by virtue of subsections 75(2) (which is likely to apply in the case of an alter ego or joint partner trust), 56(4.1), 74.1(1) or 74.1(2), the transferor cannot claim the foreign tax credit because there is no mechanism to allow the tax paid by the trust as having been paid by the transferor. (Subsection 126(1) requires that non-business foreign income tax be paid by the taxpayer claiming the foreign tax credit.) However, a deduction under subsections 20(1) and 20(12) may apply.

[2] The donation limit for the preceding year is also 100%.

[3] The transfer of property in satisfaction of a charity's income interest cannot be deducted against income arising from the deemed realization of capital gains of the trust under subsection 104(4).

[4] The CRA's view as to the issue of whether a donation or distribution is made appears to be that it is a question of fact which depends upon the specific wording of the trust agreement and the intentions of the trustees. Where the trust agreement empowers the trustees to make a gift and the trustees exercise this power, it would be appropriate for subsection 118.1(3) (gift) to apply. On the other hand, where the charity is an income beneficiary and a distribution is made out of the trust's income, subsection 104(6) would be the relevant provision, so that the deduction against deemed capital gains is restricted. (In particular, see Document No. 2000-0056625, dated April 4, 2001.) For further discussion of these issues, see "Alter ego Trusts/Joint Partner Trusts", E. Hoffstein, 2004 OC p.12A:19 *et seq*. (see also ¶6336 of CANADIAN ESTATE PLANNING GUIDE, CCH Canadian Limited). Hopefully, if the terms of an alter ego trust grant the trustees a power to encroach in favour of the settlor and if they are given full discretion as to the charity to be benefited and the amount to be transferred, the transfer would be accepted by the CRA as having been voluntary. However, Hoffstein states that there is no "bright line" test to determine whether a transfer from an alter ego or a joint partner trust to a charity will result in a charitable tax credit and that it is not entirely clear that a transfer from an alter ego or joint partner trust will necessarily be treated as a charitable gift simply because the inclusion of a power of encroachment in favour of a life tenant arguably renders the transfer to the charity discretionary. The issue of whether a gift or distribution is made is reminiscent of whether, for the purposes of the *Family Law Act* (Ontario), the distribution of property to a married beneficiary of a discretionary family trust (in itself) constitutes a gift after marriage, so as to be excluded from net family property. While some family lawyers believe this to be the case, it appears that the preponderant view is that it is not.

[5] As discussed, where there is a change of trustees, it is not clear that the saving provision in subsection 267(7) pertaining to related persons applies.

[6] Similar to the situation pointed out in the notes to Chapter 12, the trust could call for a distribution of controlling shares as a result of death, so that there would be an acquisition of control as a consequence of death – see the discussion of Document No. 2000-0017625.

[7] Paragraph (*f*) of the definition of "principal residence" in section 54 provides that a property designated as a principal residence by a trust under paragraph (*c*.1) of that definition will be deemed to have been designated as a principal residence for each specified beneficiary of the trust for the calendar year ending in that year.

[8] Or a sibling, if single and under 18.

[9] See clause 256(1.2)(*f*)(i)(*a*).

[10] See paragraph 80(2)(*a*).

[11] For further discussion, reference should be made to "Alter Ego Trusts/Joint Partner Trusts", E. Hoffstein, 2004 OC p.12A:25.

[12] Per an earlier note, subsection 75(2) does not apply to the deemed disposition on death pursuant paragraph 104(4)(*a*).

[13] See "High Net Worth/Cross-Border Personal Tax Planning – Recent Developments of Importance", Rosanne Rocchi, on the Miller Thomson Website, www.millerthomson.com.

New Protocol to Canada–U.S. Tax Treaty

On September 21, 2007, the Fifth Protocol to the Canada–U.S. Income Tax Convention was signed by the Minister of Finance and the U.S. Secretary of the Treasury. The text of this Protocol, as well as the Diplomatic Notes, Department of Finance News Release No. 2007-070, and Backgrounder that accompanied its release are posted on CCH Tax PROTOS® and CCH's News Tracker, are reproduced on CCH Online, and will be in the next CD update and an upcoming print report. As well, CCH has prepared SPECIAL REPORT No. 028H, dated September 21, 2007, containing the above-noted documents. This SPECIAL REPORT may be ordered by calling the CCH Customer Satisfaction Hotline at (416) 224-2248. Outside the Greater Toronto Area, call toll free at 1-800-268-4522.

The Fifth Protocol will enter into force when it is ratified by both the Canadian and U.S. governments, or on January 1, 2008, if it is ratified in 2007. Reproduced below is an excerpt from Department of Finance News Release No.

2007-070, dated September 21, 2007, concerning the changes to the treaty contained in the Fifth Protocol.

The fifth update of the Canada–U.S. Tax Treaty:

- eliminates withholding taxes on cross-border interest payments;
- extends treaty benefits to limited liability companies;
- allows taxpayers to require that certain key double tax issues, such as transfer pricing, be settled through arbitration;
- ensures that there is no double taxation on emigrants' gains;
- gives mutual tax recognition of pension contributions; and
- clarifies how stock options are taxed.

The Effectiveness of Price Adjustment Clauses

Desormiers v. Lalumière, Superior Court of Quebec, 2006 QCCS 2357; Quebec Court of Appeal, October 16, 2006, 500-09-016779-069

This judgment of the Superior Court of Quebec, confirmed by the Quebec Court of Appeal (leave to appeal to the Supreme Court of Canada denied), sheds doubt on the legality and effectiveness of price adjustment clauses in sales contracts. The facts may be summarized as follows.

On February 25, 1993, Réjean Lalumière (the "defendant") purchased all the issued and outstanding shares of Placage Alto Ltée (the "Company") from his father, Réal Lalumière, and his mother, Lucille Desormiers (the "plaintiff") for $500,000, payable with promissory notes (the "Notes"). Réal Lalumière subsequently transferred his claim to his wife.

The contract of sale (the "Contract") contained a clause specifying that the Notes were subject to adjustment in the event the Minister of Revenue did not accept the fair market value of the shares as established by the parties, as follows:

> The parties agree to revise the price of the said shares in the event that the Minister of Revenue does not accept the fair market value of Alto's shares as established above. In that case, the above notes will be cancelled and replaced with new ones that will reflect the revised fair market value. The parties agree to name Me Hélène Lareau as trustee, who will hold the said notes until the Minister of Revenue manifests itself and accepts the above fair market value or establishes a new one. [author's translation]

On March 7, 1995, after the defendant had started making payments on the Notes, an employee of the Canada Revenue Agency (the "Minister") issued a letter of opinion concluding that the fair market value of the purchased shares on February 25, 1993 was nil. Thereafter, the defendant refused to pay the balance due on the Notes on the basis that they were adjusted to "reflect" the Minister's evaluation of the fair market value of the purchased shares pursuant to the adjustment clause in the Contract.

The plaintiff sued her son for full payment of the original sale price on the argument that the adjustment clause did not change the sale price for commercial purposes; it was merely designed to avoid the potential double taxation that could result if the Minister, on the basis of section 69 of the *Income Tax Act* (the "ITA"), determined that the fair market value of the purchased shares was other than that determined by the related parties to the Contract.

The principal issue, therefore, was whether the Minister's fair market value determination modified the sale price of the purchased shares of the Company.

The Company's controller, who negotiated the agreement between the parties and drafted the Contract, testified that he included the adjustment clause specifically to avoid the double taxation that would otherwise result if the Minister assessed a different fair market value for only one of the contracting parties. In fact, the defendant's parents (the vendors) paid capital gains tax based on a $500,000 sale price. Therefore, if the defendant is deemed, pursuant to section 69 of the ITA, to have purchased the shares for nil consideration on the basis of the Minister's determination that that was the fair market value of the shares at that time, then double taxation would result in the absence of an adjustment clause to reduce the parents' price to nil as well.

Furthermore, Justice Riordan of the Superior Court of Quebec pointed out that the Minister's fair market value opinion was based solely on the "negative tangible asset support" of the Company and its lack of profits, and that these conditions were not relevant for the defendant, who shortly after the purchase, sold most of the Company's equipment for $60,000, and for whom the financial statements of the Company did not reflect the true value of the Company.

Based on the evidence, Justice Riordan concluded that obviously the only objective of the adjustment clause was to protect the defendant from possible double taxation, and that it was simply inconceivable that the parties could have intended that the purchase price fall to zero as a consequence of such evaluation by the Minister.

Thus, the Superior Court ruled in favour of the plaintiff and ordered the defendant to pay the full amount of the original Notes. The Quebec Court of Appeal dismissed the son's appeal, and the Supreme Court subsequently refused leave to hear a further appeal.

On a reading of the adjustment clause itself, and without delving into the circumstances, this decision would certainly appear to create uncertainty as to the legal effectiveness of price adjustment clauses. Furthermore, Judge Riordan did not seem to grasp the contradiction resulting from his decision; that is, if a price adjustment clause has no legal/commercial effect, as held by the Court, then it cannot have the desired tax effect. In the case at hand, without actually reducing the sale price, the adjustment clause could not alleviate the double taxation that

would result from a one-sided application of section 69 of the ITA.

On the face of it, the moral of this judgment is that to be legally effective, and therefore tax effective, a price adjustment clause should be drafted in such a way as to clearly indicate the parties' intention to adjust the actual sale price payable between them. In furtherance of this objective, such clauses should be drafted by reference to the sale price, as opposed to the instruments of payment, and without employing ambiguous terms such as "reflect".

On the other hand, we could perhaps hope that the only moral here is that family feuds make bad precedents . . .

– Constantine A. Kyres, Partner in the Tax Department with the Montreal Office of Fraser Milner Casgrain LLP

Recent Cases

Support arrears paid by taxpayer were deductible

The taxpayer and her former spouse divorced on October 15, 2002. In an endorsement issued by the Ontario Superior Court of Justice on January 29, 2004, the taxpayer was ordered to pay her former spouse monthly support amounts of $1,250. She was also credited $9,000 against $25,000 in owed support arrears, and was ordered to pay the $16,000 arrears balance in monthly amounts of $250. In assessing the taxpayer for 2004, the Minister denied the deduction of the $9,000 credit provided in the endorsement and another $5,000 amount paid to her former spouse during 2004. The Minister's position was that these payments were not periodic in nature, as required by paragraphs 56(1)(*b*) and 60(*b*) and subsection 56.1(4) of the Act. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was allowed. Applying the principles set out by the Federal Court of Appeal in *Tossell v. The Queen*, 2005 DTC 5365, the $9,000 and $5,000 payments in dispute, when taken with the other payments provided in the endorsement, were periodic in nature. The Minister was ordered to reassess on the basis that the payments were deductible.

Leduc, 2007 DTC 1117

Taxpayers entitled to deduct portion of rental expenses claimed

The taxpayers each owned a 50% interest in a condominium, which they rented out. In assessing the taxpayers for 2003, the Minister disallowed the deduction of a number of maintenance, repair, and renovation expenses, alleging that these were capital in nature. The taxpayers appealed to the Tax Court of Canada.

The taxpayers' appeal was allowed in part. The cost of a number of items, including blankets, sheets, cutlery, and desk lamps, was deductible since these items were portable, unattached, and subject to theft by tenants. The cost of the remaining items for which deductions had been claimed was capital in nature since these items were purchased, installed in the condominium, and were of an enduring benefit.

Gruber et al., 2007 DTC 1136

Taxpayer entitled to deduct 50% of operating expenses claimed for leased truck

The taxpayer was employed as a sheet metal worker by Metropolitan Sheet Metal Ltd. During 2000 and 2001, he leased a truck that he used exclusively to transport his tools and supplies to job sites designated by Metropolitan. In assessing the taxpayer for 2000 and 2001, the Minister disallowed the deductions claimed by the taxpayer as operating expenses for the truck. The Minister's position was that these expenses had been incurred primarily for travel between the taxpayer's home and his employer's places of business. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was allowed in part. The taxpayer should be allowed to deduct 50% of the expenses claimed, since the evidence did not show that all of the expenses were incurred in driving from the taxpayer's home to Metropolitan's place of business.

Cook, 2007 DTC 1140

Minister's assessment of shareholder's benefit and imposition of penalties upheld

In assessing the taxpayer for 2001 and 2002, the Minister included unreported amounts in his business income for 2001 and a shareholder's benefit in his income for 2002. Penalties for gross negligence were also imposed. On the taxpayer's appeal to the Tax Court of Canada, he argued that he had not deliberately failed to report income, and that the problems with his records and reporting procedures were the result of incompetence on the part of his accountant.

The taxpayer's appeal was dismissed. The issue was the taxpayer's credibility. His testimony amounted to an admission that he had lied, invented documents with forged signatures, and engaged in cash-only transactions in the course of carrying on business. Despite this admission, he still alleged that his tax returns were scrupulously honest. The Minister's assessments, including the penalties, were affirmed.

Rioux, 2007 DTC 1146

Calculation of capital gain on disposition of asset revised

In 1995, the taxpayer and another person purchased a garage that had been built in the early 1960s and required extensive repairs. During 1999, the taxpayer reported a cap-

ital gain of $10,000 on the disposition of the garage. In reassessing the taxpayer for 1995, the Minister increased the reported capital gain to $42,480. The Minister's position was that the taxpayer had included $35,000 in capital expenses in his computation of the $10,000 capital gain, when only $2,520 of that $35,000 represented true capital expenditures. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was allowed in part. Some items, such as the cost of transferring title of the garage to the taxpayer, were clearly capital in nature. However, things such as repairing the garage floor were current expenses and not capital outlays. A review of all of the expenses determined that the correct figure for the capital expenses was $9,998.72. The Minister was ordered to reassess accordingly.

Di Fruscia, 2007 DTC 1160

Fairness request re-remitted back to Minister for reconsideration

In a second-level decision, the Minister refused to waive interest owing by the deceased taxpayer's estate on the ground that there was no evidence of financial hardship or extraordinary circumstances. In allowing the estate's application for judicial review, Tremblay-Lamer, J. of the Federal Court quashed the Minister's decision and remitted the matter to the Minister for reconsideration. The Minister again refused to waive the interest owing by the estate. The estate again applied to the Federal Court for judicial review.

The estate's application was allowed. When a discretionary decision is quashed on judicial review and the matter is remitted for redetermination, the expectation is that the new decision-maker will approach the file with an open mind and make an entirely new assessment of the situation. That did not happen in this case. The new decision-maker merely cursorily reviewed the file, so that the Minister's second decision was almost identical to his first one, to the extent of using similar wording. The matter was again remitted to the Minister for a genuine reconsideration.

Dobson Estate, 2007 DTC 5426

Class C shares not required to be included in taxpayer's capital for Part I.3 tax

In allowing the corporate taxpayer's appeal for 2001 to 2003 (2006 DTC 3424), the Tax Court of Canada ordered the Minister to reassess on the basis that the taxpayer's Class C retractable preferred shares were not required to be included in its capital for large corporations tax ("LCT") purposes. The Court's position was that, under subsection 181(3) of the Act, the ordinary legal meaning of capital stock should be rejected in favour of the generally accepted accounting principle ("GAAP") treatment in the taxpayer's balance sheets for the years under appeal. This treatment excluded the Class C shares from the taxpayer's capital, classifying them as debt. In its appeal to the Federal Court of Appeal, the Crown argued that the Tax Court erred in concluding that, under the jurisprudence and subsection 181(3) of the Act, the GAAP characterization of terms in a corporate balance sheet must be accepted in determining capital for LCT purposes.

The Crown's appeal was dismissed. The Crown's argument was untenable. Capital for LCT purposes is determined under subsection 181(3) of the Act. That subsection does not contemplate a distinction between terms with ordinary legal meanings and terms with primary accounting meanings. The taxpayer's Class C shares were properly characterized as liabilities under GAAP in the taxpayer's financial statements. As well, there was nothing in Part I.3 of the Act that specifically required an alternative characterization. Therefore, the Tax Court made no reviewable error. The Minister was ordered to reassess to exclude the taxpayer's Class C shares from its capital for LCT purposes.

Ford Credit Canada Ltd., 2007 DTC 5431

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