CCH
a Wolters Kluwer business

Tax Notes

April 2009
Number 555

# Tax Planning in a Downturn (Part II)

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 the 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 the 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.

## Inside

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 the 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 12 months preceding the time at which the investor triggers the ABIL claim. This time, frame 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

**TAX NOTES**

Published monthly by CCH Canadian Limited. For subscription information, see your CCH Account Manager or call 1-800-268-4522 or (416) 224-2248 (Toronto).

*For CCH Canadian Limited*

ROBERT SPENCELEY, Editor
(416) 224-2224, ext. 6279
e-mail: Robert.Spenceley@wolterskluwer.com

ROBIN MACKIE, Director of Editorial
Tax, Accounting and Financial Planning
(416) 228-6135
e-mail: Robin.Mackie@wolterskluwer.com

TR ISLAM, Marketing Manager
(416) 228-6166
e-mail: TR Islam@wolterskluwer.com

PUBLICATIONS MAIL AGREEMENT NO. 40064546
RETURN UNDELIVERABLE CANADIAN ADDRESSES TO
CIRCULATION DEPT.
330–123 MAIN ST
TORONTO ON M5W 1A1
email circdept@publisher.com

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 transferee.[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 price.[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 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]

*– David Louis, J.D., C.A., Minden Gross, Toronto, a member of MERITAS law firms worldwide.* *Special thanks to Joan Jung, Michael Goldberg, and Samantha Prasad, of the Minden Gross Tax Group, for their presentations on which this article is based.*

**Notes:**

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

[22] Section 61.3 of the Act.

[23] These rules potentially apply where a "specified obligation" becomes held by a person at 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.

# Bill C-10, *Budget Implementation Act, 2009*

On March 12, 2009, Bill C-10, *Budget Implementation Act, 2009* (CCH Special Report 044H), received Royal Assent and is now law as S.C. 2009, c. 2. Commentary updates for the Canada Income Tax Guide are underway to incorporate the amendments contained in Bill C-10, and will be added as soon as possible.

# CRA Q&A Re 2008 RRIF Minimum Amount

Reproduced below are some questions and answers posted by the CRA on March 20, 2009 regarding the calculation of the RRIF minimum amount for 2008 as a result of the changes contained in Bill C-10, which received Royal Assent on March 12, 2009.

**What are the changes?**

The main changes are the following:

- The minimum amount that had to be withdrawn from RRIFs for 2008 was reduced by 25%. For example, if the 2008 minimum amount was $10,000, the reduced minimum amount is $7,500.

- Individuals who withdrew more than the reduced minimum amount can re contribute to their RRIFs an amount up to the 25% reduction. The re-contribution can be deducted for 2008 only.

- The re-contribution has to be made no later than 30 days after the legislative changes were enacted by Parliament. Bill C-10, which included these changes, was enacted by Parliament on March 12, 2009. Accordingly, an individual who received the 2008 unreduced minimum amount, and who has not already made their re-contribution has up to April 14, 2009 to do so.

**What date is to be included on official receipts issued by financial institutions for re-contributions made after March 1, 2009, and up to April 14, 2009?**

Financial institutions are to indicate that the contribution date is March 1, 2009.

**If the re-contribution is made to an RRSP, do the same rules apply?**

Yes. The same rules apply if the re-contribution is made to an RRSP after March 1, 2009, and up to April 14, 2009. The official RRSP receipts issued for these contributions must indicate that the contribution date is March 1, 2009.

**Do the RRSP contributions referred to above form part of the records a financial institution must include in the 2008 RRSP Contribution Information Return that has to be filed electronically by May 1, 2009?**

Yes. These contributions form part of those records. These contributions **must not be included** in the records included in the 2009 RRSP Contribution Information Return. If official RRSP receipts are issued for 2008 after the 2008 RRSP Contribution Information Return is filed with the CRA, amendments to that return must be filed. Please see the information at http://www.cra-arc.gc.ca/esrvc-srvce/rf/menu-eng.html for details about filing information returns electronically and filing amendments to those returns.

# Prescribed Interest Rates – Second Quarter of 2009

The prescribed interest rates for the second quarter of 2009 are noted below:

- 1% to calculate a deemed interest taxable benefit on subsidized employee and shareholder loans;
- 3% on refunds of income tax overpayments; and
- 5% on payments of overdue income taxes, insufficient income tax instalments, unremitted employee source deductions, CPP contributions or EI premiums, and unpaid penalties.

These rates will be in effect from April 1, 2009 to June 30, 2009.

# Recent Technical Interpretations

## Post-Mortem Bump

The CRA was asked to provide a ruling on a post-mortem "bump" transaction as to whether s. 84.1 would apply to a proposed share transfer, when a newly incorporated company acquired control of a holding company, and whether there was an available s. 88(1)(*d*) bump in respect of the of the adjusted cost base of the non-depreciable property of the holding company.

X was a resident of Canada who, at the time of his death, held all of the issued and outstanding shares of Holdco as capital property. Upon his death, X's shares of Holdco passed to his Estate. X was predeceased by his spouse. Pursuant to X's will, the residue of the Estate was bequeathed in equal shares *per stirpes* to Child 1, Child 2, and the children (Grandchild 1 and Grandchild 2) of Child 3 (who predeceased X). The principal assets of Holdco were certain real property, all the shares of Aco, all the shares of Bco, and all the shares of Cco.

The proposed transactions were identified by the Executors of X's Estate as an appropriate means of avoiding double-taxation by obtaining an increase in the adjusted cost base of the property held by Holdco. Accordingly, the proposed transactions were as follows.

The Estate would incorporate Newco. The Estate would transfer all of the shares of Holdco to Newco in exchange for shares of Newco and promissory notes in favour of the Estate. The Estate and Newco would jointly elect to have the rollover rules in s. 85(1) apply. Newco and Holdco would then amalgamate to form Amalco. The issued shares of Newco would become the shares of Amalco, while the shares of Holdco would be cancelled on the amalgamation. In connection with this amalgamation, Amalco would, under s. 87(11) and s. 88(1)(*d*), increase the ACB of the real property, shares of Aco, shares of Cco and shares of Bco (in that order of priority). The Executors would settle the G1 Trust (for Grandchild 1) and the G2 Trust (for Grandchild 2). Then the Executors would distribute the common shares and notes of Amalco to Child 1, Child 2, G1 Trust, and G2 Trust.

In its ruling, the CRA stated that s. 84.1(1)(*b*) would not apply to deem Newco to pay a dividend to the Estate as a consequence of the transfer of Holdco shares to Newco. Also, for the purpose of paragraphs 88(1)(*c*) and (*d*), Newco would be deemed to have last acquired control of Holdco from an arm's-length person at the time immediately after the death of X. Finally, there would be no s. 88(1)(*d*) bump available because Grandchild 1 and Grandchild 2 and the G1 and G2 trusts will acquire substituted property (s. 88(1)(c.3)) as part of a series of transactions (s. 88(1)(*c*)(vi)(A) and (B)) and are not specified persons under s. 88(1)(c.2)(i).

Despite this unfavourable result in respect of the s. 88(1)(*d*) bump, the CRA stated that the Department of Finance has issued a comfort letter to the CRA which stated that an acquisition of substituted property by a trust maintained for the benefit of grandchildren of a deceased person from the Estate should not result in the application of s. 88(1)(*c*)(vi) to deny the bump. The letter also stated that the Department was prepared to recommend to the Minister of Finance that the legislation be amended to achieve this result and would apply to windings-up that begin after 2004. However, as of the January 2009 Budget no such amendment had been introduced.

Document No. 2008-0288221R3, 2008

## Attribution of Trust Income – Beneficiary's Renunciation of Right in Trust Capital

The situation the CRA was asked to comment on involved an individual transferring his "qualified small business corporation shares" (as this term is defined in s. 110.6(1) of the Act) to a trust of which he was a trustee and beneficiary of the trust income and capital. Both his spouse and minor children were also beneficiaries of the trust income and capital. All those trust beneficiaries were Canadian residents. If the shares were sold at a gain, s. 75(2) would apply in respect of the capital gain realized in respect of the shares transferred by the individual and he would be unable to split the gain with the other beneficiaries and enable them to take advantage of their capital gains deduction to reduce or eliminate that gain. For tax planning purposes, the individual contemplates renouncing his right in the trust capital and resigning as trustee a few days before the sale of those shares. In other words, he would renounce receiving any property transferred to the trust or proceeds of disposition of the property or substituted property. The CRA was asked to confirm if the provisions of s. 75(2) would apply in this case. More specifically, the CRA was asked: (1) if s. 75(2) would cease to apply after the renunciation; (2) if the answer is yes, if each beneficiary of the family trust to whom a portion of the capital gain is attributed could claim a capital gains deduction for that gain; (3) if the non-taxable portion of the capital gain remaining in the trust could be paid to the beneficiaries without any immediate tax implications; (4) if the provisions of ss. 56(2) and 56(4) of the Act could apply if the renunciation was legally valid; and (5) if there was a disposition of a capital interest, assuming the renunciation was not made in favour of someone and was legally valid.

Regarding the first question, the CRA confirmed that the provisions of s. 75(2) of the Act would not apply in this case provided: (1) the individual's renunciation was legally valid and exercised before the trustees exercised their discretion; and (2) he could not under any circumstances again become a beneficiary of the trust property (i.e., qualified small business corporation shares) or of a substituted property (including the proceeds of disposition of that property). This would be the case even if the above individual was a beneficiary of the trust income under civil or common law. Other attribution rules described in ss. 74.1, 74.2, and 74.3 would still apply to this situation if the exception under s. 74.5(13) was not applicable. Regarding the second question, any portion of the taxable capital gain realized from the sale of the shares and allocated to the spouse under s. 104(21) could be attributed back to the individual under ss. 74.2(1) and 74.3(1). This would prevent the spouse from claiming the capital gains deduction available under s. 110.6(2.1) in respect of that gain. Regarding the minor beneficiaries, the above attribution rule would not apply and they could claim the capital gains deduction in respect of the taxable capital gain allocated to them but only if the taxable portion of the gain was paid to them during the year and an amount was allocated to them and designated by the trust under ss. 104(21) and 104(21.2). After the allocation and designation of the gain, the children would be deemed to have disposed of the shares and become entitled to claim a capital gains deduction. Regarding the third question, the payment of the non-taxable portion of the gain to the beneficiaries of the trust capital would not constitute a disposition for the purpose of the application of s. 107(2.1) and would thus have no tax implications provided it was made in cash and covered in paragraph (i) of the definition of "disposition" in s. 248(1). The CRA noted that, even though the payment was not covered in paragraph (i) of the above definition and s. 107(2.1) was applicable, this would have no tax implications for either the trust (since the payment would be made in cash) or the beneficiary (since the proceeds of disposition in respect of the interest, as calculated in s. 107(2.1), would be reduced from the payment described in paragraph (i) of the definition of "disposition" in s. 248(1)). Note that, if paragraph (i) did not apply, there would be a disposition of the interest under paragraph (*d*) and the provisions of s. 107(4.1) of the Act could apply to the allocation of the gain to the children. Regarding the fourth question, the provisions of ss. 56(2) and 56(4) could not apply to this situation since in the first case the capital interest which the individual renounced would not have been included in his income and in the second case the individual renounced the total property, not only the right to income. Regarding the fourth question, the CRA confirmed that, if the renunciation was legally valid and not made in favour of someone, there would be a disposition of a capital interest in a trust but the proceeds of disposition would be nil.

The CRA assumed (for the purpose of this interpretation) that the trust was a discretionary trust but would need (for the purpose of issuing an advance income tax ruling) to confirm with their legal services that a beneficiary holding an interest in the discretionary capital of a trust could renounce, before a trustee could exercise his discretion, a specific property held by the trust (including the proceeds of disposition of the property) and another property substituted for the property. Note that the CRA's legal services concluded a few years ago that it was impossible for a beneficiary of a discretionary trust to only partially renounce the income of a specific property held in a dis-

cretionary trust. A renunciation that would be considered legally invalid by the legal services would be ignored by the CRA and the capital gain would be attributed back to the individual in accordance with s. 75(2) of the Act.

Document No. 2008-0279741E5, December 16, 2008

## Interest Deductibility

The CRA was asked whether interest on borrowed money used to acquire shares would continue to be deductible pursuant to s. 20(1)(*c*) where the taxpayer disposed of the shares and the proceeds of disposition were used to fund a return of capital.

The taxpayer was a wholly owned subsidiary of Parentco. The taxpayer borrowed an amount and had an amount payable to fund the purchase of all the shares of Can Holdco, which, in turn, owned a group of foreign subsidiaries. The interest on such borrowed funds was deductible to the taxpayer under ss. 20(1)(*c*)(i) and (ii).

The taxpayer proposed a corporate reorganization, the end result of which would have been the transfer of all the taxpayer's common shares in Can Holdco to a New ULC. The taxpayer would hold a special share in New ULC, and after a series of transactions, New ULC would hold a special share in the taxpayer. The special shares would be redeemed, and such redemption would result in a return of capital to New ULC.

The CRA was satisfied that the transactions, though circuitous, satisfied the requirements for continued deductibility under s. 20(1)(*c*). The CRA stated that, to the extent that the amount of the redemption did not exceed the original indebtedness and the capital redeemed was being used for purposes that would have qualified for interest deductibility, the proposed transactions would not, in and of themselves, cause the interest to not be deductible under s. 20(1)(*c*).

Document No. 2007-0256671R3, 2008

## Foreign Exchange Loss on Disposition of Cash

The CRA was asked whether ss. 40(3.3), 40(3.4), and 40(2)(*g*)(i) apply to deny a foreign exchange loss realized on the disposition of foreign cash. Specifically, the CRA was asked whether, on a disposition of cash (i.e., to pay a dividend), where such cash was later replaced with additional cash, the additional cash would be identical property under the stop loss rules in the Act.

Canco was a corporation resident in Canada. Forco, a non-resident corporation, was a wholly owned subsidiary of Canco. Forco was the financing entity for Canco and other foreign affiliates in the corporate group. Forco invested excess cash in U.S. term deposits and kept its U.S. cash in an interest-bearing bank account. Forco and Canco considered that the term deposits and the bank account were held on capital account and were not excluded property for the purpose of calculating Canco's FAPI.

The CRA agreed that Forco was correctly reporting its foreign exchange gains or losses on account of capital. Where the cash was used to purchase U.S. term deposits, no gain or loss was reported. When the cash was used to make an investment or a loan or to pay a dividend, a gain or loss was reported. In the CRA's view, in the latter circumstances, there had been a disposition of the cash.

In respect of the stop loss rules, the CRA stated that s. 39(2) applies when a taxpayer's gain or loss on the disposition of capital property arose solely as a result of the fluctuation of foreign currency relative to the Canadian dollar. If, under s. 40, the loss is deemed to be nil, then the taxpayer has not sustained a loss.

Subparagraph 40(2)(*g*)(i) applies to deem a loss to be nil where there has been a superficial loss. Importantly, a loss is not a superficial loss if the disposition is subject to s. 40(3.4). Subsections 40(3.3) and 40(3.4) apply on a disposition of property by a corporation, trust or partnership and the transferor acquires the property or identical property within 30 days before or after the disposition. Where ss. 40(3.3) and (3.4) apply, the loss is "suspended" until neither the transferor nor an affiliated person owns the property for 30 days.

The CRA considers that "identical properties" are properties that are the same in all material respects. Subsection 248(1) defines "property" to include money (unless a contrary intent is evident). Accordingly, cash and term deposits are not identical properties. However, when cash is replaced with more cash, it is possible that ss. 40(3.3) and 40(3.4) apply to "suspend" the foreign exchange losses. If these provisions apply to the disposition of cash, then the loss, if any, could be suspended indefinitely as cash goes out of and comes into Forco.

On this point, the CRA concluded that, in the context of a foreign exchange loss on the disposition of cash, the cash would not be "property" for the purposes of ss. 40(3.3) and 40(3.4) and s. 40(2)(*g*)(i). As a result, these provisions would not apply to deny the foreign exchange loss realized by Forco when the U.S. cash is used to make an investment or a loan or to pay a dividend.

Document No. 2008-0280111I7, January 6, 2009

## Specified Investment Business

The CRA was asked whether, under two different scenarios, an associated property management company was a specified investment business under s. 125(7).

The taxpayers were Canadian resident individuals who are members of a family that owns shares in three holding companies – Holdco1, Holdco2, and Holdco3 (collectively the "holding companies"). The holding companies held certain commercial real estate rental properties.

In Scenario 1, each commercial rental property would be co-owned by the holding companies, which would carry on business in a joint venture. A new company would be established (Newco) and would be associated with each co-owner. Newco would employ more than five full-time employees and would provide exclusive property management services to the co-owner.

In Scenario 2, all commercial rental properties would be owned in a partnership, and the partnership interests would be held by the holding companies. The partnership would employ more than five full-time employees.

The CRA stated that, under Scenario 1, the applicable test would be whether, pursuant to paragraph (*b*) of the definition of "specified investment business" in s. 125(7), it could reasonably be expected that the particular corporation (i.e., each Holdco co-owner) would have required more than five full-time employees in its business had the property management services not been provided by Newco. Further, the CRA stated that it would not consider each Holdco co-owner to be in the same business as Newco because the business of each Holdco is to derive income from property in the form of rent while Newco is in the business of rendering property management services.

In respect of Scenario 2, the CRA stated a business carried on by a corporation as a member of a partnership is not a specified investment business if the partnership employs more than five full-time employees. Each corporate partner's share of the partnership income would be included in its calculation of its specified partnership income.

Additionally, though not noted by the CRA in this instance, the case of *489599 B.C. Ltd. v. R.*, 2007 DTC 347 (T.C.C.) established that "more than five full-time employees" means five full-time employees and one or more full-time or part-time employees. The CRA accepts that this definition is applicable for the purpose of the definition of "specified investment business" in s. 125(7).

Document No. 2008-0284681E5, January 20, 2009

## Employer-Paid Social Events

The CRA was asked whether an employee will be considered to have received a taxable benefit pursuant to s. 6(1)(*a*) where the employer pays for the employee to travel from an out-of-town location to the employer's main place of business in order to attend the employer's social event. The CRA stated that despite the decision in *Dunlap v. The Queen*, 1998 DTC 2053 (T.C.C.) (where it was held that where the employee and the employee's guest attended a Christmas party paid for by the employer, the employee received a taxable benefit because it was "an additional way in which this employer chose to recognize and remunerate his employees for their loyal services"), it will generally not assess a taxable benefit to an employee for attending an employer provided social event where the particular social event is "generally available to all employees" and the cost per employee is reasonable in the circumstances.

The CRA stated that "generally available to all employees" is broad enough to mean employees of a particular branch or division of a business, and that "reasonable in the circumstances" will generally include anything that costs the employer $100 per person or less. Social events that cost more than $100 per person may result in a taxable benefit, depending on the facts and circumstances. Additional costs associated with transportation will most certainly increase the cost to over $100 for out-of-town employees, but the CRA stated that "we would anticipate that in making such a trip, the employee would take the opportunity to combine work-related matters with attending the social function" and that in such a case such additional costs will not result in a taxable benefit. Furthermore, such additional costs cannot be treated as a tax-free gift or award under the CRA's administrative policy for non-cash gifts and awards.

Document No. 2008-0294521E5, January 14, 2009

CCH a Wolters Kluwer business

CCH Canadian Limited
300-90 Sheppard Avenue East
Toronto ON M2N 6X1
416 224 2248 • 1 800 268 4522 tel
416 224 2243 • 1 800 461 4131 fax
www.cch.ca