BREAKFAST FOR BUSINESS

GEARING UP FOR YEAR END

Presented

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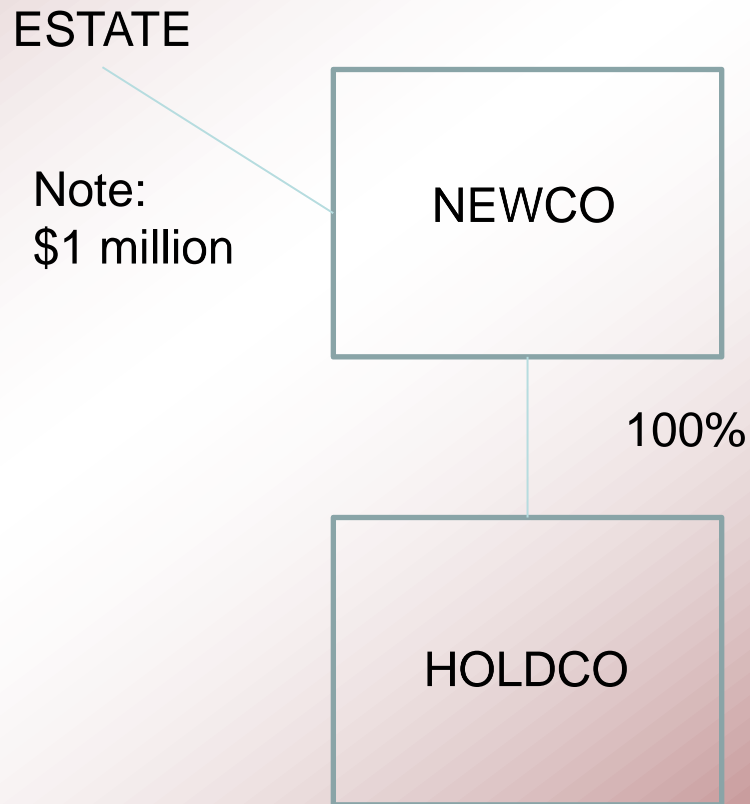
PIPELINE

Typical scenario

- Holdco shares transferred to Newco- note taken back reflecting high abc



84.1

- Possible application
- Not applicable if note does not exceed greater of paid-up capital and “actual” adjusted cost base of shares transferred

84(2)

- Why subsection 84(2) should not apply
  - Firstly, specific anti-avoidance rule 84.1 applies if it does not then conversion to capital is permitted
  - Note repaid to taxpayer "qua" creditor
  - Deemed gain on death which is subject to tax should be treated like tax paid funds, which, if used to purchase shares, can be extracted.
  - Does not have protections in this instance that are in subsection 88(2)

"WINDING UP, DISCONTINUANCE OR REORGANIZATION OF ITS BUSINESS"

- "widest import" – not just legal winding up of a corporation but of the business.
- "on" - one year deferral of wind-up not a requirement-rather determined on a case by case basis.
- "business" – presumption that a corporation has a business.

AVOIDING 84(2)

- Amalgamation
- High paid-up capital shares

CONCLUSION 84(2)

- All shareholders have to receive appropriation or distribution
- Windup or amalgamation is necessary or the “shareholders” are not Holdco’s shareholders

PIPELINE STRATEGY: IS IT WORTH IT?

EXAMPLE

Year 2000

- Z incorporates Zco with nominal share capital
- Z lends $100,000 to Zco
- Zco buys condo for $100,000
- Zco operates on break-even basis for 10 years

PIPELINE STRATEGY: IS IT WORTH IT?

EXAMPLE (Cont'd)

Year 2011

- Z dies-ACB/PUC of shares nominal
- Condo FMV is $500,000/$UCC=$80,000
- Zco owes $80,000 on shareholder loan
- Z reports $420,000 capital gain on terminal return

PIPELINE STRATEGY: IS IT WORTH IT? (Cont'd)

- EXAMPLE (Cont'd)

- Should pipeline be implemented?
- What is the value?
- May be better to trigger sale in first year of estate

Recent Cases and Legislation

- October 31 Legislative Proposals – appear to pick up the July 16, 2010 proposals which succeeded Bill C-10
- Sale Transactions:
  - Earn-out or sale price? *Smith v. The Queen* 2011 TCC 461
  - Calculation of sale proceeds - *Daishowa-Marubeni International Ltd. v. the Queen* 2011 FCA 267
- The GAAR Trilogy – Artificial Losses:
  - *Triad Gestco* – taxpayer lost
  - *1207192 Ontario Limited* – taxpayer lost
  - *Global Equity Fund Ltd* 2011 TCC 507 – CRA lost
- Comic Relief

Smith v. the Queen

- Vendor taxpayer, insurance broker, sold his client list to third party with formula price payable over several years
- Original sale agreement set out a price based on historic commission stream, with formula for adjustments based on actual commissions
- Price adjustment clause invoked and payments beyond original estimates were paid to taxpayer
- CRA assessed entire subsequent payments (not just excess over estimates) under par. 12(1)(g)
- CRA assessed interest on those payments as investment income
- Vendor claimed eligible capital treatment

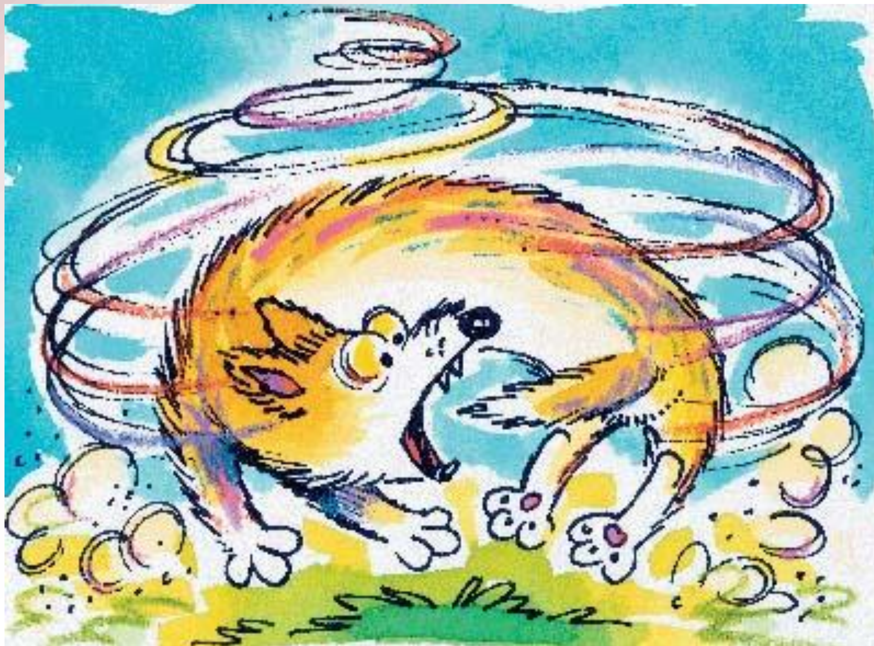
- Taxpayer claimed future payments were not dependent on production or use of property, but were established price, adjusted in accordance with contract
- Sale proceeds were received on account of capital, and s. 14 took precedence over par. 12(1)(g)
- Sale contract provided that future payments would be "adjusted each year … based on actual commission revenue"

- TCC noted case law that payment for a client list is on capital account – but that does not preclude application of par. 12(1)(g) – "it is necessary to determine whether the amounts received were dependent on the use or production of the property"
- Sale price was not fixed and determined in advance since the annual payments were calculated each year based on commissions received for the prior year. Client list was also variable as clients could be added or removed.
- Interest included in income under par 12(1)(c)

Planning in Response

- Try to establish a maximum possible sale price, with reductions if performance standards are not met (“reverse” earn out)
- That way taxpayer can demonstrate a “fixed and determined” sale price, and adjustments do not give rise to payments subject to par 12(1)(g)

Daishowa-Marubeni



Background

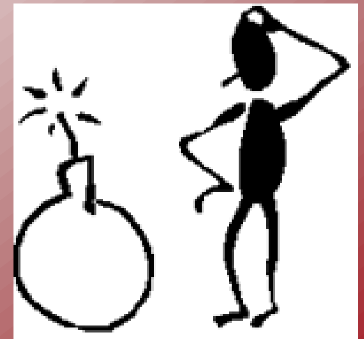
- Taxpayer sold two businesses
- Purchaser had to assume future silviculture and reforestation obligations under provincial law
- Government would not allow assignment of timber rights unless purchaser assumed future obligations; vendor thereby relieved of them
- Not clear (but doubtful) those future obligations were reflected on vendor’s balance sheet

The Problem

- CRA added to vendor's proceeds of disposition the amount of future obligations assumed
- If CRA was successful, vendor would recognize income without benefit of offsetting deduction for future expenses
- Taxpayer argued that amount of future obligation was unascertainable and should therefore be $0
- CRA – parties had agreed on an amount for the future liabilities

- CRA’s view – parties agreed on estimated amount for future obligations, which should be included in proceeds of disposition
- Court – what was the value of the benefit to the vendor of the purchaser’s assumption of the future obligations?
- Vendor could not sell without being relieved of these obligations. “How does one value a liability that effectively disappears on the transfer [of assets]?”

- Tax Court – the fact the parties agreed on an amount for future obligations in determining the cash purchase price does not mean they agreed that amount reflected the value of the assumption of the liability.
- Lack of symmetry in tax consequences further justified the discount
- Court discounted liability 80% - “even in taxation law, the law can sometimes be imprecise”!
- Judgment appealed



FCA Decision

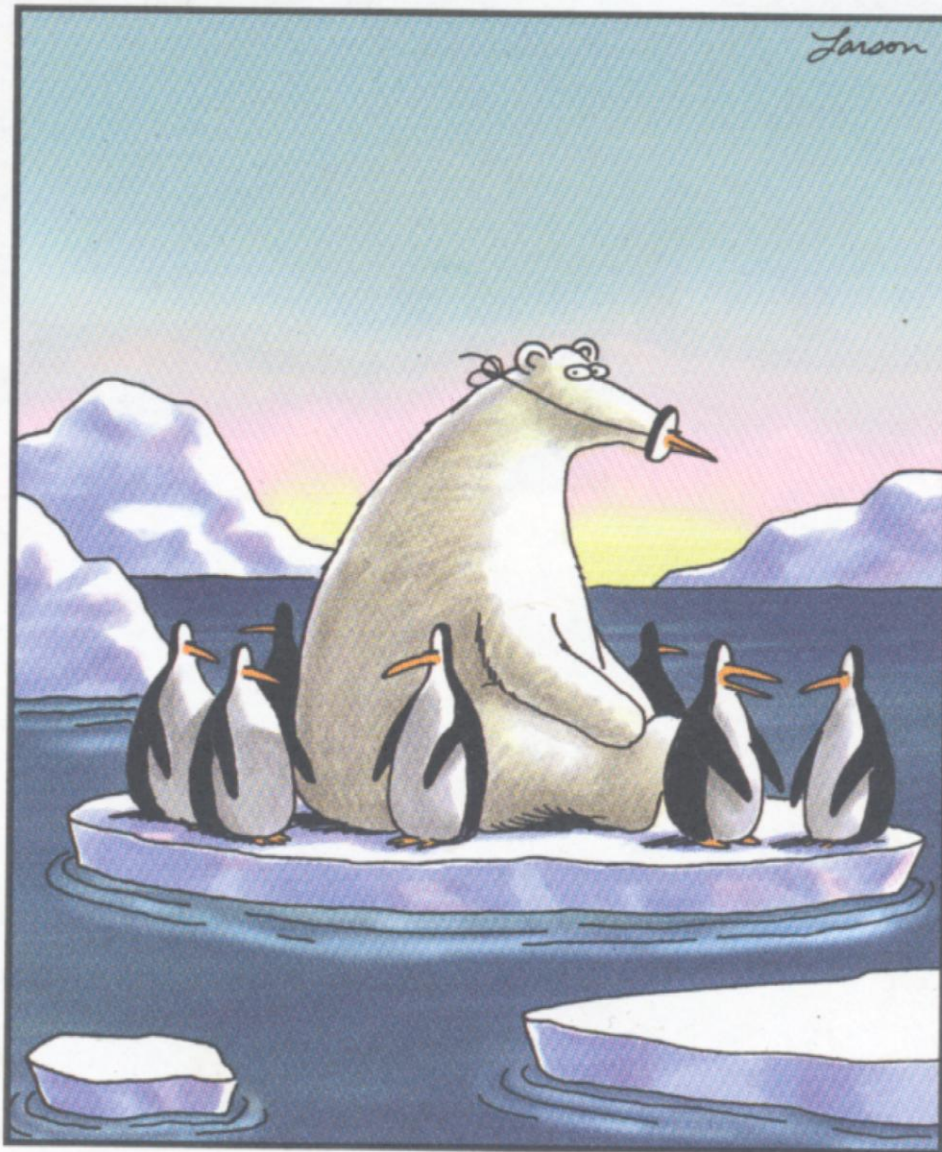
- Split decision allowing Crown’s appeal
- FCA disagreed with TCJ approach to discounting the long term liabilities (predictable)
- Majority overturned TCC decision and added entire amount of liabilities assumed to sale proceeds
- Dissent decision more compelling and reflects fundamental misunderstanding by other judges of the nature of the assets sold

Dissenting Decision

- The reforestation liabilities are an integral part of the timber rights
- Those liabilities affect the value of the timber rights, but the assumption of those liabilities is not part of the consideration
- The liabilities reduce the sale price to the vendor, and become obligations of the purchaser by the nature of the asset, not because of the purchase agreement

Planning in Response

- **The war is not over** – FCA dealt only with the sale of one division and referred the tax consequences of the sale of the second division back to the TCC – so this issue could be re-tried
- Period for appeal to SCC expires November 20, 2011
- **Sale planning for future obligations** – pension, employee severance, environmental remediation
  - Those types of obligations run with the assets acquired (workforce, land) and are not third party debts – in fact, those obligations may never arise!
  - Such obligations may reduce the price a purchaser is willing to pay, but that reduction in price does not equate to the payment of additional purchase price.



"And now Edgar's gone. … Something's going on around here."

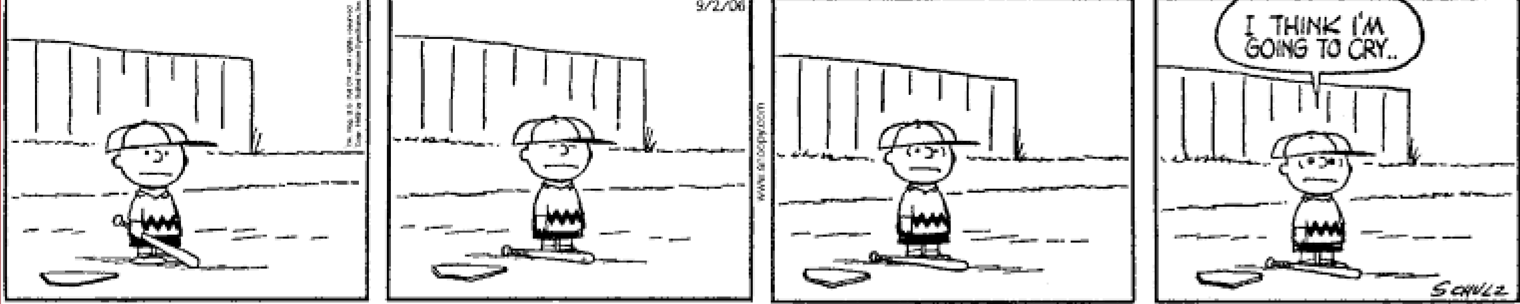
The GAAR Trilogy

Triad Gestco

- Taxpayer tried to undertake a “reverse” estate freeze, realizing a capital loss on a disposition of shares to a trust that was not affiliated with the taxpayer
- TCC – the fact that the stop loss rules in 40(2)(g)(i) as it read at the time did not apply to trusts did not prevent the transaction from being abusive.
- Subsequent amendment which brought trusts within the scope of the stop loss rule was evidence that the results of taxpayer’s acts was contrary to the object, spirit and purpose of the ITA
- Under appeal to FCA

1207192 Ontario Limited

- Taxpayer argued primary purpose of the transactions was to creditor proof the taxpayer.
- Series of transactions included a “value shift” from common shares to redeemable special shares, with a resulting capital loss on sale of the common shares to a family trust (which TCC found was not, by itself, abusive tax avoidance)
- TCC – realization of the loss not *per se* abusive – but Crown demonstrated policy behind the stop loss rules was to allow capital losses only to the extent they reflect an underlying economic loss
- Transactions “are artificial and lack substance”
- Under appeal to FCA



Global Equity Fund Ltd. v. the Queen

- Taxpayer entered into a series of value stripping transactions that produced a significant income loss which it carried back to offset profits of prior years
- CRA disallowed loss – artificial since no real economic loss was suffered
- Taxpayer – GAAR not applicable since business purpose was creditor protection, and transactions not abusive because the Act does not prevent the deduction of artificial business losses

- TCC – Crown has the burden to establish an abuse of the Act “and that burden has not been satisfied in my view”
- “Notwithstanding the result in this appeal, readers should be cautious before concluding that the GAAR does not apply to transactions of this type. If different arguments had been raised by the Crown, perhaps the result would have been similar to that reached in *Triad Gestco* and *1207192 Ontario*.”

- Par 88: “… I am not satisfied that the Crown has satisfied the burden with respect to this element of the GAAR. The Crown submits that the object and spirit of the Act is to permit losses to be deducted only if they are not artificially created losses. This appears to be eminently reasonable from a policy standpoint, and yet I am not satisfied that this is the intent of the legislative provisions relied on based on the arguments that the Crown has made. If burden is to have real meaning, the Crown must do more than allege an object and spirit – it must provide a reasonable basis for it.”

- Par 92: “the problem that I have with the Crown’s argument is that the provisions referred to by the Crown are limited in scope. None of them, either separately or together, in my view, are suggestive of the broad object and spirit that business losses are limited to real losses realized outside the economic unit.”
- Par 99: “The provisions are too narrowly drawn to disclose an intention by Parliament of a general restriction against the deduction of artificially created business losses.”

Comic Relief

- Canadian corporate taxpayer, with management and employees and operations in Canada, seeks confirmation of tax treatment of expenses to be incurred in asteroid mining
- Such expenses do not generate METC since underlying expenses are not CEE (but Q FEDE?)
- Since no deduction for off-world expenses, shouldn't income be excluded from tax net??

NASA

- CRA response – ITA s.3 refers to income from sources “outside Canada” – so asteroid mining income taxable in Canada
- No comment on treatment of other expenses:
  - Launch fees as pre-production expenses?
  - Are operations on another asteroid an extension of an existing mine, or a new mine?