When Is a Loss a Loss and When Can You Claim a Loss

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I. ABSTRACT

The authors will review the concept of loss[1] trading that was perceived as abusive by the Canada Revenue Agency (CRA) and, ultimately, by the Department of Finance as evidenced by the introduction of the concept of a "loss restriction event" (LRE) in section 251.2.[2] The authors will also analyze the application of the suspended loss rules in subsections 13(21.2), 40(3.3) and 40(3.4) as well as certain related provisions. Finally, they will review a situation where a historical ruling, if considered in advance of a transaction, may still be beneficial as well as overview some practical considerations arising as a consequence of section 256.1.

II. INTRODUCTION

Loss utilization has been canvassed extensively in Canadian tax literature. The vast amount of literature on point is likely owing to, among other things, the following reasons:

1. Complexity: as this paper will illustrate, the legislative landscape pertaining to the use of losses is often quite technical and fraught with numerous pitfalls and

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1 Unless otherwise noted, references to a "loss" is a reference to a "non-capital loss" as defined in subsection 111(8) of the *Income Tax Act* (Canada) RSC 1958, c.1 (5th Supp.), ("the Act"). Unless otherwise noted, all statutory references herein are to the Act.

2 The loss restriction rules prior to the introduction of the LRE rules in section 251.2 will be referred to in this paper as the "Old Regime" and the loss restriction rules following the introduction of the LRE rules will be referred to in this paper as the "LRE Regime."

landmines that can frustrate innocent and less than innocent loss utilization structures.

2. Competing Policies: while historically it was thought that there was no overriding policy in the Act against loss utilization other than in the circumstances specifically addressed in the Act,[3] more recent judicial[4] and legislative[5] developments call the correctness of this line of thinking into question.

3. High Value: at the risk of stating the obvious, accessing or unlocking losses can be a valuable proposition as each dollar of loss used will reduce the amount of income subject to tax in a like amount.

4. Shifting Sands: the administrative, legislative, judicial and planning landscape as it pertains to loss utilization is very dynamic, necessitating regular study, restudy and refinement.

In this paper, we review the perceived problem of loss trading, discuss the LRE Regime which is applicable to corporations and trusts, highlight the impact of certain stop loss rules and overview a historical ruling that may still be of benefit under the LRE Regime as well as consider some practical considerations arising as a consequence of section 256.1.

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3 In *Landrus v. R,* 2009 FCA 113, affirming 2008 TCC 274, the Federal Court of Appeal confirmed at paragraphs 47-48 that the existence of various loss-denial provisions in the Act does not evidence the existence of an overall policy prohibiting losses on a transfer between parties forming an economic unit.

4 The trilogy of cases of *1207192 Ontario Ltd. v. R.,* 2012 FCA 259, *Triad Gestco Ltd. v. R.,* 2012 FCA 258 and *Global Equity Fund Ltd. v. R.,* 2012 FCA 272 suggest that there is a policy in the Act to only recognize "true capital losses incurred outside the same economic unit" and that in order for business losses to be deductible, the losses "must be grounded in some form of economic or business reality."

5 Canada, Department of Finance, 2013 Budget, Budget Plan, March 21, 2013 (Budget 2013).

III. OLD REGIME

Under the Old Regime, the utilization of losses[6] by a corporation became restricted under section 111 when there was an acquisition of control of the corporation by a person or group of persons. These restrictions were such that net capital losses and non-capital losses from property incurred before the acquisition of control became non-deductible following the acquisition of control. However, non-capital losses from a business remained deductible provided that the business in which the losses were incurred continued to be carried on for a profit or with a reasonable expectation of profit. Furthermore, such non-capital losses were only deductible against income from the loss business or from a similar business (the so-called "same or similar business test").[7]

An acquisition of control of or a change in the beneficial interests in a trust did not impact the deductibility of the trust's losses under the Old Regime. Rather, the limitations on deductibility of losses under the Old Regime were restricted to loss balances of corporations. Also important to note is the Old Regime was based strictly on the concept of *de jure* control and not *de facto* control. Thus, in circumstances where there was no unanimous shareholders agreement or other atypical situation impacting the appointment of directors, the limitations on deductibility

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[6] The use of various other tax attributes also becomes restricted, including investment tax credits, scientific research and experimental development pools and resource pools as well as denying the carryover of net capital losses. In addition, the corporation undergoes a deemed year-end under subsection 249(4).

[7] The "same or similar business test" in subsection 111(5) contains numerous additional qualifiers and requirements that should be reviewed carefully when working in this area.

of losses under the Old Regime would not be engaged unless a person or group of persons[8] acquired sufficient voting shares to elect a majority of the directors of a corporation.[9] This encouraged the development of various creative structures that either:

1. Strove to shift profits or profitable businesses to corporations with available loss balances while carefully avoiding acquiring *de jure* control of such corporations;[10] or

2. Acquire all or a large proportion of the beneficial interests in trusts (especially mutual fund trusts) with available loss balances and then shift profits or profitable businesses to such trusts.

Presumably due to the proliferation of high dollar value loss utilization transactions,[11] the Department of Finance took direct aim at these structures in Budget 2013. Specifically, the Department of Finance stated that:

> These loss-trading transactions constitute aggressive tax avoidance and undermine the integrity of the income tax provisions that constrain the trading of corporate loss pools among arm's length persons. Depending on their

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8 *Silicon Graphics Ltd. v. Canada,* 2002 FCA 260 establishes that for individual shareholders to be considered a "group of persons", there must exist between them a "sufficient common connection" and that evidence of such a link might include a voting agreement, an agreement to act in concert, or business or family relationship.

9 *Buckerfield's Ltd. v. Minister of National Revenue*, [1964] C.T.C. 504 (Can. Ex. Ct.) at paragraph 10 confirmed that *de jure* control contemplates the right of control that rests in ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the board of directors.

10 As was the case in *Duha Printers (Western) Ltd. v. The Queen*, [1998] 1 SCR 795.

11 Loss utilization structures were becoming increasingly common in income trust deconversion structures.

> particular facts, these transactions can be challenged by the Government based on existing rules in the Income Tax Act. However, as any such challenge could be both time-consuming and costly, the Government is introducing specific legislative measures to ensure that the appropriate tax consequences apply to these transactions.

This signaled the introduction of the LRE Regime.

IV. LRE REGIME: CORPORATIONS

Paragraph 251.2(2)(a) provides that a corporation is subject to a LRE when control of the corporation is acquired by a person or group of persons. Thus, the acquisition of control of a corporation remains relevant for determining whether the utilization of losses by the corporation will become restricted. However, section 256.1, as part of the LRE Regime, dramatically expands the circumstances in which control of a corporation will be deemed to have been acquired by a person or group of persons as well as impacting the implications of such a deemed acquisition of control.

Section 256.1 is drafted in a modern style. Specifically, rather than having the required conditions and consequences of satisfying such conditions set out in a single provision, subsection (2) sets out the conditions that must be satisfied in order for the consequences set out in subsection (3) to apply. In addition, certain relevant definitions are set out in subsection

(1), interpretive rules are laid out in subsections (4)[12] and (5)[13] and an anti-avoidance provision is provided in subsection (6).

Subsection 256.1(2) provides that subsection 256.1(3) applies at a particular time in respect of a corporation if the following conditions are met at any particular time:

1. At the particular time, shares of the corporation held by a person[14] or group of persons have a fair market value greater than 75% of the fair market value of all the shares of the corporation;[15]

2. Immediately before the particular time, the fair market value of the shares of the corporation held by the person or group of persons had a fair market value of 75% or less of the fair market value of all the shares of the corporation;[16]

3. The person or group does not control the corporation at the particular time;[17] and

[12] This provision provides that for purposes of determining whether a person or group of persons holds shares with a fair market value greater than 75% of the fair market value of all shares of the corporation, certain transactions or events undertaken for avoiding the 75% threshold will be ignored and rights referred to in paragraph 251(5)(b) are deemed to have been exercised.

[13] This provision provides that, for the purposes of subsections 256.1(2) to (4), if the fair market value of the shares of the capital stock of a corporation is nil at any time, then for the purpose of determining the fair market value of those shares, the corporation is deemed, at that time, to have assets net of liabilities equal to $100,000 and to have $100,000 of income for the taxation year that includes that time.

[14] For these purposes, "person" includes a partnership pursuant to the definition of that term in subsection 256.1(1).

[15] Paragraph 256.1(2)(a).

[16] Paragraph 256.1(2)(b).

[17] Paragraph 256.1(2)(c).

4. It is reasonable to conclude one of the main reasons that the person or group does not control the corporation is to avoid the application of one or more specified provisions.[18]

If the four conditions listed above are satisfied, then for the purposes of the attribute trading restrictions:[19]

1. The person or group:

   (a) Is deemed to acquire control of the corporation and each corporation controlled by the corporation at the particular time,[20] and

   (b) Is not deemed to have control of the corporations at any time after the particular time solely because this paragraph applied at the particular time;[21] and

2. During the period that the person or group held shares having a fair market value greater than 75% of the fair market value of all the shares of the

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[18] Paragraph 256.1(2)(d). "[S]pecified provision" is defined in subsection 256.1(1) as any of subsections 10(10) and 13(24), paragraph 37(1)(h), subsections 66(11.4) and (11.5), 66.7(10) and (11), 69(11) and 111(4), (5), (5.1), (5.2) and (5.3), paragraphs (j) and (k) of the definition "investment tax credit" in subsection 127(9), subsections 181.1(7) and 190.1(6) and any provision of similar effect.

[19] "[A]ttribute trading restriction" means a restriction on the use of a tax attribute arising on the application, either alone or in combination with other provisions, of section 256.1, subsections 10(10) and 13(24), section 37, subsections 66(11.4) and (11.5), 66.7(10) and (11), 69(11) and 88(1.1) and (1.2), sections 111 and 127 and subsections 181.1(7), 190.1(6), 249(4) and 256(7).

[20] Subparagraph 256.1(3)(a)(i).

[21] Paragraph 256.1(3)(b).

corporation, each of the controlled corporations[22] is deemed not to be related to, or affiliated with, any person to which it was related to, or affiliated with, immediately before the 75% threshold is met.[23]

Clearly, the circumstances in which the use of losses by a corporation will be restricted have shifted radically from the requirement under the Old Regime for a person or group of persons to acquire *de jure* control of the corporation to the much broader reaching deemed acquisition of control rules under the LRE Regime together with the traditional acquisition of control rules.

V. LRE REGIME: TRUSTS

When a trust is subject to a LRE, the use of losses by the trust becomes restricted in a manner similar to a corporation that has experienced a LRE.[24] Effectively, the LRE Regime has extended the restrictions on loss utilization that formerly applied strictly on an acquisition of control of a corporation to trusts.[25]

Paragraph 251.2(2)(b) provides that, after March 20, 2013, an existing trust is subject to a LRE when a person[26] becomes a majority-interest beneficiary, or a group of persons becomes a

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22 Plus any corporation incorporated or otherwise formed subsequent to that time and controlled by the corporation.

23 Subparagraph 256.1(3)(a)(i).

24 The use of various other tax attributes, such as those highlighted in note 6 above, also become restricted as well as denying the carryover of net capital losses. In addition, the trust undergoes a deemed year-end under subsection 249(4), subject to certain limitations in subsection 251.2(7).

25 As these rules are targeted at beneficial interests in a trust rather than control of the property of the trust, they are more akin to the deemed acquisition of control rules in section 256.1 rather than the traditional acquisition of *de jure* control rules.

26 For these purposes, a "person" again includes a partnership pursuant to the definition of that term in subsection 251.2(1).

majority-interest group of beneficiaries, of the trust.[27] In general terms, if a person, together with all affiliated[28] persons, has a beneficial interest in greater than 50 percent of either the income or capital of a trust, then the person is a majority-interest beneficiary of the trust. Similarly, in general terms, if a group of beneficiaries collectively has a beneficial interest in greater than 50 percent of either the income or capital of a trust, then the group of beneficiaries is a majority-interest group of beneficiaries of the trust.

From this basic starting point, the legislative framework becomes markedly more complex, including:[29]

1. Deeming provisions that prevent a person from becoming a majority-interest beneficiary and a group of persons from becoming a majority interest group of beneficiaries of a trust (thereby avoiding subjecting the trust to a LRE) on account of certain:

    (a) Acquisitions of equity of the trust in transactions between certain persons affiliated with each other and with persons affiliated with the trust;[30]

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[27] Subsection 251.2(1) provides that, for these purposes, the terms "beneficiary", "majority-interest beneficiary" and "majority-interest group of beneficiaries" have the meanings set out in subsection 251.1(3).

[28] For these purposes, the concept of "affiliated" is substantially expanded by subparagraph 251.2(5)(a)(ii), which provides that individuals connected by blood relationship, adoption, marriage or common-law partnership are deemed to be affiliated with one another.

[29] For a more detailed discussion of these various rules, see John Burghardt and Sarah Chiu, "'Loss' Is Just a Four-Letter Word: Policy, Practice, and Proposals," *2013 Conference Report,* (Toronto: Canadian Tax Foundation, 2014), 14: 1-43.

[30] Subparagraphs 251.2(3)(a)(i) and (ii).

(b) Acquisitions and dispositions of equity of the trust by estates in limited circumstances;[31]

(c) Variations in the terms of the trust, the satisfaction or non-satisfaction of conditions under the terms of the trust or the exercise or non-exercise of powers or the redemption, surrender or termination of equity of the trust;[32]

(d) Reorganization transactions;[33]

(e) Grandfathered transactions that the parties were obligated to complete under a written agreement entered into before March 21, 2013;[34] and

(f) Transactions involving trusts that are "investment funds";[35]

2. Deeming a person to become a majority-interest beneficiary of a trust, thereby subjecting the trust to a LRE in certain circumstances;[36]

3. Outlining various interpretive rules, including:

(a) Other than for purposes of the definition of "subsidiary" in subsection 251.2(1), control refers to *de jure* control and not *de facto* control;[37]

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31 Subparagraphs 251.2(3)(a)(iii) and (iv).

32 Paragraph 251.2(3)(b).

33 Paragraphs 251.2(3)(c) and (d).

34 Paragraph 251.2(3)(e).

35 Paragraph 251.2(3)(f).

36 Subsection 251.2(4).

(b) Expanding the concept of "affiliated" in the manner described in note 28 which, in the case of two individuals, effectively equates the concept of "affiliated" with that of "related";[38]

(c) An anti-avoidance provision where transactions are undertaken in order to cause persons to be affiliated;[39]

(d) Anti-avoidance provisions relating to determining the value of a person's equity of the trust;[40]

(e) When a trust is subject to a LRE and the trust (or a group of persons a member of which is the trust) controls a corporation, then the corporation (and each other corporation controlled by the corporation) is subject to a deemed acquisition of control;[41] and

(f) Where a LRE occurs at a particular time in a day, deeming the LRE to occur at the beginning of the day, unless the trust elects otherwise in its relevant income tax return.[42]

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[37] Subparagraph 251.2(5)(i).

[38] Subparagraph 251.2(5)(ii).

[39] Subparagraph 251.2(5)(iii).

[40] Paragraph 251.2(5)(b).

[41] Paragraph 256(7)(h).

[42] Subsection 251.2(6).

VI. IMPACT OF A LRE ON NON-CAPITAL LOSSES: SUBSECTION 111(5)

As mentioned above, where a taxpayer is subject to a LRE, the taxation year of the taxpayer is deemed to end immediately before the LRE.[43] Generally, the portion of the taxpayer's non-capital loss for a taxation year ending before the LRE as may reasonably be regarded as a loss from carrying on a business (the Loss Business) may be carried forward to taxation years ending after the LRE, subject to the following restrictions:[44]

1. If the Loss Business continues to be carried on by the taxpayer for profit or with a reasonable expectation of profit throughout the particular year; and

2. Only to the extent of the total of the taxpayer's income for the particular year from:

   (a) The Loss Business; and

   (b) Where properties were sold, leased, rented or developed or services rendered in the course of carrying on the Loss Business before that time, from any other business substantially all the income of which was derived from the sale, leasing, rental or development, as the case may be, of similar properties or the rendering of similar services (i.e., the traditional same or similar business rules).

[43] Subsection 249(4).

[44] Paragraph 111(4)(a).

Where the Loss Business continues to generate losses after the LRE, post-LRE losses from the Loss Business may be carried back to taxation years ending prior to the LRE where: [45]

1. The taxpayer carried on the Loss Business throughout the relevant pre and post-LRE taxation years for profit or with a reasonable expectation of profit, and

2. Only to the extent of the taxpayer's income for the relevant pre-LRE taxation year from the Loss Business (and, where properties were sold, leased, rented or developed or services rendered in the course of carrying on the Loss Business before that time, from any other business substantially all the income of which was derived from the sale, leasing, rental or development, as the case may be, of similar properties or the rendering of similar services).

Thus, for pre-LRE losses to be carried forward to post-LRE taxation years or for post-LRE losses to be carried back to pre-LRE taxation years, the Loss Business must be operated for profit or with a reasonable expectation of profit in all relevant taxation years and losses from the Loss Business may only be deducted against income of the Loss Business or businesses similar to the Loss Business, which is the historical same or similar business test.

[45] Paragraph 111(4)(b).

VII. IMPACT OF A LRE ON NET CAPITAL LOSSES: SUBSECTION 111(4)

As mentioned above, where a taxpayer is subject to a LRE, the taxation year of the taxpayer is deemed to end immediately before the LRE.[46] Net capital losses incurred prior to this deemed year-end cannot be carried forward to taxation years ending after the deemed year-end.[47] In addition, net capital losses incurred after the deemed year-end cannot be carried back to taxation years ending prior to the LRE.[48] Effectively, net capital losses for taxation years ending before the LRE cannot be carried forward past the LRE and net capital losses for taxation years ending after the LRE cannot be carried back prior to the LRE.

The adjusted cost base of any capital property (other than depreciable property) owned by a taxpayer immediately before a LRE must be reduced to the extent that the adjusted cost base of the property immediately before the LRE exceeds its fair market value at that time.[49] In effect, accrued but unrealized capital losses are triggered immediately prior to the LRE and are treated as capital losses of the taxpayer in its taxation year ending immediately prior to the LRE.[50] However, due to the operation of paragraph 111(4)(a), any unused capital losses resulting from this rule may not be carried forward to taxation years of the taxpayer ending after the LRE. In order to mitigate the impact of this loss of net capital loss pools, the taxpayer is permitted to elect to trigger certain accrued but unrealized gains by filing a designation under

46 Subsection 249(4).

47 Paragraph 111(4)(a).

48 Paragraph 111(4)(b).

49 Paragraph 111(4)(c).

50 Paragraph 111(4)(d).

paragraph 111(4)(e), effectively increasing the cost of the property subject to such designation by triggering capital gains, recaptured capital cost allowance or a combination of both capital gains and recaptured capital cost allowance.

VIII. SUSPENDED LOSS RULES –SUBSECTIONS 13(21.2), 40(3.3), 40(3.4) AND CERTAIN RELATED PROVISIONS

It has been well established transfers of a business or assets within an affiliated group may result in the application of the suspended loss rules where the property being disposed of has an accrued loss. In general, the application of suspended loss rules results in the deferral of a loss being recognized on the initial transfer until a specified future date. The most common application of these rules relates to the transfer of depreciable property[51], capital property[52], eligible capital property[53] and inventory held as an adventure in the nature of trade[54].

Pursuant to well established case law, one of the main tenets in the Act is a taxpayer's affairs and computation of income for tax purposes is based upon the legal relationships and agreements applicable to the taxpayer and not the economic realities that may apply to a taxpayer's circumstance[55]. Therefore, in the absence of specific provisions in the Act, the legal sale of property by a taxpayer and the recognition of an accrued loss would be permitted.

[51] Subsection 13(21.2).

[52] Subsection 40(3.3).

[53] Subsection 14(12).

[54] Subsection 18(15).

[55] In *Shell Canada Limited v Her Majesty the Queen, [1999] 3 S.C.R. 622*, at paragraph 39 the court outlined "…absent a specific provision of the Act to the contrary or a finding that they are a sham, the taxpayer's legal relationships must be respected in tax cases."

However, due to the application of the suspended loss rules, the legal relationship and consequences of executing those agreements is re-characterized to endeavor to have the economic reality that a particular loss cannot been recognized on the basis the risk associated with the transferred property has not been disposed of. A general overview of the main premise of these rules is where a particular property is disposed of by a taxpayer to an affiliated person,[56] the loss remains in the hands of the taxpayer that disposed of the property until the earlier of certain events. This paper will focus on the more common application of these rules being in respect of depreciable property and capital property. It will also outline the impact of the introduction of the LRE Regime and commentary on certain specific CRA views as applicable.

A. Disposition of Depreciable Property - Application of subsection 13(21.2) and certain related provisions

a) Overview of the Legislation

The operation of subsection 13(21.2) results in a loss that would otherwise be a terminal loss as being denied on the sale of a depreciable property of a prescribed class as an immediate deduction to the transferor and does not eliminate it entirely, but simply delays the deduction to a future specified date, either over a period of time or in its entirety depending on the facts and circumstances[57]. For the provision to apply, the property or a right to acquire[58] the

[56] The term "affiliated person" and in each instance this term appears in the paper is as this term is defined in section 251.1 of the Act.

[57] As a general comment, the suspended loss rules in respect of depreciable capital property in 13(21.2) have similar application in the circumstances to which subsection 14(12) would apply in respect of eligible capital

property, at the end of the 30-day period, must be owned by the transferor or an affiliated person of the transferor. It should be noted the preamble to paragraph 13(21.2)(a) applies to a person or partnership, which is contrasted to the preamble of paragraph 40(3.3)(a) that applies to a corporation, trust or partnership. The one obvious impact of this contrast is subsection 13(21.2) applies to individuals, whereas subsection 40(3.3) does not, but rather the application of the “superficial loss” rules contained in section 54 are applicable to individuals.

In addition, the provision only applies where there is an accrued loss on the property as described in paragraph 13(21.2)(b). This provision requires the proceeds of disposition must be less than the lessor of:

(A) the capital cost of the transferred property to the transferor; and

(B) the proportion of the undepreciated capital cost to the transferor of the prescribed class to which the transferred property belonged immediately before the transfer that the fair market value of the property is of the total value of all properties of the class at the particular time.

The one consideration in the wording of this provision is subsection 13(21.2) may apply even if the particular property is not the last asset of the particular prescribed class (i.e. the application of subparagraph 13(21.2)(b)(ii)).

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property, however the reader is cautioned the specific provisions applicable to eligible capital property should be reviewed where applicable.

[58] Although a right to acquire the transferred property is not a term defined in the Act, commentary produced in respect of these provisions indicate the concept appears to include call options, as well as forward-based and executory contracts. Further expansion of this topic is beyond the scope of this paper.

Furthermore, the operation of subparagraph 13(21.2)(e)(iii) results in the taxpayer to be deemed to own a separate property ("Notional Property") with a cost amount equal to the amount calculated pursuant to paragraph 13(21.2)(b) that is in excess of the actual proceeds of disposition[59]. The operation of the provisions within subsection 13(21.2) results in this Notional Property to belong to the same prescribed class and eligible to claim capital cost allowance until any of the events described in clauses 13(21.2)(e)(iii)(A) to (E) occurs.

Clauses 13(21.2)(e)(iii)(A) to (E), for depreciable property, contain what are commonly referred to as "loss triggering events". As a general rule, the Notional Property is permitted as an immediate deduction when:

(A) a 30 day period begins throughout which neither the transferor nor an affiliated person of the transferor owns or has a right to acquire the transferred property[60];

(B) the purpose of the transferred property is changed from income-earning to non-income earning purpose[61];

(C) a deemed disposition arises from a change in the residence status[62] or taxable status[63] of the transferor[64];

(D) the transferor is subject to a LRE[65]; or

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[59] It should be noted where there are two or more properties disposed of at the same time, subparagraph 13(21.2)(e)(ii) permits the transferor to choose the specific order in which the properties actually occur and should be carefully considered.

[60] Clause 13(21.2)(e)(iii)(A).

[61] Clause 13(21.2)(e)(iii)(B).

[62] Section 128.1.

[63] Subsection 149(10).

[64] Clause i.e. 13(21.2)(e)(iii)(C).

(E) a taxable wind up of a corporate transferor has begun. A taxable wind-up is defined as a wind-up to which subsection 88(1) would not apply[66].

As it relates to item D above, further commentary is included in section b) below.

Certain related provisions for discussion, in addition to subsection 13(21.2), are subsections 13(24) and 13(25). These subsections, in summary, are intended to prevent the transfer of certain tax attributes[67] to a profitable corporation (or trust) that are in respect of certain depreciable property and control of the corporation (or trust) will be acquired. The provisions apply where the depreciable property is acquired within the 12 month period immediately before the occurrence of a LRE and the applicable depreciable property was not used in a business that was carried on by the taxpayer, or a relevant taxpayer as defined in subsection 13(24) immediately before the 12 month period began[68]. As it relates to the profitable corporation's (or trust's) ability to claim capital cost allowance, one of the consequences of the rules effectively denies the capital cost of the depreciable property from being added to the particular class's undepreciated capital cost until a taxation year ending after the LRE. In short, the tax benefit of any additional capital cost allowance does not benefit the taxpayer (or affiliated taxpayer), but will be realized by the unrelated acquirer after the applicable LRE and the depreciable property of the unrelated acquirer normally will be subject to the half-year rule

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[65] Clause 13(21.2)(e)(iii)(D).

[66] Clause 13(21.2)(e)(iii)(E).

[67] In general the tax attributes that are the subject of subsections 13(24) and 13(25) are capital cost allowance, investment tax credits and refundable investment tax credits.

[68] A relevant taxpayer as defined in subsection 13(24) is a partnership of which the taxpayer was a majority-interest partner (as defined in subsection 248(1)), a trust of which the taxpayer was a majority-interest beneficiary (as defined in subsection 251.1(3)) or by a person that would be affiliated with the taxpayer if section 251.1 were read without reference to the definition "controlled" in subsection 251.1(3).

as applicable pursuant to Regulation 1100(2) of the Act. The reader is cautioned subsections 13(24) and 13(25) may have other consequences depending on a taxpayer's particular fact situation. These other consequences are considered beyond the scope of this paper and, accordingly, the reader should review these provisions in detail when working in this area.

b) Impact of LRE Regime to subsections 13(21.2), 40(3.3) and 40(3.4)

As described in the paper above, the LRE Regime replaced the rules formerly known as the "acquisition of control" rules or the Old Regime. These changes were introduced by Budget 2013 and extended the corporate acquisition of control rules to trusts. As it relates to subsections 13(21.2), 13(24) and (13(25), the main impact was the reference in clause 13(21.2)(e)(iii)(D) and subsections 13(24) and 13(25) was amended effective March 31, 2013 to replace a former reference to an "acquisition of control" to a new reference to a "loss restriction event". In addition, subsections 13(24) and 13(25) were amended to replace a former reference to "corporation" to a new reference to a "taxpayer is subject to a loss restriction event" or related applicable wording. As it relates to subsections 40(3.3) and 40(3.4), the main impact was to the reference in subparagraph 40(3.4)(b)(iii) being amended effective March 31, 2013 to replace a former reference to an "acquisition of control" to a reference to a "loss restriction event". As a consequence, and as described in the paper at sections IV and V in particular, the application and consideration of subsections 13(21.2) and 40(3.4) in determining a loss triggering event and the application of subsections 13(24) and 13(25) will be more complex for corporations and a new reality and complexity for trusts.

c) Highlight of CRA View related to subsection 13(21.2)

CRA View Doc No 2004-0091061E5 ("the 2004 letter") outlined a scenario involving a personal trust that disposes of depreciable property to an affiliated person of the trust and the trust winds up within 30 days of the date of the disposal to that person. The 2004 letter outlines the conditions of paragraphs 13(21.2)(a) and 13(21.2)(b) would otherwise apply, but since the trust ceases to exist before the end of the 30 day period, the condition contained within paragraph 13(21.2)(c) would not be met as no person will be affiliated with the trust on the day that is 30 days after the transfer. The author noted the CRA alluded to possible tax policy concerns in respect of the conclusion documented in the 2004 letter[69]. With the introduction of the LRE Regime, the author does make note a trust certainly could be subjected to subsection 13(21.2) and the loss otherwise suspended within the Notional Property would be permitted as a deduction where the trust is subject to a LRE. However, the author is of the view paragraph 13(21.2)(c), for the scenario outlined in the 2004 letter, will still not be met where the trust is actually wound up within 30 days of the disposal date. Consequently, any terminal loss that may otherwise arise in a manner consistent with the scenario outlined in the 2004 letter will not be suspended pursuant to subsection 13(21.2) under the LRE Regime.

B. Disposition of Capital Property - Application of subsections 40(3.3), 40(3.4) and certain related provisions

a) Overview of the Legislation

The operation of subsections 40(3.3) and 40(3.4) results in a loss that would otherwise be a capital loss as being denied on the sale of a capital property, but again does not eliminate the

[69] An excerpted comment from the 2004 letter as published is as follows "REASONS: Despite possible tax policy concerns, the wording of subsection 13(21.2) does not appear to apply if the transferee is no longer affiliated with the trust at the end of the 30 day period referred to in that subsection."

loss as is the case with the parallel rules for depreciable property, eligible capital property and inventory held as an adventure in the nature of trade. Where the transferor is a corporation, trust or partnership, the loss effectively becomes suspended from being deducted in the transferor's hands until the occurrence of future specified events[70]. Subject to certain exceptions[71] [72], for the provision to apply to the aforementioned group of taxpayers, the property or an identical property[73] (referred to as the "Substituted Property"), must meet two separate time sensitive tests. First, the Substituted Property must be acquired during a period that begins 30 days before and ends 30 days after the disposition ("the 60 day period") by the transferor or an affiliated person of the transferor. Secondly, the Substituted Property must be owned at the end of the 60 day period by the transferor or an affiliated person of the transferor. As noted in section VIII)A)a) above, the preamble of subsection 40(3.3) specifically references its application to a corporation, trust or partnership, and as a result does not apply

[70] As a general comment, the suspended loss rules in respect of capital property in subsection 40(3.3) have similar application in the circumstances to which subsection 18(15) would apply in respect of inventory held as an adventure in the nature of trade, however the reader is cautioned the specific provisions applicable to inventory held as an adventure in the nature of trade should be reviewed where applicable.

[71] Where the transferor is an individual (other than a trust), the capital loss will be a "superficial loss" within the meaning of section 54 and subparagraph 40(2)(g)(i) will apply to deny the loss. Further expansion and commentary on the application of the "superficial loss rules" was considered as being beyond the scope of this paper.

[72] Subsection 40(3.3) lists out certain exceptions that are for the purpose of computing certain surplus balances of a foreign affiliate of a taxpayer. Further evaluation of these exceptions was considered as being beyond the scope of this paper.

[73] The provisions of subsection 40(3.5) provide for five separate rules that define the concept of "identical property" as well as the period of ownership of a substituted property. This provision should be reviewed by the reader as applicable and further detailed analysis of this item is beyond the scope of this paper.

to individuals. For individuals, the parallel rules contained within the "superficial loss" rules in section 54 are applicable[74].

As noted above, the amount of the suspended loss is deferred from deduction in the hands of the transferor and is realized at a time that is immediately "before" the earliest of the events described in subparagraphs 40(3.4)(b)(i) to (v) occurs. Subparagraphs 40(3.4)(b)(i) to (v), for capital property, are commonly referred to as "loss triggering events". As a general rule, a suspended loss is permitted as a deduction immediately before the earliest of the following loss triggering events:

(A) the Substituted Property is disposed of and, for a 30 day period after the disposition, neither the transferor nor an affiliated person of the transferor owns the property or an identical property[75] acquired within the 30 day period beginning before the disposition;

(B) a deemed disposition of the Substituted Property arises from a change in the residence status[76] or taxable status[77] of the transferor[78];

(C) the transferor is subject to a LRE[79];

[74] Please refer to note 71.

[75] Please refer to note 73.

[76] Section 128.1.

[77] Subsection 149(10).

[78] Subparagraph 40(3.4)(b)(ii).

[79] Subparagraph 40(3.4)(b)(iii).

(D) a Substituted Property that is a debt obligation or a share is deemed to be disposed of under section 50 ether as a debt that becomes bad or a share of a corporation that becomes insolvent or bankrupt[80]; or

(E) a taxable wind up of a corporate transferor has begun. A taxable wind-up is defined as a wind-up to which subsection 88(1) would not apply[81].

As it relates to item C above, further commentary is included in section VII)A)b) above.

<u>Special Rule for Share Redemptions – Subsection 40(3.6)</u>

The reader should also note subsection 40(3.6) is applicable in the special circumstances where the shares of a corporation are disposed of by a taxpayer to the corporation in the course of a share redemption to which the transferee is an affiliated person of the transferor immediately after the disposition. The provisions of subsection 40(3.6) are similar to that of subsection 40(3.4), except subsection 40(3.6) applies to a corporation, trust, partnership and an individual. In addition, the denied loss is not suspended, but rather the amount of the loss is added to the cost of any shares of the corporation owned by the transferor after the disposition of the shares.[82]

<u>Capital Dividend Account – Special considerations – Subsection 112(3)</u>

Of one additional special note, a separate "stop loss" rule contained in subsection 112(3) should be considered (in addition to subsections 40(3.3) and 40(3.6)) and reviewed in detail where a loss is experienced on the disposition of a share, that is a capital property of the

[80] Subparagraph 40(3.4)(b)(iv).

[81] Subparagraph 40(3.4)(b)(v).

[82] Paragraph 53(1)(f.2).

taxpayer (other than a share that is property of a partnership), by a taxpayer (other than a trust) and the applicable taxpayer had received at "any time during the ownership of the share" a particular dividend and most notably a capital dividend[83]. Where subsection 112(3) applies, the loss otherwise determined pursuant to the provisions of the Act is reduced by the amount of the particular dividend[84]. Subsection 112(3) does not contain any offsetting addition to the adjusted cost base of any share; therefore the denial of the loss in this circumstance is permanent. In addition, the reader should also make note the CRA has recently issued commentary where subsections 40(3.6) or 112(3) apply to deem a corporate taxpayer's loss to be nil, the corporation's loss is not considered to reduce the balance in the pertinent taxpayer's capital dividend account pursuant to the provisions of subsection 39(1)[85].

The reader should also note special considerations of these suspended loss rules (or other similar rules in the Act) may apply where the taxpayer involved is a prescribed venture capital corporation or where the loss is on shares held as inventory, or as they may apply to losses on shares of a foreign affiliate. Commentary on these topics was considered beyond the scope of this paper.

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[83] A dividend in respect of which an election was made under subsection 83(2) where subsection 83(2.1) does not deem the dividend to be a taxable dividend.

[84] Subsection 112(3) are also subject to provisions contained in subsections 112(5.5) and 112(5.6). These provisions should be reviewed carefully when working in this area.

[85] The CRA commented on a situation where a private company shareholder ("the Shareholder") holds shares of another private company and the private company repurchases shares from the Shareholder to which subsection 40(3.6) applied or was deemed nil because of the application of subsection 112(3). Under both circumstances, CRA's comments support the contention the loss is also deemed nil for the purpose of paragraph 39(1)(b), and there will be no reduction to the capital dividend account of a private corporation (CRA Views Doc No 2014-0540361E5).

b) Highlight of CRA View related to subsections 40(3.3) and 40(3.4)

In addition to the recent CRA view referred to in respect of the impact of certain "stop loss" provisions on the capital dividend account of a private company noted above (i.e. CRA Views Doc No 2014-0540361E5), another recent CRA publication (CRA Views Doc No 2014-0529731E5) reviewed three different hypothetical situations and whether subsections 40(3.3) and 40(3.4) would apply to deem a corporate taxpayer's loss to be nil. This recent document and the related scenarios effectively bring together two historical published CRA administrative positions. The first historical position deals with allowing the taxpayer to designate the ordering of the sale of a property ("the 2003 letter")[86] and the second policy letter outlines the use of an algebraic formula intended to "permit a portion" of a loss that otherwise would be deemed nil upon strict application of subsection 40(3.3) ("the 2001 letter")[87].

The following is a review of these scenarios to outline both the operations of subsections 40(3.3) and 40(3.4) as well as the impact of the CRA's administrative positions.

Scenario I

This scenario outlines a company ("Portco") owning 1,000 shares of a certain public corporation ("Publico"), which are capital property to Portco under all three scenarios, on January 1 of a particular year, but then in the 15 day period commencing on December 15 of the particular year and ending on December 31 engages in additional transactions specific to the Publico

[86] Please refer to CRA views doc No 2003-0002915.

[87] Please refer to CRA views doc No 2001-0088155.

shares and each property in the particular transaction would be an identical property[88] to the initial Publico shares. The transactions involve Portco effecting the following:

- Acquiring an additional 200 Publico shares on December 15;
- Disposing of 200 Publico shares to a non-affiliated person on December 16 at a loss of $400; and
- Disposing of another 200 Publico shares to a non-affiliated person on December 31 at a loss of $500.

Upon a strict application of paragraphs 40(3.3)(b) and 40(3.3)(c), since 200 Publico shares were acquired (i.e. the Substituted Property) on December 15 (i.e. within the 30 days prior to both the December 16 and December 31 dispositions) and the Substituted Property is owned at the end of the 30 day period after the disposition[89] (i.e. January 14 of the subsequent year since Portco owns 800 Publico shares), both the $400 and $500 losses, respectively, should be deemed nil and suspended pursuant to the provisions of subsections 40(3.3) and 40(3.4). However, the CRA confirms the 2003 letter continues to apply and the taxpayer may choose the order of dispositions of shares that are identical properties[90]. In this regard, where Portco decides the December 31 loss of $500 was in fact recognized from those shares acquired on December 15 (i.e. the Substituted Property), subsections 40(3.3) and 40(3.4) would not apply to

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[88] Please refer to note 73.

[89] Provisions in the Act deeming the taxpayer to dispose of identical properties in respect of 40(3.3) in a particular order are absent. As an example, subsection 7(1.3) deems the ordering of disposition of securities that are identical properties in respect of shares acquired to which the stock option rules in section 7 of the Act otherwise apply.

[90] Please refer to note 73.

restrict either the December 16 $400 loss or the December 31 $500 loss. The basis for this conclusion is the condition contained within paragraph 40(3.3)(c) is not met. Particularly, the Substituted Property was disposed of on December 31, therefore at the end of the 30 day period (i.e. January 14 of the subsequent year) the Substituted Property was not owned.

Scenario II

This scenario outlines Portco engaging in transactions specific to Publico shares commencing with an acquisition of 100 Publico shares on February 1 of a particular "non-leap year" and continues to engage in additional transactions specific to the Publico shares and each property in the particular transaction would be an identical property[91] to the initial Publico shares. The transactions occur over a subsequent 43 day period ending on March 16 of the particular year. The transactions involve Portco effecting the following:

- Acquiring an additional 50 Publico shares on February 28;
- Disposing of 60 Publico shares to a non-affiliated person on March 15 at a loss of $100; and
- Disposing of another 50 Publico shares to a non-affiliated person on March 16 and realizes neither a gain nor a capital loss.

Once again, upon a strict application of paragraphs 40(3.3)(b) and 40(3.3)(c), since 50 Publico shares were acquired on February 28 (i.e. the Substituted Property) prior to both dispositions (i.e. within the 30 days prior to both the March 15 and March 16 dispositions) and the

[91] Please refer to note 73.

Substituted Property is owned at the end of the 30 period[92] after the March 15 loss disposition (i.e. April 14 of the particular year since Portco still owns 40 shares of Publico), the $100 loss should be deemed nil and suspended pursuant to the provisions of subsections 40(3.3) and 40(3.4). However, the CRA confirms both the previously issued 2001 letter and 2003 letter continue to apply in this Scenario. In its first comment, the March 15 disposition of 60 shares for a loss of $100, pursuant to the application of the algebraic formula contained within the 2001 letter[93], would seem to result in a suspended loss of $83.33[94]. Then as a secondary comment, the application of the 2003 letter and Portco choosing the 50 shares acquired on February 28 and disposed of on March 16 results in the condition contained within paragraph 40(3.3)(c) is not met as it specifically relates to this particular Substituted Property. Accordingly, the initial suspended loss of $83.33 is not actually subject to being suspended on the basis the condition contained within paragraph 40(3.3)(c) is not met at the end of the period. This results since the initial Substituted Property acquired on February 28 is designated as being disposed of by Portco on March 16.

<u>Scenario III</u>

This scenario outlines Portco engaging in transactions specific to Publico shares that are exactly the same as Scenario II, with one exception as follows:

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[92] Please refer to note 89.

[93] DL = (least of S, P, and B) / S × L: **DL** is the amount of loss deemed to be nil; **S** is the number of items disposed at that time; **P** is the number of items bought in the 60 day period; **B** is the number of items left at the end of the period; and **L** is the loss on the disposition as otherwise determined.

[94] The calculation pursuant to the algebraic formula contained in the 2001 letter is $83.33 = 50 being the number of Substituted Properties on hand and on hand at the end of the first disposition of March 15, divided by 60 being the March 15 disposition, multiplied by $100 loss otherwise determined.

- Of the 50 Publico shares disposed of on March 16, 25 were disposed of to a non-affiliated person and 25 to an affiliated person of Portco.

Once again, upon a strict application of paragraphs 40(3.3)(b) and 40(3.3)(c), since 50 Publico shares were acquired (i.e. the Substituted Property) prior to the both dispositions and still owned at the end of the period[95], the $100 loss should be deemed nil and suspended pursuant to the provisions of subsections 40(3.3) and 40(3.4). With this slight change of facts, the CRA confirms since both conditions of paragraphs 40(3.3)(b) (i.e. 50 shares acquired on February 28) and 40(3.3)(c) (i.e. 25 shares of the Substituted Property are still owned at the end of the period), the provisions result in the suspended loss rules as being applicable, but only a portion of the loss is suspended on the basis of the algebraic formula contained within the 2001 letter[96]. On the basis of the calculations, the suspended loss is only $41.67 since only ½ of the 50 Substituted shares, as compared to Scenario II, are still owned at the end of the period[97].

IX. HISTORICAL RULING REVIEW AND 256.1 PRACTICALITIES

Throughout the history of the Act, the application and use of losses has been a constant topic of debate by taxpayers, those who strive for tax equity[98] and legislators, including Finance and the CRA. The debate has ranged from the access and deduction of losses generated by taxpayers, and those acquired through acquisition, including the life span of losses, to the potential for

[95] Please refer to note 89.

[96] Please refer to note 93.

[97] The calculation pursuant to the algebraic formula contained in the 2001 letter is $41.67 = 50 shares acquired on February 28, minus 25 shares sold to non-affiliated on March 16, divided by 60 shares sold on March 15, multiplied by the $100 loss otherwise determined.

[98] Update on Planning with Losses, Canadian Petroleum Tax Journal, Vol. 27, 2014-1.

refundability of tax losses incurred. The idea of an equitable tax system has long been present; however, both the *Carter Commission Report* of 1966[99] and the *Mintz Report* of 1997[100] concluded tax equity can only be achieved when the Government equalizes the treatment of losses with tax revenues generated from taxable income.[101]

Our objective within the following is not to contribute to the debate, which currently has a platform in the market, but rather to discuss aspects of a certain tax planning strategy available to corporate taxpayers, and how the CRA and current legislation can impact this strategy. While the strategy discussed will no doubt be familiar to most Canadian tax practitioners, it stands to reason that as we embark upon new economic times, refreshing the understanding of the mechanics and issues within various tax plans used to consolidate and/or trade losses is of high importance.

A. Non-arm's Length Transfer of Debt Followed by a Winding-up and a Share Sale:

Otherwise known as the ATR-66[102] plan, this strategy has been in play for a number of years, with the CRA formalizing its position on April 20, 1995 in an advanced tax ruling. It should be noted the CRA has since cancelled the ATR-66 document effective September 30, 2012. However, in April 2014, subsequent to the commencement of the LRE Regime, the CRA was asked to comment on the cancellation of ATR-66 and the potential for the general anti-

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99 Report of the Royal Commission on Taxation, (Ottawa: Queen's Printer, 1966).

100 Report of the Technical Committee on Business Taxation (Ottawa: Department of Finance, December 1997).

101 Update on Planning with Losses, Canadian Petroleum Tax Journal, Vol. 27, 2014-1.

102 ATR-66 (Cancelled) – Non-arm's Length Transfer of Debt Followed by a Winding-up and a Share Sale.

avoidance rule (the “GAAR”) to now apply to such tax plans[103]. The CRA subsequently issued an interpretation indicating its position has not changed with respect to such a tax plan, and the cancellation does not reflect a change in the application of the GAAR to such a plan. According to the CRA, the principal reason for the cancellation was to purge outdated information, such as tax rulings with outdated references to sections of the Act.

While the steps required to execute an ATR-66 plan are beyond the scope of this discussion, we must consider the pitfalls of failing to plan and execute an ATR-66 plan as part of an acquisition transaction, i.e. when debt forgiveness would apply and tax pools otherwise believed to be acquired are ground down.

Consider the following where ATR-66 was not considered:

- SellCo owns 100% of the shares of OpCo
- SellCo has funded OpCo operations since inception by way of intercompany advances (“Note1”)
- Since inception, OpCo has only generated losses
- Due to the losses in OpCo, the fair market value of Note1 is less than the principal amount of Note1
- ProfitCo, an profitable arm’s length party, wishes to acquire all of the shares and debts of OpCo, including Note1

[103] Interpretation – external 2014-0522501E5 – Cancellation of ATR-66.

- On acquisition of OpCo by ProfitCo, the cost of Note1 would be reduced to its fair market value

- OpCo is then amalgamated or wound up with ProfitCo to create AmalCo thereby settling Note1 at its cost amount.

Since the cost of Note1 would be less than its face value, debt forgiveness would result where the transaction is implemented as outlined above. The forgiven amount would then reduce the non-capital losses of AmalCo, which was a desired tax attribute that ProfitCo was looking to acquire from the outset. Of note to the reader, we have simplified the analysis and taken the assumption the resulting LRE does not impede the use of the losses in AmalCo, in other words a business carried on with an expectation, or reasonable expectation, of profit to which the losses may be applied to income from that business or a similar one[104].

The author submits a purchaser must engage in proper due diligence to identify a situation where ATR-66 planning may be implemented in advance of a transaction. Where this does not occur, there certainly may be an erosion of otherwise anticipated tax attributes within the target acquired.

B. 256.1 Acquisition of 75% is Control (the new rules):

Finance and the CRA take a hard line when it comes to the trading of losses with arm's length taxpayers. While the Act does contain provisions to limit the ability to trade tax losses, the cost

[104] Subsection 111(5)

and time to fully challenge new and typically aggressive tax plans was overly burdensome to the CRA, and thus the LRE Regime was introduced in the 2013 Federal Budget.[105]

As discussed earlier in this paper, the application of section 256.1 creates a much broader acquisition of control test. Recall, the test sets out the following criterion in subsection 256.1(2)[106] (emphasis added):

> *256.1(2) Application of subsec. (3) — Subsection (3) applies at a particular time in respect of a corporation if*
>
> *(a) shares of the capital stock of the corporation held by a person, or the total of all shares of the capital stock of the corporation held by members of a group of persons, as the case may be, have at the particular time a fair market value that* ***exceeds 75% of the fair market value of all the shares of the capital stock of the corporation****;*
>
> *(b) shares, if any, of the capital stock of the corporation held by the person, or the total of all shares, if any, of the capital stock of the corporation held by members of the group, have* ***immediately before the particular time a fair market value that does not exceed 75% of the fair market value of all the shares of the capital stock of the corporation****;*
>
> *(c) the person or group does not control the corporation at the particular time; and*
>
> *(d) it is* ***reasonable to conclude that one of the main reasons that the person or group does not control the corporation is to avoid the application of one or more specified provisions***[107]*.*

[105] Oct. 2013 Technical Notes (budget/technical).

[106] Subsection 256.1(2).

Clearly Finance and the CRA are taking aim at specific tax plans which circumvent the "old" acquisition of control rules under the Old Regime. Historically, *de jure* control was the factor for which acquisition of control of a corporation was determined. However, with the "new" rules we now see the transition to *de facto* control being an additional factor of consideration. The question now becomes, what if a tax plan considers the impact of section 256.1, but the taxpayer determines the 75% fair market value of the capital stock criterion is not achieved? If the CRA determines a fair market value acquired of at least 75%, then how would one resolve this difference in value assessment? For a publicly traded corporation, we could turn to the market, however, what about the value of corporations where the market for its securities is very thin, or what about the value of a private corporation where there is no market for its securities? This could very well become a burden of proof requirement passed along to the corporation(s) and/or shareholders. Understanding and being able to support the fair market value of a corporation and the value of any shares acquired will be pivotal in making sure the 75% fair market value threshold is not breached.

In addition, now consider if the reason, or purpose, for a person or group of persons acquiring 75% of the fair market value of the capital stock was not to avoid the application of the specified provisions? Again, here we would likely have a burden of proof requirement placed on the taxpayer. What if the purpose of the share acquisition was to facilitate a value freeze to a corporation or individual? Consider a fact pattern where a transferor corporation, or individual,

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[107] Specified provisions include: subsections 10(10) and 13(24), paragraph 37(1)(h), subsections 66(11.4) and (11.5), 66.7(10) and (11), 69(11) and 111(4), (5), (5.1), (5.2) and (5.3), paragraphs (j) and (k) of the definition "investment tax credit" in subsection 127(9), subsections 181.1(7) and 190.1(6) and any provision of similar effect.

wishes to transfer a “business” or assets to a transferee corporation on a taxable basis in exchange for preferred shares with a cumulative dividend entitlement. The rationale for using the preferred shares is to freeze the value of the assets or business transferred at a moment in time and to provide an income stream to the transferor in the form of dividends until such time in the future when the preferred shares can be fully redeemed. Obviously all future value would accrue to the common shares of the transferee corporation.

If the intent was not to circumvent the specified provisions[108] of the Act, then how does a taxpayer support its actual intent? One can only assume by documenting the original intent, this would be the best basis for ensuring support of how and why the transaction was executed the way it was.

The two issues discussed above will no doubt have an impact on the private company sector where valuations are generally not readily available and where freeze transactions, with no ill intent to circumvent subsection 111(5), are likely to occur. Unfortunately with section 256.1 being such a new reality, there has simply not been much consideration, i.e. interpretations, advanced tax rulings or court cases, for the tax professional community to consider. We can only assume, slowly over the next few years, the CRA will be forced to issue interpretations or rulings around the application of section 256.1, and hopefully then we will have a better understanding of the CRA’s fair market value determination process and how the purpose test, avoiding specified provisions[109], will be assessed.

[108] Please refer to note 107.

[109] Please refer to note 107.

In summation, as we begin, so to do we end. The recent addition of section 256.1 once again cements the assertion that the Act is, and will remain, a dynamic set of laws. Unfortunately, as with most new additions to the Act, section 256.1 does not move us closer to tax equity, and most would argue this actually moves us further from a truly equitable tax system in Canada.

As one tax plan is addressed by new legislation a new tax plan will be derived, and so the cycle will continue.

X. CONCLUSION

The CRA and, ultimately, by the Department of Finance implemented provisions they felt were required to address the perceived abuse of loss trading as evidenced by the introduction of the concept of a LRE. The paper overviewed the impact a LRE had in respect of certain suspended loss rules and also reviewed a few situations highlighted in certain CRA Views including, but not limited to the confirmation of certain historical administrative positions as still be applicable in the LRE Regime. Finally, we also reviewed a situation where a historical ruling would continue to be beneficial. In addition, we reviewed certain practical considerations under section 256.1 and outlined the potential need for additional guidance for private companies given lack of a publically traded value to assist in confirming certainty in respect of the value of its shares.