ANNUAL SURVEY OF CANADIAN LAW

TAXATION

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I. INTRODUCTION

Three years have passed since the last Annual Survey on Taxation.[1] That Survey, it will be remembered, was "not intended as a comprehensive survey of the latest developments in the area of Taxation. Rather it [was] a comment on certain aspects of the Budget of November 18th, 1974 which affect taxation."[2] Similarly the 1973 Taxation Survey[3] was limited to a commentary on the then recent major overhaul of the Canadian Income Tax Act. This Survey will continue this approach. It will be primarily concerned with the legislative developments since the Spring 1976 Budget. However, an effort will also be made to comment on some of the more significant judicial decisions which have appeared during this period. Thus, while the intention is to broaden substantially the scope of this Survey, it should still not be looked at as a comprehensive survey of all developments[4] since the last Annual Survey.[5]

II. DEVELOPMENTS IN THE AREA OF PERSONAL TAXATION

Taxation of the individual attracts less attention than some of the more sophisticated provisions dealing with the taxation of business activities and corporate taxpayers. The rules regulating the taxation of an individual have tended to remain less complex and less subject to frequent, incomprehensible and inconsistent changes. Unfortunately, however, even this basic area is no longer safe from continued and regular intrusion by both the legislatures and the courts.[6] Some of the most significant changes lie in the areas of employee remuneration, the family unit and tax deferral plans.

A. *Employee Remuneration*

The continued increase in wages and salaries paid to employees, and the consequently increasing tax burden has resulted in various employer/

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[1] Jones, *Annual Survey of Canadian Law: Taxation*, 7 OTTAWA L. REV. 450 (1975).

[2] *Editors Note*, *id.* at 450.

[3] Jones, *Annual Survey of Canadian Law: Taxation*, 6 OTTAWA L. REV. 245 (1973).

[4] To be comprehensive would require a book. *See, e.g.*, the various proceedings at the annual conference of the Canadian Tax Foundation, which tend to concentrate on current developments and normally encompass approximately 1,000 pages each. The latest, for example, the REPORT OF THE TWENTY-NINTH TAX CONFERENCE (1977) is 940 pages.

[5] Since the preparation of this Survey the Hon. Jean Chrétien, Minister of Finance, presented the Budget of Nov. 16, 1978. The amendments found therein have now been incorporated in Bill C-37, 30th Parl., 4th sess., 1978-79 (first reading Jan. 29, 1979) [hereinafter cited as Bill C-37].

[6] *See* the cases involving termination payments for judicial uncertainty: *e.g.*, Specht v. The Queen, [1975] C.T.C. 126, 75 D.T.C. 5069 (F.C. Trial D.), *rev'g* [1973] C.T.C. 2018 (Tax A.B.) (termination payment considered a retiring allowance); The Queen v. Atkins, [1975] C.T.C. 377, 75 D.T.C. 5263 (F.C. Trial D.) (termination payment part of employment contract and therefore income); Fordham v. M.N.R., [1975] C.T.C. 2071, 75

employee attempts to devise methods of remuneration which may not be subject to taxation. The introduction of wage and price controls in 1975 further encouraged the utilization of less obvious methods of employee remuneration. The expansion of stock option plans, the payment of lump sums on termination of employment and interest-free loans were only three of the reactions by employers and employees to the system.

1. *Interest-Free Loans*

When employees require large sums of money for personal use (to buy a home or a car, for example) they normally approach a chartered bank, finance company or other lending institution. As part of the borrowing process there is an obligation to pay interest on the monies borrowed but as the monies are used for personal purposes this interest is not deductible. To enable the employee to maintain any given standard of living the employer must therefore increase the employee's salary by an amount that will enable him to retain enough after-tax dollars to pay the interest. If, on the other hand, the employer provides the loan interest-free, the employee may get the benefit of the use of the money without having to pay interest and the employer may get the benefit of having to pay less to put the employee in the same financial position. However, this is so only if the employee has received no benefit under the Income Tax Act.[7]

The use of such loans was apparently considered objectionable by the Revenue authorities. From the available approaches to this area (such as prohibiting the loan, disallowing the expense of the loan to the employer, deeming the interest foregone on the loan to be a benefit at fair market value, or some combination thereof) the Revenue officials chose the fair market value approach. In May, 1976 it was announced[8] that as of January 1, 1977 the benefit conferred by interest-free loans would arbitrarily be set at eight per cent per annum and that such amount would be included in the income of the recipient of the loan. No doubt in light of the jurisprudence in the area[9] such a position would have been difficult to maintain. One might even argue, tongue in cheek, that the Revenue officials were estopped from deeming such interest-free loans to be a benefit, at least for the taxation of loans already outstanding or promised.[10] The Department

D.T.C. 106 (Tax A.B.) (termination payment considered other remuneration under s. 5(1)). The history of s. 62 is a good example of legislative indecision.

[7] The Income Tax Act, S.C. 1970-71-72, c. 63, s. 6, *as amended by* S.C 1973-74, c. 14, s. 1 [hereinafter cited as ITA].

[8] *See* comments in *Tax Times*, in 161 CAN. TAX SERV. (De Boo) (Supp.), and CANADA TAX LETTER, 279 CAN. TAX SERV. (De Boo).

[9] *See* Ransom v. M.N.R., [1967] C.T.C. 346, 67 D.T.C. 5235 (Ex.) for an example of how courts sometimes view benefits.

[10] The Queen v. Langille, [1977] C.T.C. 144, 77 D.T.C. 5086 (F.C. Trial D.), *aff'g* [1975] C.T.C. 2367 (Tax Rev. B.) favoured the unprecedented position that the Crown may be subject to estoppel arguments.

of Finance eliminated these problems when it amended the Act.[11]

The present position[12] deems that the recipient has received a taxable benefit from such loans of an amount equal to the difference between the actual interest paid and the interest computed at a prescribed rate,[13] arbitrarily set. In addition, the legislation provides for the exemption of loans which can be more easily justified as legitimate borrowing.[14] The present provisions effectively permit interest-free housing loans up to $50,000 if they arise out of relocations in the course of employment.[15] In addition, small loans on which the interest would be inconsequential ($500) are exempt — no doubt due to the administrative difficulty which would arise in enforcing the deemed interest provisions on nominal short-term borrowings between employer and employee.[16]

It is interesting to note that while the exception for small loans is difficult to rationalize on any basis other than administrative convenience, the wording is such that it excludes the first $500 worth of deemed interest on *all* loans, regardless of size. One can only speculate that it was easier to draft a basic exemption than to try to achieve equity by drafting complicated provisions for those taxpayers whose deemed interest income would have been $600, $550 or even $501. Everyone would concede that it would be unfair to allow the taxpayer with $500 deemed interest income to be exempt and to tax the taxpayer in full if his deemed interest income were $501.

The provisions dealing with interest-free loans apply not only to employees or officers but also to related persons.[17] The deemed interest income provisions are so drafted as to include in income all anticipated situations and then to exclude the legitimate transactions.[18] At the present time the exclusion in respect of housing loans is dependent upon the taxpayer being eligible for a section 62 deduction.[19] Unfortunately this

[11] Notice of Ways and Means Motion, Oct. 20, 1977, by the Hon. Jean Chrétien, Minister of Finance.

[12] ITA, s. 6(9), *as amended by* S.C. 1977-78, c. 1, s. 2. The actual rules occur in two separate provisions. One, s. 6(9), deems such amounts to be income from office and employment and the other, s. 80.4, *as added by* S.C. 1977, c. 1, s. 35, provides the mechanisms for the calculation of the amounts. These provisions are applicable to 1979 *et seq*.

[13] The rate is actually to be set by reference to the prime rate charged by chartered banks so perhaps the use of the word "arbitrary" is a bit harsh. However, as the prescribed rate is not embodied by statute, it is not unrealistic to assume that the rate will be set "arbitrarily" from time to time. *See* similar comment in *Tax Rep*. (CCH CAN) para. 9898.

[14] *E.g.*, under ITA, s. 80.4(2)(a), *as amended by* S.C. 1977-78, c. 32, s. 16(2), loans to purchase shares are exempt. It would appear that if a benefit were deemed, the amount of the benefit would be deductible as an expense under s. 9.

[15] ITA, s. 80.4(2)(b), *as amended by* S.C. 1977-78, c. 32, s. 16(3).

[16] ITA, s. 80.4(1), *as added by* S.C. 1977, c. 1, s. 35.

[17] *See* s. 80.4(1)(a).

[18] It appears that the Nov. 16, 1978 Budget is an attempt to restrict the number of housing loans to one per husband-wife unit. *See* Bill C-37, cl. 25.

[19] Presumably to provide for the pre-1972 interest-free loans, the Act also exempts those persons who otherwise qualified and who would have been entitled to a s. 62 deduction if they had moved after 1971. *See* Bill C-37, cl. 25.

reference to section 62 creates some application problems. The most obvious problems concern those taxpayers whose moves are paid in full by their employer and those taxpayers whose moves cross our national boundaries. In the case of the former situation one could argue that the taxpayer is entitled to a deduction but that it is limited to a zero amount because of the employer's contribution. He is therefore entitled to a moving expense deduction and so is eligible for the exempt interest-free loans. One can only hope that the administrators at Revenue Canada accept this view.[20] The second problem, arising from international moves, is not capable of resolution under the present Act[21] as the taxpayers do not fall within the conditions set out in section 62.

2. *Stock Options*

When a taxpayer is employed in the upper management levels of a corporation, it is not unusual to remunerate him and to encourage him to assist in increasing the company's productivity by offering him the opportunity to purchase shares at some time in the future at a predetermined price. If the value of the shares meets or exceeds the expectation of the parties the employee need simply purchase and resell the shares to obtain a "profit" and thus a taxable benefit.[22] While the provisions appeared suitable for taxing the usual situations[23] they created a hardship if the recipient of the shares did not want to dispose of them immediately. To alleviate this problem and to encourage investment in Canadian-controlled private corporations the Act was amended[24] to provide very favourable treatment to taxpayers who purchase shares of Canadian-controlled private corporations in certain stated circumstances. Basically the amendment suspends the operation of subsection 7(1) of the Act until the earlier of two years or the time the employee sells the shares. With subsection 7(1), there is no provision which would specifically deem a benefit to occur and consequently the acquisition of the shares at below

[20] This problem does not appear to have been reviewed in Revenue Canada publications to date.

[21] It may be that the phrase "or would have been had he moved from a location in Canada" in s. 80.4(2)(b) is intended to "deem" international moves to be the equivalent of Canadian moves. If that interpretation were given to the phrase the result would certainly be fair.

[22] ITA, s. 7(1)(a) deems the amount by which the value of the shares exceeds the purchase price to be a benefit and thus included in income.

[23] *But see* The Queen v. Huestis, [1975] C.T.C. 560, 75 D.T.C. 5393 (F.C. App. D.), *aff'g* [1975] C.T.C. 85 (F.C. Trial D.), *rev'g* [1974] C.T.C. 2135 (Tax Rev. B.), where the Federal Court of Appeal considered that shares of another corporation substituted instead of the option shares did not give rise to a benefit. The Trial Division and probably the Appeal Division (the judgment is very brief) emphasized that the substituted shares were delivered not in substitution for the original option shares, but rather in settlement of a cause of action. One can only suggest that, as indicated at note 32, *infra*, the courts are more concerned with the legal distinction between performance of a contract and payment for breach thereof than with the realities of the situation to "the man on the street".

[24] ITA, s. 7(1.1), *as added by* S.C. 1977-78, c. 1, s. 3(1).

cost occurs without immediate tax implications. The amendment provides further that if the shares are sold within two years,[25] a benefit will be deemed to be conferred at the time of the sale with a concurrent tax liability. If the shares are held for a period of two years, the operation of subsection 7(1) is suspended permanently with the result that no deemed benefit occurs and the taxpayer is subjected only to capital gains on the eventual disposition of the shares.

3. *Termination Payments*

Despite a flurry of activity in the courts, the legislators have failed to amend the area of termination payments to provide even a minimum degree of certainty and equity in the system.[26]

Since 1973 there have been at least five major cases[27] which considered the appropriate characterization to be attached to payments made as a consequence of termination of employment. While all the cases involved detailed arguments based on the facts, in each case the employee had his employment terminated and in due course received a lump sum payment. The amounts so received could be characterized as (a) income from employment and thus subject to tax at the regular rates,[28] (b) a retiring allowance and thus capable of tax deferral,[29] or (c) damages and not taxable at all.[30] It appeared that the problem of characterization had been finally and reasonably determined when Mr. Justice Cattanach held that payments made after a wrongful termination of a contract of employment were taxable as income notwithstanding the fact that the taxpayer could have sued and recovered damages for wrongful dismissal.[31] The obligation under the contract was to give the taxpayer reasonable notice of termination and upon failing to do so, to pay him his salary for that reasonable period. Mr. Justice Cattanach rightly indicated that the tax consequences depended on the true nature of the payment, not on the label put on the amount by the parties.[32]

Chief Justice Jackett in the *Atkins* case[33] failed to accept the logic of

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[25] ITA, s. 7(1.2), *as added by* S.C. 1977-78, c. 1, s. 3(2).

[26] The Notice of Ways and Means Motion of Nov. 16, 1978 suggests in para. 16 that the government is proposing to step into this area. The Notice suggests that the amount of a termination payment will be treated as income to the extent of six months salary. Bill C-37, cls. 15 and 65(7) would implement para. 16 of the Notice.

[27] Alexander v. M.N.R., [1973] C.T.C. 405, 73 D.T.C. 5321 (F.C. Trial D.), *aff'g* [1971] Tax A.B.C. 990; Quance v. The Queen, [1974] C.T.C. 225, 74 D.T.C. 6210 (F.C. Trial D.); Choquette v. The Queen, [1974] C.T.C. 742, 74 D.T.C. 6563 (F.C. Trial D.); Specht v. The Queen, *supra* note 6; The Queen v. Atkins, [1976] C.T.C. 497, 76 D.T.C. 6258 (F.C. App. D.), *aff'g* [1975] C.T.C. 377 (F.C. Trial D.).

[28] ITA, s. 5(1) or 6(1)(a).

[29] ITA, s. 56(1)(a) and s. 61 make the amounts capable of being deferred through the use of an income averaging annuity contract.

[30] *See* Interpretation Bulletin I.T.-365. At para. 2, Revenue Canada concedes this point.

[31] Quance v. The Queen, *supra* note 27.

[32] *Id.* at 230.

[33] *Supra* note 27.

the above statement. Relying on a strict interpretation of law, he determined that once a contract of employment is breached, any payments made can no longer be made in respect of that contract; rather, such payments are made in respect of the breach of the contract. With all due respect, the reasoning of Mr. Justice Cattanach is more in accord with reality and is to be preferred over that of the Chief Justice of the Court of Appeal.

In addition to preventing the taxation of lump sum payments as income from office and employment, it appears that taxation of the amounts as a retiring allowance is also prevented.[34] As a final closing of the door on the taxation of such lump sum payments, Mr. Justice Collier appears to have distinguished the precedent established in *Curran v. M.N.R.*[35] such that it does not have any application to damages for wrongful dismissal.[36] One wonders whether the matter has now been laid to rest or whether Revenue Canada is simply lying in the shadows waiting for a more likely (and even less sympathetic) case to emerge before trying again.[37]

Indeed it is difficult to understand why there has not been an attempt by the Department of Justice to accept the characterization of the transaction and to proceed to the next logical step. Presumably the employee has a right to receive income until the expiration of a reasonable period of notice. The termination of employment without notice could logically be characterized as the disposition of the right to receive income from employment in exchange for the right to pursue legal action and to obtain damages. The value of the legal rights should then be determined and such amount included in income from office and employment. Upon the resolution of the legal rights the employee would take into account in calculating his income the amount by which the proceeds of disposition of the legal rights exceeded (or fell short of) the adjusted cost base of those rights (the amount included in income as income from office and employment).

At the very least one would have assumed that Revenue Canada would consider the money arising from the disposition of the legal right to damages as constituting potential capital gains. Perhaps the potential capital losses in such situations outweigh the possible capital gains. It may also be that it is politically unacceptable to tax damages at this time. It would only be a small step to start taxing damages received in respect of accidents involving loss of sight or loss of limb. From there it would again be a small step to tax insurance proceeds for disability and then death. The

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[34] Specht v. The Queen, *supra* note 6. After losing the *Specht* case on this point, Revenue Canada failed even to pursue it in the Federal Court of Appeal in the *Atkins* case, *supra* note 27.

[35] [1959] C.T.C. 416, 59 D.T.C. 1247 (S.C.C.).

[36] In this case the Court decided that a lump sum payment made to the appellant to induce him to leave his present employment for the payee's employment was a payment for services to be rendered and therefore taxable.

[37] Revenue Canada suggests they are resigned to this position and are waiting for the Department of Finance to correct the situation. *See* Interpretation Bulletin I.T.-365

reluctance of our society to subject payments involving damages to taxation is further illustrated by the refusal of the Federal Court to permit the taxation of damages in respect of loss of income.[38]

B. *Provisions Related to the Family*

The family unit is dealt with in the statute in two distinct ways: first by specific provisions for inclusions and deductions, particularly in subdivisions (d) and (e), and secondly by the provision of special "non-arm's length" rules. As the purpose of all of these provisions is to vary the basic rules for taxing family situations, both types of provisions will be dealt with here.

1. *Alimony and Maintenance*

The principles governing the inclusion or deduction of amounts in respect of alimony and maintenance now appear to be firmly established[39] although the flow of cases to the courts appears to continue almost unabated.[40] The well-established requirement[41] that the statutory provisions be strictly construed has continued unchanged if not unchallenged. The importance of strict compliance with the requirements is well illustrated in *Brooks v. M.N.R.*[42] Revenue Canada argued (unsuccessfully) that payments made after the date of a court order, but prior to the entry of the order, were not deductible. This argument appears to be consistent with the established position that payments made prior to the court order[43] or in excess of the stated amounts[44] or after the termination of a court order[45] do not fall within the provisions of the statute. While one can have sympathy for a system which must abide by rules and regulations, it is difficult to justify a principle of law which lives by rules and regulations at the expense of fairness to the unsophisticated victim. Payments in excess of stated amounts are clearly questionable, but one must wonder at the objection which can be raised as to those payments made prior to a court order, particularly those which are made pursuant to provisions of the legal system.

[38] *See, e.g.*, Cirella v. The Queen, [1978] C.T.C. 1, 77 D.T.C. 5442 (F.C. Trial D.).

[39] *See* Arnold, *Income Tax Consequences of Separation and Divorce*, in 1977 TAX CONFERENCE REPORT, *supra* note 4, at 193; Arnold, *Tax Aspects of Alimony & Maintenance*, 9 C.I.T. TAX PLANNING AND MANAGEMENT #7; Sheppard, *Taxation of the Family Divided: Divorce — Canadian Style*, in CANADIAN TAX FOUNDATION, REPORT OF PROCEEDINGS OF THE TWENTY-SIXTH TAX CONFERENCE 316 (1974).

[40] Deductions in respect of alimony and maintenance appear to be the kinds of inclusions and deductions in taxable income which upset taxpayers as a matter of principle. No doubt the fact of having to pay, or the insufficiency of the amount received, leave the taxpayers in a strained frame of mind and an unfavourable assessment by Revenue Canada is the last straw.

[41] *See, e.g.*, Ivey v. M.N.R., [1969] Tax A.B.C. 903, 69 D.T.C. 630.

[42] [1977] C.T.C. 2048, 77 D.T.C. 38 (Tax Rev. B.).

[43] Gagné v. M.N.R., [1976] C.T.C. 2163, 76 D.T.C. 1125 (Tax Rev. B).

[44] Fisch v. M.N.R., [1977] C.T.C. 2335, 77 D.T.C. 241 (Tax Rev. B.).

[45] Richter v. M.N.R., [1977] C.T.C. 2261, 77 D.T.C. 183 (Tax Rev. B.).

In *Horkins v. M.N.R.*[46] the taxpayer, when faced with a possible court order to pay interim alimony, agreed, pursuant to rules specifically provided for the purpose,[47] to pay $800 monthly as interim alimony. Revenue Canada denied the alimony deduction. Upon a trial of the issue, Mr. Justice Collier agreed with Revenue; the taxpayer had agreed on the fairness of the amount, and the court would undoubtedly have ordered payment of an amount at least equal to the agreed amount. One can only agree with the comment made by Professor Arnold: "[T]he lesson is clear: the taxpayer should not have consented to pay interim alimony unless his spouse executed a written agreement to that effect."[48] While his advice is sound, it is unfortunate that it is not possible to add some common sense to such an absurd situation. Revenue Canada could be well protected (although perhaps fearful of the resulting reduction in the income of lawyers) by simpler, more realistic evaluations of such situations.

Alimony and maintenance provisions by their very nature are intended to provide for the payment of certain expenditures which are incurred for the maintenance, welfare or education of the recipients. Unfortunately, it is not possible to predetermine with any degree of accuracy the actual amounts which will be so required. The parties (or courts) are faced with a "best guess" situation as to the needs of the parties; alternatively, they must content themselves with determining what types of expenses will be subject to the maintenance provisions and allow future circumstances to determine the amount. It would be more equitable to apply the latter method, as it would more realistically reflect the actual needs of the parties (and avoid the disadvantages associated with overly excessive or insufficient payments).

The taxpayers in *The Queen v. Pascoe*[49] adopted the latter approach. The husband was required to pay his wife $290 per month for her maintenance and for the maintenance of the children of the marriage. In addition, he had to pay the education, medical and dental bills for the children. The Federal Court of Appeal disallowed a deduction for the education, medical and dental expenses on the basis that the payments in respect of those amounts did not constitute an allowance. Pratte J. stated:

> An allowance is, in our view, a limited predetermined sum of money paid to enable the recipient to provide for certain kinds of expense: its amount is determined in advance and, once paid, it is at the complete disposition of the recipient who is not required to account for it. A payment in satisfaction of an obligation to indemnify or reimburse someone or to defray his or her actual expenses is not an allowance: it is not a sum allowed to the recipient to be applied in his or her discretion to meet certain kinds of expense.[50]

Having concluded that the payments did not constitute an allowance, the

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[46] [1976] C.T.C. 52, 76 D.T.C. 6043 (F.C. Trial D.), *aff'g* [1975] C.T.C 2338 (Tax Rev. B.).

[47] See O.R.P. 386(3).

[48] Arnold, *supra* note 39, at 195.

[49] [1975] C.T.C. 656, 75 D.T.C. 5427 (F.C. App. D.), *rev'g* [1975] C.T.C 58 (F.C. Trial D.).

[50] ITA, s. 60(b).

court then went on to find that even if they did constitute an allowance, the amounts were not deductible as they did not constitute payments payable on a periodic basis. The fact that they were in fact paid on a periodic basis was not sufficient to meet the requirements of the Act.

The more recent decision of *Fisch v. M.N.R.*[51] from the Tax Review Board appears to cast some doubt on the *Pascoe* case. On similar facts the Board held that payments by the taxpayer to a school for the education of his children constituted an allowance even though the amount was not fixed but varied with the actual cost of education. Although it has been suggested that the case is wrong,[52] it is submitted that it is consistent with common sense and the policy basis of the provisions. Surely the only real reason for requiring strict compliance for allowances and periodic payments is to ensure that taxpayers do not collude to defraud Revenue Canada. By establishing maintenance obligations fixed by reference to external factors, such as the cost of education, the opportunity for collusion is in fact minimized. Indeed a strict application of the *Pascoe* test would apparently preclude the deduction of maintenance payments by the payer in those cases where the amount is readjusted from year to year by reference to the increase in the cost of living or by reference to an increase in the income of the payer. Is that a *limited* predetermined amount? It is submitted there is no difference between the two situations. Indeed if the administrators of the legislation suggest that there is a difference, then the solution would appear to be to include a base amount in the alimony and maintenance payments and to provide that the amount will be increased by an amount equal to the amount by which the cost of educating (or of providing medical or dental care) exceeds the base amount. In the case of medical or dental payments the allowance would run a year in arrears but it may still be more realistic then to attempt to predetermine the amounts of such expenses.

Despite the amendment of the Act in 1974[53] it appears that the *Pascoe* case may bar the deduction of payments made to third parties as such payments would not meet the definition formulated for an allowance. To date there appears to be no judicial guidance available to resolve this problem. Indeed in view of the number of taxpayers now affected by the alimony and maintenance provisions one would have thought the courts would have given more serious consideration to the problem than is evident in the *Pascoe* and other alimony and maintenance cases.[54]

2. *Non-Arm's Length Rules*

Section 67, in an apparent attempt to protect Revenue Canada, deems

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[51] *Supra* note 33.

[52] Arnold, *supra* note 39, at 200.

[53] ITA, s. 56.1, *as amended by* S.C. 1974-75-76, c. 26, s. 28; and ITA, s. 60.1, *as amended by* S.C. 1974-75-76, c. 26, s. 31.

[54] The *Pascoe* case is only three pages long, whereas business income cases such as the *Leon* case, *infra* note 200 and the *Shabro Investments* case, *infra* note 141 are much longer.

that those transactions which result in a loss to Revenue occur at fair market value. A careful reading of the section will indicate that there appears to be no attempt to ensure that the provisions are fair: indeed they only deem one-half of the transaction to occur at fair market value, forcing the other party to the transaction to live with the actual transaction. Taxpayers have long recognized the pitfalls of this section by drafting price adjustment clauses to ensure that if the deeming provision applied to the disadvantage of one taxpayer it would also apply to the disadvantage of the other. Finally Revenue Canada appears to have conceded that the means for avoiding the inequity of the deeming provision may also be applied to those taxpayers who do not have the benefit of knowledge of taxation and price adjustment clauses.[55] They have indicated that:

> In the situations described above, where it can be shown that the transfer occurred at an amount other than the fair market value by reason of an honest error and not by a deliberate attempt to evade or avoid tax, the Department may permit an adjustment in the amount of the proceeds of disposition or purchase price to reflect the amounts deemed by paragraph 69(1)(*a*) or 69(1)(*b*) to have been paid or received.[56]

In family situations the Act has provided relief from the provisions of section 67 by the application of "rollover" provisions. Until 1977 the benefit of this rollover applied only to a transfer of property by a taxpayer to his spouse or to a trust for his spouse.[57] As part and parcel of the rollover provisions it was necessary to provide that the recipient receive the property at an amount equal to the proceeds of disposition to the transferor[58] and to further transfer historical costs to ensure potential recapture would occur in the appropriate circumstances.[59]

As the Canadian tax system is based on the taxation of the individual rather than the family unit,[60] there would be a benefit available to spouses if they transferred property in such a way as to split income. To prevent this result the tax system provided rules which result in the attribution of income and capital gains to the transferor spouse.[61] The inequity of attributing only income and capital gains and not losses and allowable capital losses was rectified in 1975[62] so that losses are no longer "lost".

In the last few years most Canadian jurisdictions have either enacted[63] or proposed[64] new family law legislation affecting the obligations of

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[55] Interpretation Bulletin I.T.-405.

[56] *Id.* at para. 5.

[57] ITA, s. 73(1), *as amended by* S.C. 1977-78, c. 32, s. 15(1)

[58] ITA, s. 73(2), *as amended by* S.C. 1977-78, c. 32, s. 15(1)

[59] ITA, s. 73(2)(b).

[60] *See* Woodman, *The Taxation Unit*, in ESSAYS ON CANADIAN TAXATION 69 (B Hansen, V. Krishna & J. Rendall eds. 1978) for a discussion of the taxation of the marital unit.

[61] ITA, s. 74, *as amended by* S.C. 1974-75-76, c. 26, s. 39(1)

[62] S.C. 1974-75-76, c. 26, s. 39(1).

[63] *See, e.g.*, The Marital Property Act, S.M. 1978, c. 24; The Family Law Reform Act, 1978, S.O. 1978, c. 2; Family Law Reform Act, S.P.E.I. 1978, c 6

[64] *E.g.*, British Columbia and Alberta.

marital parties and establishing new principles for the division of certain marital assets. The provisions of some of these provincial enactments do not blend harmoniously with the provisions of the Income Tax Act.

The Income Tax Act has been based on the recognition of legally recognized marital unions[65] and the existence of legitimate children only.[66] New provincial legislation is increasingly refusing to distinguish between common law unions and legitimate marriages and appears not to be prepared to discriminate in any way against illegitimate children.[67]

In the first response to modern reality, the April 1978 Budget announced that "[t]echnical changes will be made to the Income Tax Act to facilitate the division of property between spouses without incurring a capital gains tax liability".[68] At that time the words in the Ways and Means Motion stated:

> That for the 1978 and subsequent taxation years the provisions of section 73 of the Act relating to the transfer of property by a taxpayer to his spouse be extended to apply to transfer of property under provincial legislation relating to marital property.[69]

Since that time the legislation has been presented and passed into law.[70] An examination of the provisions of the amendment, however, indicates that the "technical changes" referred to by the Minister of Finance and the "transfer of property by the taxpayer to his spouse" are only a very small part of the actual amendments. The new section 73 refers not to a transfer by a taxpayer but rather to instances where the property of a taxpayer "has been transferred".

With these changes it is no longer necessary for property settlements to occur before the dissolution of a marriage. Indeed it would appear that it is no longer necessary for any marriage to in fact have existed at all. The provisions of the rollovers have been extended to include not only spouses and spousal trusts but also former spouses and certain other individuals. The meaning of former spouse requires no further clarification. The other individuals who fall within the provisions of the legislation are those who receive property "pursuant to a decree, order or judgment of a competent tribunal made in accordance with prescribed provisions of the law of a province"[71] if the person entered into a written agreement with the taxpayer according to the law of that province or if the person received the proprty by reason of having fallen within the provisions of that law. The wording appears to include the transfer of property to a common law

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[65] *See* the provisions dealing with alimony (s. 60(b)), maintenance (s. 60(c)) and personal deductions (*e.g.*, s. 109).

[66] While the problem with illegitimate children is not as severe as it was in the area of succession legislation, the onus rules in s. 109(3) still can provide difficulties.

[67] *See, e.g.*, The Family Law Reform Act, 1978, S.O. 1978, c. 2 and The Succession Law Reform Act, S.O. 1977, c. 48.

[68] Budget, Hon. Jean Chrétien, Minister of Finance, Apr. 10, 1978.

[69] Notice of Ways and Means Motion, Apr. 10, 1978.

[70] ITA, s. 73, *as amended by* S.C. 1977-78, c. 32, s. 15(1).

[71] ITA, s. 73(1)(d), *as amended by* S.C. 1977-78, c. 32, s. 15(1).

spouse if the spouse had a written agreement and the order for the transfer is made by a court of law. It is interesting to note that the legislation appears to require a court to order the transfer pursuant to the written agreement and that a voluntary transfer pursuant to the same agreement would not qualify. Similarly it appears that any court-ordered transfer, if made pursuant to provincial legislation will fall within the provisions regardless of the relationship of the recipient. The application of the rollover provisions thus appears to have been substantially widened.

The apparent increase in the number of situations in which the section applies does not simplify the provision. The reference throughout is to property "transferred". The question thus arises as to the meaning to be attributed to that term. For example, does it apply to those situations where the competent tribunal finds that the property (or a fraction thereof) always belonged to another party and simply declares that to be the case? Appropriate documents would have to be prepared and executed. It is difficult to agree that such a situation constitutes a transfer; it is a simple declaration of a state of affairs that has always existed.

If the above reasoning is acceptable, major problems will arise in characterizing the decisions of provincial tribunals. It is not likely that the judgments of provincial courts will always adequately explain the legal basis of the judgment. Indeed it is unlikely that the provincial courts would be required to even consider the matter as they can rely on the appropriate provincial legislation to make the determination.

One would be inclined to suggest that the simple solution is to interpret the word "transfer" to include all instances in which the record reflects a change in legal ownership. That is exactly the approach taken by the legislation when it includes in the category not only property transferred by the transferor but also any property which the recipient is "declared to have".[72] As the direct result of having property pass pursuant to the provisions of section 73(1) is to create potential recapture problems, the fairness of this solution must be challenged. If a spouse is declared by a competent tribunal to have always owned a particular property, it is unfair to require that person to include in his or her income recapture in respect of the capital cost allowance taken by the previous "registered" owner.

The reference in section 73(1) is to "prescribed provisions" of the applicable provincial legislation. At the present time there appear to be no regulations identifying the meaning of "prescribed provisions". If the term means that the property is transferred by operation of provincial law, then the Department of Finance has just succeeded in placing a tax on litigation when it applies to depreciable property. It is suggested that without more, the provisions, although intended to deal with family situations, apply to all transfers ordered by a court of law.[73]

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[72] ITA, s. 73(1.1), *as amended by* S.C. 1977-78, c. 32, s. 15(1).

[73] Surely the legislators did not intend this result to apply and as it is unlikely that this result will benefit the recipient, he is unlikely to rely on these interpretation provisions. It would appear, however, that taxpayers who are required to transfer property pursuant to

As a normal component of the tax system, transactions involving rollovers normally gave rise to the application of the attribution rules.[74] While it is unlikely that *bona fide* transactions will occur between non-married individuals in situations where a rollover would apply, it is not beyond the realm of possibility. It appears that there is no provision for attributing income in those cases to the transferor spouse.

One final comment should be made. As all rollover provisions are intended to relieve the parties of an onerous tax burden, they should be free to determine whether they desire such relief. Recent amendments to the Income Tax Act permit such optional treatment for rollover on death[75] and it does not appear inappropriate to suggest that such treatment is desirable in this area of property transfer also.

3. *General Comment*

One must conclude that the present provisions dealing with the taxation of the marital unit are unsatisfactory. They are too complex for situations which involve such a large portion of our society. They are a hopeless conglomeration of attempts to tax the individual, to prevent income splitting and to provide concessions to the marital unit.[76] Reform, whether provided by the courts or legislature, is necessary to provide the kind of simplicity that is essential to so basic an area of the tax system.

C. *The Tax Deferral Provisions*

There has always been a desire among a significant proportion of the population to set aside monies which will be available to them upon their retirement or to their families upon their death. The most obvious ways to achieve these results are (a) the purchase of insurance, (b) the voluntary saving and investment of monies, and (c) forced savings (for example, the purchase of assets on credit in circumstances in which the assets not only are eventually paid for but also provide an accelerated benefit until that time). The tax system has variously recognized, encouraged and ignored these objectives in society. Unlike the United States, despite continued pressure,[77] there has been a resistance by the legislators to making provision for the deduction of interest in the acquisition of the major asset acquired by most taxpayers — their home. On the other hand there has

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any litigation may argue that their proceeds of disposition are equal to their adjusted cost base or undepreciated capital cost, as the case may be. The recipient would have no difficulties in respect of potential capital gains in either situation.

[74] ITA, s. 74, *as amended by* S.C. 1974-75-76, c. 26, s. 39(1).

[75] *See* ITA, s. 70(6.2), *as added by* S.C. 1976-77, c. 4, s. 27(2).

[76] *See* Woodman, *supra* note 60.

[77] It is understood that the government has received numerous submissions requesting that interest be deductible in acquiring major assets, such as a home. The press carries frequent reports of the difference between Canada and the U.S.A. on this point. Recently the Opposition has announced that it intends to permit the deduction of interest for home-purchasing loans.

been significant encouragement given to investment in certain types of savings plans.[78]

1. *Life Insurance*

The purchase of life insurance is a personal and living expense and while the cost of the premium is not deductible for tax purposes, the proceeds of the policy are not taxable either. At the same time another person who puts his money in investments other than life insurance must include the income from the investment annually when he calculates his tax liability. The inconsistency of these two positions was recognized by the Royal Commission on Taxation[79] in 1966 when it stated:

> In most permanent life insurance there is a substantial element of saving, arising primarily from the fact that life insurance policies generally call for the payment of equal premiums over a substantial number of years. This level premium plan results in substantial saving, and therefore significant investment income. The early premiums exceed the real cost of the protection, and the excess is in effect saved to make up the deficiency when the insured is older and the higher cost of protection exceeds the premium.[80]

It is obvious that if the life insurance policy provides for a large savings element, the income from those savings may not be subject to taxation in the hands of the insured. Despite this recognition of "untaxed income", Tax Reform failed to totally correct the situation, applying instead a two-step system: (a) a nominal tax rate of fifteen per cent was applied to income accruing for the benefit of the shareholder; and (b) the income portion of benefits received by the policy holder, other than on death, was taxed upon receipt.[81] Tax imposed on the life insurance company is considered to be beyond the scope of this Survey and thus will receive no further consideration. It will be obvious that in the normal situation taxpayers would get the income from their savings tax-free upon death, as the benefit payable to the estate would be equal to the savings accrued plus the insurance element of the policy.

In responding to this problem the government was faced with a dilemma. There was a need to encourage savings for retirement, as was indicated by the government policy on a variety of pension provisions[82] and other savings incentives.[83] At the same time it appeared inequitable in effect to favour one form of savings over another.

An amendment,[84] effective in 1977, provided that the income on the

[78] While at the same time the tax advantages previously granted to other plans have been reduced or eliminated. *E.g.*, the penalty on RRSP's for over-contributions, the changes to RESP's and the restrictions imposed on RHOSP's.

[79] Vol. 3, REPORT OF THE ROYAL COMMISSION ON TAXATION (Carter Commission, 1966).

[80] *Id.* at 407.

[81] ITA, ss. 208, 209 (*repealed by* S.C. 1977-78, c. 1, s. 91). "Receipt" refers to legal entitlement, not necessarily actual receipt.

[82] *See* the text at note 89, *infra*.

[83] *See* the Budget statements in recent years for numerous examples.

[84] S.C. 1977-78, c. 1, s. 74.

savings element of a life insurance contract would be allowed to accumulate tax-free. The accumulated income from the savings aspect of the insurance policy would be taxable upon the death of the insured. It was proposed at the time that in addition to deferring the tax on the savings accumulated until death, there would also be a basic exemption of $10,000. Subsequent to the introduction of the Spring 1977 budget proposals the Minister of Finance announced that the tax upon death would not be proceeded with immediately.[85]

Policy loans are now to be treated as dispositions of an interest in the life insurance policy with the potential for taxable gain. As loans against insurance policies would normally provide for interest payments, the legislation specifically authorizes the addition of the interest paid to the adjusted cost basis of the policy.[86] The addition of the interest to the basis (with the consequent reduction of potential future taxable gains) occurs as long as the interest is not deductible by virtue of paragraph 20(1)(c) or (d) in calculating the income of the taxpayer.

An interesting twist has also been added to the savings aspect of insurance policies. Taxpayers are given the opportunity to defer any gain (much like the provision involving subsection 13(4) and section 44) in the event that they actually pay back the loan.[87]

2. *Pension Plans*

Registered retirement savings plans and registered pension plans were fully developed in 1972.[88] Since that time the limits of allowable contributions have been increased and the provisions dealing with Registered Retirement Savings Plans (RRSP's) have been both expanded and tightened up. The contribution limits in respect of both plans have been increased to $3,500 from $2,500 and to $5,500 from $4,000.[89]

The provisions allowing contributions to spousal plans added in 1974[90] immediately created problems of income splitting as the attribution rules in respect of receipts for such plans were suspended. The result was that high income taxpayers could split income with their spouses, and defer taxation for a year, by making contributions to a spousal plan. The spouse would immediately collapse the plan with the result that the taxpayer with the high income was able to reduce his income while at the same time keeping the monies available for the use of the family. To prevent abuse,

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[85] Since the Budget proposal and subsequent legislation (S.C. 1977-78, c. 1, s. 91) repealed Part XII tax, the income earned through the savings element of insurance policies is totally free of any form of taxation. Obviously this area is still under constant review, as evidenced by the numerous technical changes proposed by the Nov. 16, 1978 Budget. *See* Bill C-37, cls. 44, 50.

[86] ITA, s. 148, *as amended by* S.C. 1977-78, c. 1, s. 74(1).

[87] ITA, s. 148(9)(a), *as amended by* S.C. 1977-78, c. 1, s. 74(4), *as combined with* s. 20(1)(hh) (*added by* S.C. 1977-78, c. 1, s. 14(1)).

[88] *See* ITA, s. 146.

[89] ITA, s. 146(5), *as amended by* S.C. 1976-77, c. 4, s. 56(4).

[90] ITA, s. 146(5.1), *as added by* S.C. 1974-75-76, c. 26, s. 99(3).

subsection 146(8.3) was recently added as an amendment.[91] Basically the intention of the amendment is to attribute receipts from a spousal plan back to the contributing spouse. The attribution applies not only to prevent in-and-out transactions in the same year but also to attribute amounts to the transferor to the extent that he made contributions to the plan within the two immediately preceding years. The attribution is limited to the amount of the contributions so that it does not appear that there will be any attribution of the income earned by the contributions.

Subsection 146(8.3) specifies the ordering of withdrawals from the plan so that it is not possible to argue that the withdrawals were the most recent contributions and that consequent withdrawals in later years were outside the attribution period. It should be noted, however, that the ordering appears to apply only to the period in which attribution occurs. For example, if in 1979 a taxpayer withdraws $1,500 from a plan it will be considered to be the contribution made in 1977 and not the one made in 1976 or 1978. Despite the attempt at ordering, there is no provision for withdrawal from a plan if the spouse and the annuitant both made contributions. It thus appears there will be attribution even though the parties may argue that the withdrawal is the annuitant's contribution. It would thus be advisable to keep separate spousal plans if both the spouse and the annuitant intend to contribute to the annuitant's RRSP.

The harshness of the attribution rule is lessened by the fact that it does not apply in the event of death of the spouse contributor.[92] As the requirement for cash may be very real at that time, this provision should assist greatly in preventing undue hardship upon death.

As the income earned by contributions to RRSP's is not subject to tax, high income investors discovered that it was to their advantage to make excessive contributions to RRSP's. Although the contributions were only deductible within the usual limits, the income was shielded, with the result that after a reasonable number of years the investor was better off having over-contributed to the plan even though there would be eventual double taxation of the original contributed sum. The merits of this plan were enhanced when the Tax Review Board determined that there could not be double taxation of the same income dollars.[93]

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[91] S.C. 1977-78, c. 1, s. 72(3). Arguably, the most flagrant abuses could also be attacked on the basis that they constituted shams and that they were not in fact contributions to RRSP's as the parties did not intend to set up a plan. The logical extension of the judgment in Grimson v. M.N.R., [1977] C.T.C. 2095, 77 D.T.C. 101 (Tax Rev. B.) would support this argument.

[92] ITA, s. 146(8.7) *as added by* S.C. 1977-78, c. 1, s. 72(3).

[93] In The Queen v. Langille, *supra* note 10, the taxpayer made contributions to a Canadian government annuity contract which was a registered retirement savings plan. He did not deduct the amount of his contributions from his income and upon receipt of monies under the contract argued that a portion of these payments represented a return of capital. Mr. Justice Grant found there was a presumption against double taxation and then found an ambiguity in the meaning of benefit in s. 146(8). The result was that the taxpayer did not have to include in his income the portion of the receipts which did not constitute a benefit. Similarly, in Grimson v. M.N.R., *supra* note 91, the taxpayer had made contributions to an RRSP. He did not receive a deduction as he had earned no income. Revenue Canada

The implementation of a penalty of one per cent per month[94] on excess contributions was intended to prevent this abuse. The section appears to be strictly a penalty section as it is framed in a manner whereby the taxpayer is given the benefit of the doubt. For example, the penalty provisions apply to RRSP's only in respect of contributions over the absolute maximum amount of $5,500 and the penalty does not apply for any months after the excess amounts have been returned to the taxpayer.[95]

3. *Registered Home Ownership Savings Plans*

When the Registered Home Ownership Savings Plans (RHOSP's) were introduced[96] they appeared to be the perfect tax planning device. The taxpayer could shelter income, allow the income to earn income in turn and then obtain the entire amount free of tax. The only interference with this ideal situation was that the taxpayer could only contribute $1,000 per year to a maximum of $10,000.

Immediately after the introduction of the legislation there was a scramble to comply with the conditions necessary to take advantage of the situation. In 1977 the Act was amended to prevent the worst abuses.[97] The amendments may be summarized as follows:

(a) Contributions must be made within the year. Prior to this contributions could, as is the case for RRSP's, be made within sixty days of the end of the year.

(b) No contributions may be made to the plans if the taxpayer resided with his/her spouse during that year and the previous year and if the spouse had an owner-occupied home. Prior to the amendment the taxpayer could make a contribution even if the only reason he did not have an owner-occupied home was that he had transferred it to his spouse prior to the beginning of the particular year.

(c) The proceeds of RHOSP's can no longer be used to purchase house furnishings.

(d) While the proceeds of the RHOSP have to be included in the income of the taxpayer if he does not purchase a home in the year or within sixty days of the year end, the proceeds can effectively be received tax-free if the taxpayer purchases a house within the next three years. Clearly the problems arising from the existence of unregistered condominiums where the taxpayer pays his down

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attempted to tax receipt of the amounts contributed. The basis of the decision appears to be that the mechanics of the withdrawal of the monies were such that they were not received out of an RRSP. Relying on a perceived ambiguity in the section, the Board then decided that double taxation should not be allowed in ambiguous situations.

It should be noted that the more recent cases of Buchmann v. M.N.R., [1978] C.T.C. 2135, 78 D.T.C. 1105 (Tax Rev. B.) and Gauthier v. M.N.R., [1978] C.T.C. 2175, 78 D.T.C. 1126 (Tax Rev. B.) followed the letter of the Act, unlike the *Langille* and *Grimson* cases.

[94] *See* ITA, s. 204.1, *as added by* S.C. 1976-77, c. 4, s. 69.

[95] *See* ITA, s. 204.2, *as added by* S.C. 1976-77, c. 4, s. 69.

[96] ITA, s. 146.2, *as added by* S.C. 1974-75-76, c. 26, s. 100.

[97] ITA, s. 146.2, *as amended by* S.C. 1977-78, c. 1, s. 73.

payment but does not acquire title (either legal or indeed equitable) until the condominium is registered are now covered.

4. *Registered Education Savings Plans*

Until the decision of the Federal Court in *The Queen v. Quinn*[98] it was thought that monies allocated to a Registered Education Savings Plan (RESP) were income for the contributor. After the decision in the *Quinn* case the Department of Finance amended the Act[99] to provide a more realistic method of taxing income earned in RESP's. The system adopted provides for registration of the plan. Monies paid into the plan by the subscriber are not tax deductible; the income earned in the plan is not taxed as it is accumulated; and the original contributions are returned tax-free as a refund of payments. The income earned by the plan is taxed when it is finally paid out to the beneficiary for his use.

The amendments to the Act have retroactive effect to 1972.[100] As some income in the plan had already been subjected to taxation under the rules previously applied it was necessary to include a set of provisions[101] to allow the previously taxed income to be received without a further incidence of taxation.

D. *Monetary Reassessments and Other Personal Deductions*

Changes in numerical limits or standard deductions can hardly be classed as changes of principle. At the same time the impact of some of these monetary changes is so great that they require at least a passing reference in a Survey of this type.

Of general application and major impact is the introduction of the concept of indexing into the tax system. While the indexing provisions have been subjected to amendment[102] the concept remains the same[103] and the impact continues. Indeed it is interesting to note that indexing has resulted in an increase in the individual personal deduction from $1,600 to $2,430,[104] an increase of $830 or over fifty per cent based on the original deduction. In a similar way the basic employment expense deduction has been increased from $150 to $250[105] so as to more accurately reflect the basic employment expenses of individuals.

Child care expenditures have long been inadequately provided for in the tax system. The limit on the deduction of $500 per child and $1,000 per family bore no resemblance to the actual cost of child care outside the

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[98] [1973] C.T.C. 258, 73 D.T.C. 5215 (F.C. Trial D.), *aff'g* [1972] C.T.C 2517, 72 D.T.C. 1417 (Tax Rev. B.).

[99] ITA, s. 146.1, *as added by* S.C. 1974-75-76, c. 26, s 100.

[100] ITA, s. 146.1, *as added by* S.C. 1974-75-76, c. 26, s. 100.

[101] ITA, s. 146.1(7), 146.1(8), *as added by* S.C. 1974-75-76, c. 26, s 100.

[102] *See* S.C. 1976-77, c. 10, s. 52(4).

[103] ITA, s. 117.1, *as added by* S.C. 1973-74, c. 30, s. 15.

[104] ITA, s. 109(1)(a) (subject to annual adjustment for 1978 under s 117 1)

[105] ITA, s. 8(1)(a), *as amended by* S.C. 1977-78, c. 1, s. 4. Bill C-37 would further increase the deduction to $500. *See* cl. 1(1).

home of the taxpayer. The limitations on child care expenses have been doubled to entitle the taxpayer to deduct up to $1,000 per child and $4,000 per family.[106]

In addition to attempting to revise the tax system to more equitably reflect the realities of life, from time to time there has been an apparent attempt to reduce the tax burden on those least able to pay. Rather than attempt a wholesale revision of the tax system this intention was carried out by an abatement of the tax otherwise payable.[107] The abatement of three per cent of tax payable, or a minimum of $100[108] has now been increased to provide for an abatement of the greater of $300 or nine per cent of the tax payable[109] and the reference to the maximum abatement has now been removed. As well the 1977 amendment added for the first time an abatement in respect of each dependent child.

The final major monetary change affects those individual taxpayers who have the resources to earn income (and in some situations to incur substantial capital losses) from investments. The interest and dividend income deduction has been broadened to include taxable capital gains on Canadian securities.[110] The treatment to be accorded to allowable capital losses has also been liberalized so that the deduction from other income has been increased to $2,000.[111]

The *Ransom* case[112] has been considered clear authority for the proposition that reimbursement of an employee's moving expenses by the employer does not give rise to taxable income. Tax Reform in 1971 expanded this logical concept to state that if the employee is not reimbursed he should be able to deduct his moving expenses from his income.[113] Unfortunately the definition of moving expenses has never been either particularly enlightening or particularly equitable. Tax Reform simply provided that "moving expenses" include any expense incurred as or on account of one of five enumerated topics.[114] The section failed to limit or otherwise confine the term, thereby suggesting that moving expenses may have a much broader meaning. Revenue Canada made an attempt to restrict such a broad interpretation[115] but it does not appear that the courts have been called on to make a determination of exactly what constitutes moving expenses. In 1976 the government made official the interpretation provided by Revenue Canada by announcing that legal costs incurred in the acquisition of a new home were not intended to be deductible.[116] This was followed by the appropriate legislation which

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[106] ITA. s. 63(1)(d), *as amended by* S.C. 1976-77, c. 4, s. 21(1).

[107] ITA. s. 120(3.1), *as added by* S.C. 1972, c. 9, s. 1.

[108] The deduction of the entire amount of tax payable to a specific maximum amount was added by S.C. 1973-74, c. 30, s. 17.

[109] ITA, s. 120(3.1), *as amended by* S.C. 1977-78, c. 1, s. 57(2).

[110] ITA, s. 110.1(1)(b), *as added by* S.C. 1977-78, c. 1, s. 52.

[111] ITA, s. 111(1)(b), *as amended by* S.C. 1977-78, c. 1, s. 54(1).

[112] *Supra* note 9.

[113] ITA, s. 60(1)(c).

[114] ITA, s. 62(3).

[115] *See* Interpretation Bulletin I.T.-178R.

[116] Notice of Ways and Means Motion (Dep't of Finance, May 25, 1976).

provided that "moving expenses does not include costs incurred by the taxpayer in respect of the acquisition of a new residence".[117] The legislative enactment took effect as passed on May 25, 1976 but its life was rather short. In a matter of seven months that enactment was no longer in force although the formal announcement of the reversal did not occur until almost a year after the effective date of the change.[118]

At present it appears that "moving expenses", while still not defined in a satisfactory manner, include legal fees and land transfer fees and taxes which are incurred as a result of the purchase of a new home.[119] It must be pointed out, however, that the number of instances in which the legal costs are deductible are specifically and strictly limited. For example, it appears that the following situations do not give rise to a deductible moving expense for legal fees:

(a) Taxpayer is transferred to City *A* and sells his home in Town *B*. He cannot afford a home in City *A* so he rents an apartment. In a year he is transferred to Town *C* where he purchases a home.
(b) Taxpayer is transferred to City *A* for a limited term and sells his home in Town *B*. As the term is short he does not purchase a home until his transfer to Town *C* a year later.
(c) Taxpayer is transferred to Town *C* from City *A* where he had an apartment. Apartments are non-existent in Town *C* so taxpayer is forced to purchase a house.

Perhaps one could venture to suggest that the changes in the provisions of section 62 are more important in the context of tax amendments than in specifics. Section 62 is an illustration of one of the more glaring examples of policy reversals existing in the history of the Income Tax Act. One can only wonder whether the amendments are a result of careful reconsideration by the Department of Finance, as a result of pressure by taxpayers or simply a rectification of an error which occurred due to lack of careful consideration by the draftsmen and/or policy advisors. What is clear is that in a one year period from early 1976 to early 1977 a taxpayer's tax position could be determined under one of three rules according to the date of his move. As almost all the legislation had retroactive effect it appears that not only were there three rules in existence at various times during the year but that the taxpayer could not have determined at any time what the actual rule then was.

The special concession granted to students was also reconsidered in 1976.[120] The result was that this relatively simple deduction was complicated by the requirement that the student file prescribed supporting documentation. The possibility of transferring the student deduction to a person other than a supporting spouse was also limited by the prohibition of such transfer if the student was an individual for whom a spouse had made a section 109 deduction.[121]

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[117] ITA, s. 62(3), *as amended by* S.C. 1976-77, c. 4, s. 20.
[118] Ways and Means Motion, *supra* note 11.
[119] ITA, s. 62(3)(f), *as added by* S.C. 1977-78, c. 1, s. 27.
[120] ITA, s. 110(1)(g), *as amended by* S.C. 1976-77, c. 4, s. 43(3).
[121] ITA, s. 110(1)(h), *as amended by* S.C. 1976-77, c. 4, s. 43(3).

III. Income from Business and Property

A. *Characterization of Receipts*

Income from business normally arises when a taxpayer sells property which he deliberately set out to acquire and dispose of with a view to profit. If the taxpayer acquires the same property with a simple investment intention, the subsequent disposition of the property gives rise not to profit or income, but to capital gains. Because of the different tax treatment accorded to the latter transactions, taxpayers are inclined to structure their affairs in such a way as to give rise to capital gains. At the same time, the Revenue authorities have developed a variety of bases on which they argue that the transaction should give rise to income. Included in Revenue Canada's methods of attack are the utilization of the extended definition of business being an adventure or concern in the nature of trade and the secondary intention doctrine.

1. *Adventure or Concern in the Nature of Trade*

That the purchase and resale of toilet tissue is an adventure in the nature of trade and difficult to categorize as an investment is obvious.[122] Other situations are less clear despite the decision of the Supreme Court of Canada in the *Sissons*[123] case. In that case the Court reaffirmed that even a single transaction entered into for profit takes on a business character if it cannot be characterized as an investment. With few supporting reasons, the trial court and the Court of Appeal continued the *Sissons* line of reasoning in *Steeves v. The Queen*.[124] The case is significant in that a rather normal business transaction (the purchase of outstanding debt obligations at a discount and as part of the reorganization of an insolvent business) was found to be part of the profit-making scheme of the underlying business. It seems, however, that there is a fundamental distinction. In the *Sissons* case the taxpayers were carrying out a transaction motivated by a desire to save tax, whereas it is at least arguable that in the *Steeves* case the taxpayers, in carrying out a business transaction, did so in the most desirable manner from the tax viewpoint.[125] Without referring to the *Steeves* case, another member of the Tax Review Board arrived at the opposite result on a similar set of facts in *Meronek v. M.N.R.*[126] While the case can be carefully distinguished from the *Steeves* case on the facts it appears that the Supreme Court of Canada will again have to consider this question before the matter of what is or is not an adventure in the nature of trade is resolved.

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[122] Rutledge v. Inland Revenue Comm'rs, [1929] S.C. 379, 14 T.C. 490 (Sess.).

[123] M.N.R. v. Sissons, [1969] S.C.R. 507, [1969] C.T.C. 184, 69 D.T.C. 5152.

[124] [1977] C.T.C. 325, 77 D.T.C. 5320 (F.C. App. D.), *aff'g* [1976] C.T.C. 470, 76 D.T.C. 6269 (F.C. Trial D.).

[125] *See* Note, 25 Can. Tax J. 494 (1977).

[126] [1977] C.T.C. 2111, 77 D.T.C. 77 (Tax Rev. B.).

2. Secondary Intention

Regal Heights Ltd. v. M.N.R.[127] established that whether a taxpayer had a secondary intention to turn property to account was a question of fact. Since that time the courts have been grappling with what is necessary to establish a secondary intention.[128] Secondary intention has been considered in terms of whether the possibility of resale was "an operating motive" for the original acquisition of the property,[129] whether the taxpayer had the "thought that he might sell at a profit" at the time of the purchase[130] and whether the possibility of acquiring an investment property "was the exclusive purpose at the time of the acquisition".[131] In characterizing securities transactions the view has developed that such transactions give rise to capital gains and capital losses[132] rather than income or business losses. However, in the *Boissin* case[133] the previous established position was seriously challenged when Mr. Justice Collier characterized the loss on a securities transaction as being in the nature of income. In *Western Wholesale Drug Ltd. v. The Queen*[134] the reasoning applied in the *Boissin* case was again used to characterize a share purchase transaction as giving rise to income and not capital gains. There, Mr. Justice Mahoney, in considering the question of whether the taxpayer considered the possibility of the disposition of the shares at a profit, clearly indicated a desire to apply the secondary intention doctrine to security transactions as it has been applied to transactions involving other assets.

One of the most difficult areas of characterization of expenditures is that arising in respect of loan guarantees. Unfortunately for the guarantor, from time to time he is in fact called upon to honour his guarantee. In most instances the guarantor has an ulterior motive in executing the guarantee: he will earn income directly or indirectly by reason of the operation of the borrowing person. When the guarantor is called upon to pay, he normally attempts to deduct the payments as a loss from business or property. In *The Queen v. H. Griffiths Co.*,[135] Mr. Justice Dubé reviewed the mass of Canadian decisions and then overturned the Tax Review Board's determination that the amount was an outlay or expense

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[127] [1969] S.C.R. 902, [1960] C.T.C. 384, 60 D.T.C. 1270.

[128] *See, e.g.*, Reicher v. The Queen, [1975] C.T.C. 659, 76 D.T.C 6001 (F C App D.); De Salaberry Realties Ltd. v. The Queen, [1976] C.T.C. 656, 76 D T.C 6408 (F.C. App. D.); Hillsdale Shopping Centre Ltd. v. M.N.R., [1977] C.T.C. 402, 77 D T.C 5256 (F.C. Trial D.); Mainland Crystal Glass Ltd. v. The Queen, [1977] C.T C. 117, 77 D T.C. 5080 (F.C. Trial D.).

[129] *De Salaberry Realties*, *id.* at 659, 76 D.T.C. at 6411

[130] *Mainland Crystal Glass*, *supra* note 128, at 121, 77 D.T.C at 5082

[131] *Hillsdale Shopping Centre*, *supra* note 128, at 415, 77 D.T.C at 5264

[132] Irrigation Industries Ltd. v. M.N.R., [1962] S.C.R. 346, [1962] C T C 215, 62 D.T.C. 1131, *rev'g* [1960] C.T.C. 329 (Ex.).

[133] Boissin v. The Queen, [1976] C.T.C. 358, 76 D.T.C 6196 (F C Trial D).

[134] [1977] C.T.C. 1, 77 D.T.C. 5021 (F.C. Trial D.)

[135] [1976] C.T.C. 454, 76 D.T.C. 6261 (F.C. Trial D.), *rev'g* [1975] C T C 2120, 75 D.T.C. 97 (Tax Rev. B.).

for the purpose of gaining or producing income. In determining that the creation of the business entity on whose behalf the taxpayer executed a guarantee brought into existence an asset of enduring benefit, the Federal Court continued to recognize the artificial distinction between separate business entities deliberately created by the taxpayer. Not only does the case indicate that guarantees will be characterized as capital expenditures, it raises the spectre of "nothing" expenses. In particular, if the guarantee is not for the purpose of earning income it will not even give rise to allowable capital losses.[136]

Accepting the legitimacy of a secondary intention attack upon a transaction, it is necessary to determine the time at which the secondary intention must have existed. The *Racine* case[137] said the intention must have existed at the moment of purchase. The "moment of purchase" appears to be a simple, straight-forward test — unless the purchase transaction continues for a lengthy period of time. In *Dickson v. The Queen*[138] the purchase took several months to finalize. The taxpayer argued that the appropriate time was when he made the first formal attempt to purchase. At trial that position was rejected on the basis of the decision of the Exchequer Court in *Warnford Court (Canada) Ltd. v. M.N.R.*[139] where it was stated that the time to view the transaction was when it became legally binding. As the Court of Appeal did not disturb the result, it appears that the secondary intention doctrine will now apply to the detriment of a taxpayer if he forms a secondary intention at any time up to the date of acquiring legal title, even if the legal title is acquired by the exercise of rights under an earlier option.[140]

As the taxpayer has the onus of establishing the invalidity of the Minister's assessment, the present state of the law is entirely unsatisfactory. Although one may be less than sympathetic toward those who are able to acquire huge increases in their net worth, the taxpayer should be given more guidance as to the way he will be treated. It appears that with the introduction of the secondary intention doctrine, and its consequent expansion, the tax system is making it impossible for any sophisticated taxpayer to acquire capital gains status. If that result is viewed as desirable, it should be legislated and the fiction of taxpayers pretending that they entered into transactions with no secondary intention should be laid to rest.

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[136] The problem of characterizing allowable capital losses and the methods devised by taxpayers to allow a deduction are exemplified by Neifer v. M.N.R., [1976] C.T.C. 2080, 76 D.T.C. 1071 (Tax Rev. B.) and Crevier v. M.N.R., [1976] C.T.C. 2271, 76 D.T.C. 1208 (Tax Rev. B.). The characterization of receipts by the taxpayer by reason of executing guarantees is considered in Audet v. M.N.R., [1976] C.T.C. 2436, 76 D.T.C. 1320 (Tax Rev. B.).

[137] Racine v. M.N.R., [1965] 2 Ex. C.R. 338, [1965] C.T.C. 150, 65 D.T.C. 5098.

[138] [1977] C.T.C. 64, 77 D.T.C. 5061 (F.C. App. D.), *aff'g* [1974] C.T.C. 753, 74 D.T.C. 6653 (F.C. Trial D.).

[139] [1964] 1 Ex. C.R. 944, [1964] C.T.C. 175, 64 D.T.C. 5103.

[140] Although the cases do not say so, it would appear difficult for a taxpayer to argue successfully that a secondary intention which existed early in negotiations disappeared by the time the transaction was finalized.

B. *Characterization of Expenditures*

Before expenditures can be reflected in the calculation of income from business or property, it is necessary to characterize those expenditures.

The important distinction between capital and current expenditures was recently considered in *Shabro Investments Ltd. v. The Queen*.[141] The taxpayer had constructed a building on land which had formerly served as a garbage landfill site. With the passage of time the garbage decomposed, causing the floor of the building to collapse. Rather than replace the floor with a similar type (concrete slabs on grade), the taxpayer chose to install a new floor supported by steel piles and reinforced with steel. The cost of the floor was in excess of $95,000. The learned trial judge reviewed many old authorities and appeared to rely on the *Canada Steamships*[142] case in concluding that the expenditure was of a capital nature. The basis of the judgment appeared to be that the new floor was so materially different from and so superior to the old floor that it was a change in the character of the floor and an upgrading of the building. Though the decision could have been anticipated, the basis of the judgment appears to add a further test to the distinction between capital and current expenditures. While one cannot argue with the decision in this case it should be observed that with continued technological improvements, it is likely that many, if not most, repairs or replacements involve parts which are alleged (at least by the vendors) to be superior to those which were replaced. In theory, the expression "materially different" should eliminate most problems, but one cannot help but be concerned by the addition of another nebulous test to this already over-considered area.

A slightly different problem arises in considering whether the taxpayer has acquired inventory or incurred a business expenditure. In the absence of a "profit" definition the determination must be made according to accepted business and accounting practices.[143] The issue is further complicated when the expenditure is in respect of items which would be considered expenses if consumed during the year. In *Kelly, Douglas & Co. v. M.N.R.*[144] the taxpayer acquired a substantial quantity of stationery. When it attempted to deduct the cost, the Minister argued that the expenditures were made in respect of inventory and had to be treated as such. Despite the fact that the company showed the stationery on hand as inventory on its balance sheet, the Tax Review Board permitted its characterization as a current expenditure.

In small businesses, expenditures which are normally clearly business expenses may in fact be disguised personal or living expenses. The kind

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[141] [1977] C.T.C. 429, 77 D.T.C. 5293 (F.C. Trial D.).

[142] Canada Steamship Lines Ltd. v. M.N.R., [1966] Ex. C.R. 972, [1966] C.T.C. 255, 66 D.T.C. 5205.

[143] Publishers Guild of Canada Ltd. v. M.N.R., [1956-60] Ex. C.R. 33, [1957] C.T.C. 1, 57 D.T.C. 1017.

[144] [1976] C.T.C. 2107, 76 D.T.C. 1090 (Tax Rev. B.).

of situations in which this can occur is indicated in *Kiss v. M.N.R.*[145] The taxpayer borrowed a substantial sum of money to set up a professional practice. During the relevant years the earnings of the taxpayer were less than his drawings from the professional practice so that he was in fact drawing part of the borrowed money. If he had borrowed directly from the bank the interest would not have been deductible and the Minister was successful in arguing that the same reasoning should apply in this case.[146]

The distinction between current expenditures and eligible capital expenditures still arises, but with the introduction of deductions in respect of eligible capital expenditures the frequency of such cases appears to have been reduced. In *Moreau v. M.N.R.*[147] the Tax Review Board reiterated the view expressed in *Cumberland Investments Ltd. v. The Queen*[148] that the test was whether or not the expenditures were calculated to absorb the vendor's business and at the same time effectively eliminate that concern and its owner as a business competitor.

In view of the relative certainty in the area of characterization of expenditures there should be fewer cases appearing before the courts and those that do appear should be disposed of along well-developed principles of characterization.

C. *Jurisprudential Developments in Deductions from Business Income*

Despite the lead provided by the Exchequer Court in 1964 in *M.N.R. v. Eldridge*,[149] it took twelve years for the next major step involving the deductibility of penalties or fines to occur. In *Eldridge*, the Exchequer Court decided that the expenses involved in the operation of a call girl service were deductible in computing the income from the business. While the taxpayer in that case had real problems of proof, it appeared that as a result of the case bribes, penalties, fines, legal fees, *etc.* would be deductible.

In *Day & Ross Ltd. v. The Queen*[150] the taxpayer was in the highway transport business. As part of its business it regularly incurred fines for operating overweight vehicles without a required permit. The nature of the taxpayer's business was such that it was impossible to ensure that the trucks were not overweight as the taxpayer had to rely on the statements of its clients. When there was no doubt as to which of the clients had caused the vehicle to be overweight the taxpayer charged the client the amount of the fine. Where it was unable to determine the cause of the excess weight it paid the fines and chose to treat them as normal business expenses deductible by virtue of the meaning of profit in section 9. Counsel for the Minister argued that the amounts were not incurred for the purpose of

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[145] [1976] C.T.C. 2112, 76 D.T.C. 1093 (Tax Rev. B.).

[146] For an interesting analysis of how much of the expenditure should be characterized as a business expense, *see* Note, 24 CAN. TAX J. 324 (1976).

[147] [1977] C.T.C. 2249, 77 D.T.C. 153 (Tax Rev. B.).

[148] [1975] C.T.C. 439, 75 D.T.C. 5309 (F.C. App. D.).

[149] [1965] 1 Ex. C.R. 758, [1964] C.T.C. 545, 64 D.T.C. 5338.

[150] [1977] 1 F.C. 780, [1976] C.T.C. 707, 76 D.T.C. 6433 (Trial D.).

gaining or producing income[151] and that the deduction of such amounts was contrary to public policy. The fines were found by Mr. Justice Dubé to be the result of the day-to-day operation of its business and thus similar to the *Imperial Oil* case,[152] where it was determined that the negligence of the taxpayer's employees was a normal and ordinary risk of the company's business activities. Mr. Justice Dubé obviously considered fines to be a normal aspect of carrying on the particular business and not a particularly serious transgression of public policy.[153]

If the businessman's approach is taken to the case, it is hard to dispute its validity. Clearly, minor violations of the rules and regulations of our society are undertaken with full knowledge of the consequences. Indeed it is likely that they are considered a necessary cost of doing business.[154] The problem arises in distinguishing certain minor violations of society's rules from serious transgressions. As a matter of taxation the distinction should be unimportant, the appropriate guiding principle being simply: was the expense incurred for the purpose of earning income? The comment by Dubé J. that the particular fines were not outrageous transgressions of public policy implies that other types of penalties and offences are. Revenue Canada has already accepted deductions for fines and kickbacks[155] (subject to questions of proof) and it is suggested that fines for breach of combines legislation, environmental control legislation and consumer protection legislation should be similarly deductible. On the other hand, payments made to commit murder or penalties imposed for homicide convictions should not be.[156] If the government is to participate in the profits of illegal business activity, it appears appropriate that the profit be measured by reference to the kinds of expenditures which occur to create that form of profit. As such, all expenses incurred as a result of the business activity, and falling within the guidelines set out in the *Imperial Oil* case,[157] should be deductible.[158]

Although the lack of a definition of "profit" in the Income Tax Act gives rise to numerous references to the courts, it is not the only area in

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[151] This argument was successful in M.N.R. v. Pooler and Co., [1963] Ex. C R 16, [1962] C.T.C. 527, 62 D.T.C. 1321.

[152] Imperial Oil Ltd. v. M.N.R., [1947] Ex. C.R. 527, [1947] C.T.C. 353, 3 D T C 1090.

[153] *Supra* note 150, at 794-95, [1976] C.T.C. at 718, 76 D.T.C at 6440.

[154] A common example is the ignoring of parking by-laws (not only by businessmen drivers): clearly such violations are carried out with full knowledge that a small penalty may be imposed. Another, less common, example of breach of society's rules involves the use of bribes and kickbacks at upper levels of business in instances where the only motive can be profit.

[155] Information Circular 76-4R.

[156] It is recognized that the taxpayer could argue that the death of a competitor will increase his business, but even then (tongue in cheek) surely he should be considered to have made a capital expenditure the deduction of which is prohibited by s. 18(1)(b).

[157] *Supra* note 152.

[158] *Cf.* Canada Motor Sales Ltd. v. M.N.R., [1977] C.T.C. 2037, 77 D T.C 30 (Tax Rev. B.).

which significant litigation has arisen in the past few years. One of the most difficult areas has been the treatment to be accorded depreciable property. In *The Queen v. Canadian Pacific Ltd.*[159] the taxpayer acquired certain depreciable property and was reimbursed in whole or in part by other parties. The company attempted to calculate capital cost allowance on the basis of the cost of the assets acquired without taking into account the reimbursement received. The various transactions in respect of which this had occurred fell into two broad categories: (a) the occasions when C.P. made the expenditures on its own behalf pursuant to an agreement that another party would pay C.P. a sum not exceeding the amount of the expenditures; and (b) those cases where C.P. made the expenditures on behalf of a customer who then paid C.P. for the construction, but C.P. by means of a separate transaction later became the owner of the depreciable property involved.

The argument advanced in respect of both categories was that the receipts were not earmarked for any particular purpose. As the company was free to utilize the funds in whatever manner it desired, it was argued that the reimbursements did not diminish the capital cost of the property. This argument was accepted by the trial court.[160]

On appeal, however, the trial decision in respect of the second category was reversed.[161] In that situation, the newly-created asset temporarily became the property of the customer. It was by means of a separate transaction (although part of the same scheme) that it eventually became the property of C.P., which then attempted to include the amount paid by it, but charged to the customer, in its calculation of the capital cost of the asset. Mr. Justice Pratte, speaking for the court, had no difficulty holding that this amount was simply a current expense of carrying out a building contract and consequently it was not an expenditure giving rise to a deduction in respect of capital cost allowance.

If the first point in the case is examined in isolation it gives rise to a rather unusual result: where a taxpayer acquires depreciable property by means of expenditures for which he is reimbursed in whole or in part, he is able to deduct the entire expenditure in respect of capital cost allowance. Yet in the normal situation, the reimbursement will probably not give rise to income and therefore it will not be taxable at all. The only possible basis for taxation might be as capital gain, but even this suggestion appears to be debatable.[162] As this particular case involved railway properties (which are subject to special rules) the case can perhaps be considered a special situation with little general significance.

In another court case, *Henuset*,[163] the issue involved not the question of what the capital cost was but rather when it was incurred. The taxpayer

[159] [1977] C.T.C. 606, 77 D.T.C. 5383 (F.C. App. D.).

[160] [1976] 2 F.C. 563, [1976] C.T.C. 221, 76 D.T.C. 6120 (Trial D.).

[161] *Supra* note 159, at 613-14, 77 D.T.C. at 5387-88.

[162] *See* similar reasoning in the text accompanying note 38, *supra*.

[163] The Queen v. Henuset Bros., [1977] C.T.C. 228, 77 D.T.C. 5169 (F.C. Trial D.).

had entered into negotiations to purchase tractors late in the taxation year. The actual documents were executed on December 29 and called for a down payment, the execution of a conditional sales contract, and the issue of promissory notes. The tractors were delivered in the subsequent taxation year. By reason of the conditional sales contract, title did not pass until the terms of the conditional sales contract were fulfilled.

The Tax Review Board[164] was prepared to allow capital cost allowance on the basis that the purchaser had all the incidents of title, such as possession, use and risk. As there was no actual possession, it was necessary to determine that the taxpayer had constructive possession. The case is unusual in that neither physical possession nor legal title resided with the taxpayer. An appeal to the Trial Division of the Federal Court did not change the result. Mr. Justice Bastin thought the reservation of legal title as security "did not affect the issue any more than the taking of security or the tractors in the form of a chattel mortgage would have done".[165] It is submitted that disregarding the distinction between conditional sale and chattel mortgage is to be commended. However, the case should be recognized for what it is: a transaction entered into with a view to reducing the tax payable by the taxpayer for the year in which the transaction occurred.

D. *Legislative Developments Affecting Deductions From Business and Property Income*

The deductions available to taxpayers earning income from business and property have been reconsidered both in light of tax equity and with a view to encouraging investment activity.[166] Among the more significant changes are those affecting inventory allowance, capital cost allowance, and investment tax credits.

1. *Inventory Allowance*

Many representations over a number of years finally resulted in an amendment to the Act in 1977 to take into account the effects of inflation on the inventory of business enterprises.[167] The allowance appears to be relatively simple and applies to all business activities, whether or not the taxpayer is incorporated. The deduction permitted is an amount equal to three per cent of the cost of inventory on hand at the beginning of the year. The types of inventory to be taken into account in the calculation of the inventory allowance are restricted to tangible assets other than real property or an interest in real property.

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[164] [1976] C.T.C. 2039, 76 D.T.C. 1043 (Tax Rev. B.).

[165] *Supra* note 163, at 229, 77 D.T.C. at 5170.

[166] Income bonds, used as a method of assisting business activity, are severely curtailed in the proposed amendment to the Act. *See* Bill C-37, cl. 5. Cl. 65(5) modifies the definition of income bonds.

[167] ITA, s. 20(1)(gg), *as added by* S.C. 1977-78, c. 1, s. 14(1). Bill C-37 proposes another inventory adjustment: *see* cls. 3, 7(2) and 28(2).

2. *Capital Cost Allowance*

Capital cost allowance, being one of the discretionary deductions available to investors, is regularly used to achieve desired social and economic objectives.[168] In addition to the regular review of the allowances permitted to taxpayers, there have been a number of changes which have eliminated anomalies, clarified existing rules and extended the application of the recapture rules on replacement properties.

The option to claim or defer capital cost allowance has been removed in those instances in which the taxpayer no longer has property remaining in a prescribed class.[169] It is now necessary for the taxpayer to take the deduction or lose it, even though the result will be that a loss is created from the business or property for the year.

Any argument as to the tax treatment of costs incurred in disposing of depreciable property has been resolved. Paragraph 13(21)(f) now provides[170] that the cost of disposing of property shall be deducted from the proceeds of disposition actually received in determining undepreciated capital cost and therefore potential recapture.[171]

Potential problems arising on the acquisition of property in which the taxpayer previously held a leasehold interest have been resolved by the simple expedient of a deemed disposition of the leasehold interest and deemed acquisition of the property at its undepreciated capital cost.[172] To ensure recapture, the capital cost allowance taken on the leasehold class is added to the capital cost allowance taken on the class to which the acquired property was added. The amount added to the undepreciated capital cost of the class is the capital cost allowance taken less the amount claimed by the taxpayer. The rules for determining the amount of capital cost allowance claimed are set out in subsections 13(5) to 13(7). While it is assumed that these rules will also apply to determine the capital cost allowance taken in respect of the particular property, it should be pointed out that more equitable results could probably be obtained by using a variation of those rules. This is particularly so as leasehold interests may in fact have been depreciated according to the provisions of class 13 and schedule H, with the result that the deduction was based on a pro-rated portion of the capital cost to the taxpayer of the particular leasehold interest.

A major change in the treatment of depreciable property is the

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[168] Past examples of the utilization of capital cost allowance provisions for non-tax reasons include accelerated capital cost allowance rates for Expo '67 developments, pollution control equipment and scientific research expenditures. Past examples of deferral of equitable capital cost allowance deductions include the deferred rates on investment buildings provided for in Regulations 1107 and 1110.

[169] ITA, s. 20(16), *as added by* S.C. 1977-78, c. 1, s. 14(4).

[170] ITA, s. 13(21)(f)(iv) and (v), *as amended by* S.C. 1977-78, c. 1, s. 6(10).

[171] It would appear also that expenses of disposition in those cases in which the property has appreciated will result in capital expense treatment of the amounts so expended. *Quaere* whether the taxpayer may opt to treat the expense as a current expense in view of the amendment to s. 13(21)(f).

[172] ITA, s. 13(5.1), *as added by* S.C. 1977-78, c. 1, s. 6(3).

extension of the deferral provisions for recapture of capital cost allowance in respect of replacement properties. Provisions for deferring recapture had existed even prior to Tax Reform but the application was restricted to accidental recapture (that is, insurance proceeds).[173] Since that time the application of the deferral rules has been extended on several occasions. First, as part of Tax Reform it was extended[174] to apply to amounts payable as compensation for property expropriated or sold under threat of expropriation.[175] At that time the deferral only applied if replacement occurred within one year, and the taxpayer did not have the option of declining the concession so granted to him. In May 1974 the restrictive time limit was extended in two ways: directly, by permitting the taxpayer two years to obtain the replacement;[176] and indirectly, by redefining the point from which the time limitation would run.[177] The mechanics of the application rules were brought more closely in line with those applying to capital gains, and further rules were devised to prevent the replacement property from being disposed of prior to disposition of the original property.[178]

In 1977, attempts were made once again to integrate more fully the deferral provisions with the general rules applicable to capital cost allowance, capital gains, and eligible capital property.[179] As well, for the first time the taxpayer was given the option of deciding whether he desired the benefits of the deferral provisions. The extension of the deferral to cases involving theft is at least as equitable as its application to any other receipts in respect of involuntary loss and requires no further comment. When a disposition occurs voluntarily, the taxpayer has time to plan for it. Taking into account the importance of the distinction between voluntary and involuntary dispositions, it was apparently thought unnecessary to provide two years for a replacement property to be acquired in the case of voluntary dispositions.

The definition of replacement property has also been clarified.[180] To fall within the provision, the property must have been acquired by the

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[173] ITA, s. 20(5a), *as added by* S.C. 1955, c. 54, s. 2(1), *as amended by* S.C 1966-67, c. 91, s. 5(3), and S.C. 1968-69, c. 28, s. 105.

[174] ITA, s. 13(4), *as added by* S.C. 1970-71-72, c. 63, s. 1

[175] It should be noted that similar deferral provisions were also provided at that time in respect of capital gains arising from the same transactions.

[176] ITA, s. 13(4), *as amended by* S.C. 1974-75-76, c 26, s. 6(2).

[177] The Act, prior to May 6, 1974, provided no guidelines as to when time began to run. In the absence of guidelines it was arguable that time started when proceeds were receivable.

[178] ITA, s. 13(4)(c)(ii). Without such rules it would have been arguable that deferral occurred forever since both properties could have been identified as being both original properties and replacement properties.

[179] ITA, s. 13(4), *as amended by* S.C. 1977-78, c. 1, s. 6(2). (At this time deferral rules were also introduced in respect of eligible capital property: ITA, s. 14(6), *as added by* S.C. 1977-78, c. 1, s. 7(3).) The introduction of the negative adjusted cost base in 1976 required appropriate technical amendments to the deferral section to reflect more accurately the accounting treatment being applied in these cases.

[180] ITA, s. 13(4.1), *as added by* S.C. 1977-78, c. 1, s. 6(2), *as amended by* S.C 1977-78, c. 32, s. 2.

taxpayer for the same use as the former property. If it was a former business property it must have been acquired for the purpose of earning income from that or a similar business.

Whether in fact these amendments have changed the tax treatment applicable to the kinds of disposition referred to is debatable.[181] What is clear, however, is that the intention to provide relatively lenient rules in this area has been legislatively recognized. Unfortunately, the area is still lacking in technical detail and will require further amendments to remove anomalies.[182] Allowing a taxpayer to dispose of property voluntarily and still defer recapture is no doubt the most significant development in this area. The deferral on voluntary dispositions applies whenever a taxpayer disposes of a "former business property".[183] That term is defined, not in subsection 13(21) as one might expect, but rather in section 248. The term encompasses capital property that was used by the taxpayer primarily for the purpose of gaining or producing income from a business, and that was real property or an interest in real property. This definition is rather broad, so there is added to it a list of exceptions which effectively remove from the definition all rented properties. Then, to take into account the fact that many business activities are carried on by groups of closely associated taxpayers, the definition permits the inclusion of property which is "rented" to a lessee under an agreement by which the lessee uses the property to assist the taxable owner.

3. *Investment Tax Credits*

Since 1975 the tax system has provided an investment tax credit[184] equal to five per cent of the cost of qualified property. The credit was originally of a temporary nature, intended to expire on June 30, 1977. The temporary nature has not been eliminated; however, the term has now been extended to 1980[185] and the qualifying property has been expanded to include a "qualified expenditure" in respect of scientific research.[186] In essence, the term now includes eligible current and capital expenditures on scientific research and qualifying expenditures used in the production of industrial minerals[187] and large logging trucks.[188]

In addition, areas of the country considered to be in need of

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[181] *See* Harris, *Replacement Property*, in 1977 TAX CONFERENCE REPORT, *supra* note 4, at 395 for a very illuminating comment to the contrary.

[182] *Id.* at 403 *et seq.*, Professor Harris calls attention to numerous problems.

[183] ITA, s. 13(4)(b), *as amended by* S.C. 1977-78, c. 1, s. 6(2).

[184] ITA, s. 127(5), *as added by* S.C. 1974-75-76, c. 71, s. 9.

[185] S.C. 1977-78, c. 1, ss. 61(6), (9) and (10). The proposed amendment would remove the termination date and significantly enrich the investment credit program: Bill C-37, cl. 40.

[186] ITA, s. 127(10.1)(c), *as added by* S.C. 1977-78, c. 1, s. 61(10); s. 37(1)(e), *as added by* S.C. 1977-78, c. 1, s. 15.

[187] ITA, s. 127(10)(c)(x), *as added by* S.C. 1977-78, c. 1, s. 61(7).

[188] Income Tax Regulations, s. 4600(2)(ea), *as added by* S.O.R./78-137 (112 Can. Gazette, Pt. II, 572) [hereinafter cited as ITR].

investment are entitled to additional investment tax credits of two and one-half per cent[189] or five per cent.[190]

E. *The Business of Farming*

Taxpayers "farm" for many reasons. Some feel attachment to the land, some hope eventually to earn a full living from the farm, some intend to do so immediately, and still others want to live on a country estate. All farmers have one thing in common: if they suffer a loss, they wish to take it into account in calculating their tax liability. Section 31 is intended to prevent the deduction of farming losses in certain circumstances.

In *Moldowan v. The Queen*[191] the Supreme Court of Canada had the opportunity to consider the meaning of the predecessor of section 31 after both the Trial Division and Court of Appeal had found against the taxpayer. The taxpayer had been engaged in training, boarding and racing horses for a number of years and suffered losses in almost all the years. Mr. Justice Dickson determined that the activities of the taxpayer constituted farming[192] and, citing *Dorfman v. M.N.R.*,[193] held that farming could constitute a "source of income" so long as there was "a reasonable expectation of profit".[194]

The question of whether or not there was a reasonable expectation of profit was an objective determination to be made from all the facts and a number of criteria had to be considered. These included "the profit and loss experience in past years, the taxpayer's training, the taxpayer's intended course of action" and the capability of the venture to make a profit in view of the investment involved and after taking into account capital cost allowance.[195]

The determination of whether or not farming was a chief source of income was to be made by both a relative and objective test. The main feature was "the taxpayer's reasonable expectation of income from his various revenue sources and his ordinary mode and habit of work".[196] By looking at the time spent, the investment and the actual and potential profit ability the determination could be made.

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[189] ITA, s. 127(9)(a.2), *as added by* S.C. 1977-78, c. 1, s. 61(3); s. 127(10.1)(c), *as added by* S.C. 1977-78, c. 1, s. 61(10). The 2.5 per cent credit is given in "designated areas", *i.e.*, designated under the Regional Development Incentives Act, R.S.C. 1970, c. R-3.

[190] ITA, s. 127(9)(a.1), *as added by* S.C. 1977-78, c. 1, s. 61(3). The five per cent credit is available in Newfoundland, Prince Edward Island, Nova Scotia, New Brunswick and the Gaspé Peninsula.

[191] [1978] 1 S.C.R. 480, [1977] C.T.C. 310, 77 D.T.C. 5213, *aff'g* [1976] F.C 355, [1975] C.T.C. 323, 75 D.T.C. 5216 (App. D.), *aff'g* [1974] C.T.C. 638, 74 D.T C. 6496 (F.C. Trial D.).

[192] The definition of "farming" in s. 248(1) includes the maintaining of horses for racing.

[193] [1972] C.T.C. 151, 72 D.T.C. 6131 (F.C. Trial D.).

[194] *Supra* note 191, at 485, [1977] C.T.C. at 313, 77 D.T.C. at 5215.

[195] *Id.* at 486, [1977] C.T.C. at 314, 77 D.T.C. at 5215.

[196] *Id.* at 486, [1977] C.T.C. at 314, 77 D.T.C. at 5215-16.

In determining what constituted a "combination" within the meaning of the section, Mr. Justice Dickson found that the number of situations involving "farming" could be broken down into three groups:

(a) a taxpayer who looks to farming for his livelihood: he is not affected by section 31;
(b) a taxpayer who carries on farming only as a sideline business and does not look to it for his livelihood: this farmer will be subject to the section 31 restriction on farming losses;
(c) a taxpayer who does not look to farming for his livelihood and carries on farming as a hobby: he will not be entitled to deduct any farming losses.[197]

Mr. Justice Dickson then decided that a "combination" of farming and another source fit within the first group above.

A discussion of the problems raised in the earlier case of *Brown v. The Queen*,[198] which also dealt with farming losses, appears to be unnecessary. In that case, Cattanach J. discussed the difficulties in ascertaining what constitutes a "combination of farming and some other source of income". This problem is resolved by *Moldowan*: a combination "contemplates a man whose major pre-occupation is farming. But it recognizes that such a man may have other pecuniary interests as well, such as income from investments, or income from a sideline employment or business."[199] The result, apparently, is that a taxpayer who carries on another business which amounts to more than a sideline may be prevented from deducting his farming losses in full.

F. *State Interference in Tax-Planned Business Transactions*

> "If the agreement or transaction lacks a *bona fide* business purpose, it is a sham."[200]
>
> "Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be."[201]

The above comments reflect, more than any lengthy commentary can, the extremes of the position on this matter. Historically, transactions which could be characterized as shams were disallowed, with the result that tax liability was incurred as if the transaction had not taken place. According to the Supreme Court of Canada in *M.N.R. v. Cameron*,[202] a sham may be characterized as a transaction in which the documents executed by the parties are intended to give the appearance of creating legal rights and obligations different from the actual legal rights and

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[197] *Id.* at 487-88, [1977] C.T.C. at 315, 77 D.T.C. at 5216.
[198] [1975] C.T.C. 611, 75 D.T.C. 5433 (F.C. Trial D.).
[199] *Supra* note 191, at 488, [1977] C.T.C. at 315, 77 D.T.C. at 5216.
[200] M.N.R. v. Leon, [1977] 1 F.C. 249, at 256, [1976] C.T.C. 532, at 539, 76 D.T.C. 6299, at 6302 (App. D.).
[201] Inland Revenue Comm'rs v. Duke of Westminster, [1936] A.C. 1, at 19, [1935] All E.R. Rep. 259, at 267 (H.L.).
[202] [1974] S.C.R. 1062, [1972] C.T.C. 380, 72 D.T.C. 6325, *relying on* Snook v. London & West Riding Invs., Ltd., [1967] 2 Q.B. 786, [1967] 1 All E.R. 518 (C.A.).

obligations created by the parties. In other words, the actual rights must be different than those expressed in the documents.

Serious concern as to the exact meaning to be attributed to "sham" occurred after the release of the decision of the Federal Court of Appeal in *M.N.R. v. Leon.*[203] The only basis within the Act for the disallowance of business transactions is set out in sections 245 to 247. Canadian courts have traditionally adopted the reasoning of *Commissioners of Inland Revenue v. Duke of Westminster*[204] as is indicated in the Federal Court of Appeal decision of *M.N.R. v. Smith Estate*: "Admittedly, what the taxpayer did was to indulge in estate planning to reduce the tax applying to her estate. It is trite law to say that every taxpayer is entitled to so manage his affairs as to minimize the incidence of tax payable."[205]

The *Leon* case involved an interposition of a management corporation between the taxpayer and the operating business. The management corporation entered into a management agreement with the operating business entity; the management corporation then entered into an employment contract with its shareholder. The management corporation had no telephone, letterhead, office, other employees or other indicia of business involvement. The arrangements apparently were legally effective and were not disqualified by reason of impediments such as those in *Richardson Terminals Ltd. v. M.N.R.*,[206] *Kindree v. M.N.R.*[207] and *Oakfield Developments (Toronto) Ltd. v. M.N.R.*[208] The judge in the Trial Division found that the sole purpose of the interposition of the management company was to save tax.[209]

On appeal to the Federal Court of Appeal, Mr. Justice Heald distinguished the *Cameron* case[210] by finding that the arrangements in that case were put into effect for a business purpose and that the tax saving was merely incidental, whereas in *Leon*, tax saving was the sole purpose. It could be argued that Mr. Justice Heald extended the sham concept unjustifiably.[211] This concern was reinforced by a sister case, *Ablan Leon (1964) Ltd. v. M.N.R.*[212] In that case Mr. Justice Heald, with the

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[203] *Supra* note 200. *See, e.g., Editorial Note*, [1976] C.T.C. 533; Ware, *The Business Purpose Test and Sham Transactions*, in REPORT OF THE TWENTY-EIGHTH TAX CONFERENCE 602, at 607 (1976).

[204] *Supra* note 201.

[205] [1975] C.T.C. 335, at 344, 75 D.T.C. 5242, at 5248 (F.C. App. D.).

[206] [1971] C.T.C. 42, 71 D.T.C. 5028 (Ex.), *aff'd* [1972] C.T.C. 528, 72 D.T.C. 6431 (S.C.C.), where the business had simply not been made that of the interposed company.

[207] [1970] Tax A.B.C. 62, 70 D.T.C. 1054, where it was held that a practice of medicine could not in fact or law be carried out by a corporation.

[208] [1969] 2 Ex. C.R. 149, [1969] C.T.C. 219, 69 D.T.C. 5175, where an allotment of shares was invalid because they were issued under supplementary letters patent which bore a date antecedent to their actual issuance.

[209] [1974] 2 F.C. 708, at 717, [1974] C.T.C. 588, at 593, 74 D.T.C 6443, at 6448 (Trial D.).

[210] *Supra* note 202.

[211] *See, e.g.*, Note, 24 CAN. TAX J. 468 (1976).

[212] [1976] C.T.C. 506, 76 D.T.C. 6280 (F.C. App. D.).

concurrence of Mr. Justice Ryan, refused to recognize that trusts had been legally created. There were in fact defects in the legal creation of the trusts, but even if there had not been, it appears that the court would have reached the same decision.[213] The only conclusion which can be drawn is that where the sole purpose of the transaction is to reduce taxes payable, the courts will go out of their way to refuse to recognize the transaction. The impact of these two similar cases from the Federal Court of Appeal is tempered only slightly by the fact that they involved only one set of taxpayers and that the decisions were handed down by the same members of the court.[214]

Some of the concern was laid to rest in 1977 with the release of the decision of the Federal Court of Appeal in *Massey Ferguson Ltd. v. The Queen*.[215] In this case the taxpayer wished to make an interest-free loan to a wholly-owned foreign subsidiary. Such a transaction would have resulted in deemed income to Massey Ferguson Ltd., and to avoid that result the loan was made to a wholly-owned Canadian subsidiary of Massey Ferguson. The Canadian subsidiary in turn loaned the money to the foreign subsidiary. By reason of the operation of subsection 19(3) (now subsection 17(3)) the deeming provisions did not apply if the two steps of the transaction were legally recognized.

Mr. Justice Urie, speaking for the Court of Appeal, found that the lower level courts were wrong in finding that there was no legitimate business purpose for the two-step transaction. The intermediary subsidiary was in fact in the business of acting as financing agent for the various subsidiaries; the loan was thus a legitimate part of that business. In making his decision, Mr. Justice Urie employed the *Snook*[216] definition of sham which had been cited in *Cameron*.[217] In addition to distinguishing the *Leon* case[218] as a case in which there was no *bona fide* business purpose for the existence of the management company, he made the following statement: "I am not at all sure that I would have agreed with the broad principles relating to a finding of sham as enunciated in that case, and, I think, that the principle so stated should perhaps be confined to the facts of that case."[219]

This last comment, by itself, suggests that the *Leon* case should be ignored. However, it must be read in light of his earlier discussion of the function of the intermediary company and the facts of the transaction in question, where the existence of a business purpose is expressly acknowledged. Thus *Massey Ferguson* does not make it clear whether there must exist a "business purpose" above and beyond the desire to effect tax savings.[220]

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[213] *Id.* at 527-28, 76 D.T.C. at 6295.
[214] It is noted that Deputy Judge MacKay dissented in *Ablan Leon (1964) Ltd.*
[215] [1977] F.C. 760, [1977] C.T.C. 6, 77 D.T.C. 5013 (App. D. 1976).
[216] *Supra* note 202.
[217] *Supra* note 202.
[218] *Supra* note 200.
[219] *Supra* note 215, at 772, [1977] C.T.C. at 16, 77 D.T.C. at 5020.
[220] Fotheringham v. M.N.R., [1977] C.T.C. 2372, 77 D.T.C. 274 (Tax Rev. B.)

The "business purpose" of a transaction plays a role not only in the application of the sham doctrine but also in respect of some of the specific provisions of the Act.[221] Basically, the cases suggest that one of the criteria in determining whether a particular outlay or expense has resulted in an undue or artificial reduction of income is the absence of a business purpose. The existence of a tax saving motive seems further to jeopardize a finding of legitimacy.

There have been recent indications that the motive and effect of transactions will not be considered to reduce income artificially or unduly if the taxpayer relies on specific provisions of the Act. In *Alberta and Southern Gas Co.*[222] the taxpayer entered into a transaction expressly authorized by statute. It appeared that the motive for entering into the transaction was to save tax and that the parties had no intention of carrying out the entire scheme involved in the transaction. The Trial Division found that, as the taxpayer was relying on a specific provision of the Act (section 66), the more general provision of subsection 245(1) could not be used to defeat the taxpayer's position. The trial court went further by specifically stating that if the taxpayer placed himself precisely within the provision of the Act, his motive in doing so was irrelevant. The Appellate Division dismissed the appeal by the Minister but refused to affirm the reasoning of the trial court. "Parliament must have intended the provision to have some effect and a non-statutory rule of interpretation is merely a crystallization of the judicial reasoning employed in ascertaining Parliament's intention in enacting a particular provision."[223] Later, Jackett C.J. said: "In my view, considering it in its context in the scheme of the Act, section 245(1) is applicable to every class of deductible expenses."[224]

Having refused to accept the reasoning of the trial court the Chief Justice then found that subsection 245(1) had no application to the specific case. However, the Court of Appeal did find that the taxpayer had acted within the object and spirit of section 66,[225] and in so doing it appears that the court has reduced the importance of motive, at least for those transactions that are technically valid. Indeed, a similar result was

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relied on the *Leon* case, but there is no indication that the *Massey Ferguson* decision had been brought to the attention of the Board, or indeed that it had been released prior to the argument.

[221] McDonnell, *Recent Developments Relating to Sham, Benefits and Business Purpose*, in 1977 TAX CONFERENCE REPORT, *supra* note 4, at 104 *et seq.* breaks the provisions down to three groups. The first includes ss. 103, 246 and 247, where motive is expressly relevant. The second consists of ss. 55 and 245(1), which deal with "unduly or artificially" reducing income, and he suggests that the business purpose test has a very legitimate role. In the third group he places those sections in which a "reasonableness" test has been adopted and suggests that a business purpose test is implied.

[222] The Queen v. Alberta and Southern Gas Co., [1978] 1 F.C. 454, [1977] C.T.C. 388, 77 D.T.C. 5244 (App. D.), *aff'g on different grounds* [1977] 1 F.C. 395, [1976] C.T.C. 639, 76 D.T.C. 6362 (Trial D.).

[223] *Id.* at 460, [1977] C.T.C. at 395, 77 D.T.C. at 5247.

[224] *Id.* at 461, [1977] C.T.C. at 396, 77 D.T.C. at 5248.

[225] *Id.* at 462-63, [1977] C.T.C. at 397, 77 D.T.C. at 5249.

reached in *Produits LDG Products Inc. v. The Queen*[226] when Mr. Justice Pratte refused to be influenced by the motives of the taxpayer when it established a substantial past service payment to a pension plan.

Decisions involving tax-planned transactions are not capable of satisfactory summary. Cases appear to be variously based on the concept of sham, lack of business purpose, inadequacy of documentation, and inadequacy of implementation. The Court of Appeal had an opportunity to give a final determinative answer in *Dominion Bridge v. The Queen*[227] but merely approved the Trial Division's finding of sham according to the *Snook* definition.[228]

Revenue Canada, no doubt not wishing to prejudice its position, states simply that the existence of a business purpose will assist in the establishment of the basis for a legitimate business transaction.[229] But J. R. Robertson, Director of the Rulings Division of Revenue Canada stated that Revenue Canada accepts the *Snook* decision[230] but that "the form is disregarded when it is illusory or is otherwise considered not to reflect the true legal position".[231]

While Revenue Canada continues to defend the importance of a business purpose in a transaction, one wonders whether the defence is presented with conviction. Mr. Robertson fails, despite his topic — *Tax Evasion and Tax Avoidance* — to provide a strong defence of the *Leon* case. Interpretation Bulletin IT-376 was also an ideal opportunity for the Department to express the necessity of having a business purpose in situations which were particularly suspect. With the lack of a more forceful statement, and in view of the failure to attempt an appeal of the *Massey Ferguson* case, one wonders about the necessity of a business purpose (other than the saving of tax) in business transactions. Certainly, the businessman on the street, if asked to give a business reason for complex transactions, would probably state that one of the main business reasons is the saving of tax.

IV. THE TAXATION OF CORPORATIONS AND SHAREHOLDERS

There have been a number of significant judicial and statutory developments in the area of corporate taxation since the last Survey.[232]

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[226] [1976] C.T.C. 591, 76 D.T.C. 6344 (F.C. App. D.).

[227] Dominion Bridge Co. v. The Queen, [1977] C.T.C. 554, 77 D.T.C. 5367 (F.C. App. D.), *aff'g* [1975] C.T.C. 263, 75 D.T.C. 5150 (F.C. Trial D.).

[228] Snook v. London & West Riding Invs., Ltd., *supra* note 202. The Trial Division found that the operations of the subsidiary were an integrated part of the taxpayer's steel processing business and were not a separate trading business from the taxpayer: the acts performed and documents executed were intended to give the false appearance that the subsidiary's operations were separate.

[229] *See* Interpretation Bulletin I.T.-376.

[230] Robertson, *The Use of Tax Evasion and Tax Avoidance by Multinational Companies: A Canadian View*, 25 CAN. TAX J. 513, at 523 (1977).

[231] *Id.* at 516.

[232] *Supra* note 1.

Some of those developments have been considered previously as part of the treatment of business income. It should be noted that it is inappropriate to consider the statutory amendments in this area as developments in corporate taxation, as they reflect a change rather than a development or extension of the previous law.

A. *Judicial Developments*

1. *Residence of Corporations*

Any reference to residence and taxation recalls to mind those first days of exposure to an Income Tax course and the maze of conflicting illogical decisions establishing a basis for taxation. In *Birmount Holdings Ltd. v. The Queen*[233] the question of corporate residence was revisited. Birmount Holdings Ltd. was incorporated in Ontario in 1960 to hold real estate just outside the city of Toronto. Three shares were held by residents of Canada as nominees of a non-resident. Until 1972, the three shareholders were also the directors. In that year the company sold the land in response to an unsolicited offer and realized a substantial appreciation in the value of the land. The Minister attempted to tax on the basis that the realized appreciation was income and that the company was resident in Canada.

Deputy Justice Sweet concluded that the realized appreciation was income arising out of a transaction in the nature of trade. He then proceeded to consider whether the corporation was resident in Canada at the relevant time. By reference to paragraph 250(4)(c) he determined that the corporation would be resident if it carried on business in Canada. Thus the question became whether the corporation carried on business in Canada in such a way as to bring the section into operation.

In discussing the term, the Supreme Court of Canada in *Tara Exploration and Development Co. v. M.N.R.*[234] suggested that carrying on business involved continuity of time or operations rather than an isolated transaction. Deputy Justice Sweet, however, distinguished the *Tara* case on the facts; in *Tara* the adventure referred to was not related to the company's business whereas in *Birmount* the company had no business other than the ownership of the property in question. Referring to the single objects clause, which in this case was very narrow (*i.e.*, to acquire by purchase the land in question), he concluded that the transaction was in fact a business transaction,[235] thus bringing the corporation within the provisions of paragraph 250(4)(c).

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[233] [1977] C.T.C. 34, 77 D.T.C. 5031 (F.C. Trial D.).

[234] [1970] C.T.C. 557, 70 D.T.C. 6370 (Ex.), *aff'd* [1972] C.T.C. 328 (S.C.C.)

[235] *Supra* note 233, at 46, 77 D.T.C. at 5039. It thus appears that perhaps the "objects" clause of corporations may be used to determine the status to be accorded to transactions. One will recall that the courts have frowned on the use of objects clauses to establish intention when the clauses were too broadly drafted. *See* Sutton Lumber & Trading Co. v. M.N.R., [1953] 2 S.C.R. 77, [1953] C.T.C. 237, 53 D.T.C. 1158, *rev'g* [1952] Ex. C.R. 498.

The earlier decisions were logical in that they recognized that the objects clauses gave

As a result of *Birmount*, the concept of corporate residence, as enunciated in the *Tara* case, seems to have once again been cast in doubt. It may of course be argued that the effect of the decision should be restricted to the particular facts of that case. It must be remembered that much of the jurisprudence surrounding the definition of business income arose in the days before Tax Reform;[236] the courts were quick to categorize a receipt as income rather than (non-taxable) capital gain in order to ensure that successful entrepreneurs did not escape tax entirely. In contrast, in establishing residence as a basis for taxation the application of the deeming provisions is not essential to maintain the integrity of the tax system and an interpretation of "carried on business" should reflect a less frenzied attempt to collect tax.[237] Similarly, the fact that there is a very extensive definition of "carrying on business",[238] as it applies to non-residents, does not affect the basis of this determination. In the case of non-residents, as with the extended meaning of "carrying on business" for residents, the attempt is to tax those particular transactions which it would be equitable to tax. In the *Birmount* type of situation the result would be the taxation of world income even though, in fact, Canada would have little or no moral basis for doing so.[239]

In *Victoria Insurance Co. v. M.N.R.*,[240] a less sympathetic situation requiring the determination of residence, the Tax Review Board found against the Minister. As the corporation in question was incorporated in the Bahamas, subsection 250(4) did not apply. Thus, the final determination of residence had to be based on the judicially developed concepts of central control and management. As all actions of the company were carried on outside Canada, it would have been necessary to determine that central control and management resided in Canada even in the absence of formal corporate action in Canada. The Tax Review Board was not prepared to accept that position. It chose instead to emphasize the fact that the majority of the directors were non-residents (in fact, the Canadian

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the corporation the power or capacity to transact in the same manner as an individual. However, if the objects clause was too narrow it made it impossible for the corporation to enter into any transactions not falling therein and therefore the corporation may have found that it could not displace the Minister's assessment by establishing other motives or objects.

[236] The case law developments in the area of "adventure in the nature of trade" are pre-1972. *See, e.g.*, M.N.R. v. Taylor, [1956-60] Ex. C.R. 3, [1956] C.T.C. 189, 56 D.T.C. 1125.

[237] The problems arise in respect of corporations which are "Canadian" by virtue of incorporation in Canada. It should be borne in mind that such incorporation was encouraged by the government of the day. The real position in fact is that the corporation is within the Canadian grasp only by an accident of jurisdiction of incorporation.

[238] ITA, s. 253.

[239] *See also* Note, 25 CAN. TAX J. 127, at 130 (1977). Therein, T. E. McDonnell criticized the case on the basis that the cases considering what constitutes "carrying on business" were not examined. It is suggested that this omission provides further support for the proposition that the jurisprudence in that area has no application to the provisions considered in the *Birmount* case.

[240] [1977] C.T.C. 2443, 77 D.T.C. 320 (Tax Rev. B.).

directors had either resigned or taken up permanent residence in the Bahamas), that the meetings were held outside Canada and that relevant contracts were executed outside Canada, and concluded that central control and management resided in the Bahamas. Canadian participation existed only by virtue of the fact that a Canadian parent company owned the Bahamian sudsidiary in question.

Although it may be difficult to reconcile the case with previous decisions, which suggest the determining factor to be the location of actual control,[241] it is an administratively simple test to apply and indeed is consistent with a strict legal interpretation of the corporate law rules.

2. *Interference with Corporate Status*

The tax advantages arising out of the utilization of corporations often result in more extensive use by the taxpayer of corporate intermediaries. The Minister, conscious of such attempts, is continually on the lookout to block the tax advantages which arise in such situations. Included in the present war zone are management corporations, personal service corporations and multiple corporations.

Since *Sazio*'s[242] success before the courts, management and personal service corporations appear to have proliferated.[243] The problems with the utilization of such corporations have already been touched on in the context of business purposes.[244] *Titeley v. M.N.R.*[245] looks at another problem created by such corporations.

The case involved two professionals (optometrists) who caused a company to be incorporated. They subscribed for a class of shares which provided full voting control but did not make provision for participation rights. The wives of the doctors purchased non-voting participating shares. The corporation carried on its business in the same premises and with the same staff as the doctors' partnership. The company paid each of the doctors an annual management fee of $18,000. The doctors used their voting rights to declare dividends of almost $100,000 over a period of four years. The recipients of the dividends were the doctors' wives. The dividends were not in fact paid but were set up as accounts payable by the company and the wives reported the amounts as income.

The Tax Review Board found the transaction to be *bona fide* but questioned whether the situation fell within the provisions of subsection 56(2).[246] Unfortunately, the Board did not in fact decide this issue; the dismissal of the appeal appears to be based on comments which do not

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[241] *See, e.g.*, Bedford Overseas Freighters Ltd. v. M.N.R., [1970] C.T.C. 69, 70 D.T.C. 6072 (Ex.).

[242] Sazio v. M.N.R., [1969] 1 Ex. C.R. 373, [1968] C.T.C. 579, 69 D.T.C. 5001.

[243] *But see* Bill C-37, cl. 38(1)(3)(d) whereby "active business" is redefined so as to curtail the use of such management and personal service corporations.

[244] *See* the discussion, *supra* under "State Interference in Tax-Planned Business Transactions".

[245] [1977] C.T.C. 2045, 77 D.T.C. 36 (Tax Rev. B.).

[246] *Id.* at 2047-48, 77 D.T.C. at 38.

relate to the subsection raised. If reference had not been made to the provision of subsection 56(2) the case could be explained as another example of a sham, absence of business purpose or other similar reason. The effect of the reference to that subsection, however, raises a different basis of attack; the declaration of substantial dividends in favour of the wives became taxable in the optometrists' hands as an indirect payment to themselves.[247]

In the present case the implications of company law must be examined. Directors in Canadian jurisdictions are bound to act in particular ways, with the result that it would not be theoretically possible for them to have appropriated the corporation's earnings by unreasonably increasing their management fees. Indeed most Canadian jurisdictions provide specific mechanisms for the injured shareholders to prevent such occurrences or to obtain redress. Perhaps the type of problem raised here could be more fruitfully examined if one assumed that the marriage between the parties had broken down. Moreover, an examination of the facts in the light of commercial reality would illustrate that the transactions adopted were in fact "normal", although one should acknowledge that they may constitute "[s]chemes . . . for the blatant avoidance of income taxes".[248] The case has been made more difficult by the fact that the dividends were retained by the corporation. However, that fact can be explained by reference to corporate law, which recognizes a declared but unpaid dividend as an enforceable debt.[249] In the past, Revenue Canada has been able to attack situations such as this simply by looking at the reasonableness of the payments.[250] There seems to be no reason why the situations which involve abuse could not be limited by reference to presently developed jurisprudence and the appropriate provisions of the Income Tax Act.[251]

In *Jutan Importers Ltd. v. M.N.R.*[252] the company had been in existence for some time and carried on the business of selling electronic equipment for several well-known manufacturers. The company had two equal beneficial shareholders, named Tannenbaum and Singer. In 1968 the wives of the shareholders of Jutan and a Japanese corporation, Crown Radio Corporation Japan, incorporated Crown Radio Corporation Ltd. The new company entered into a distributorship agreement with Crown Japan

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[247] *See also* M.N.R. v. Bronfman, [1966] Ex. C.R. 172, [1965] C.T.C. 378, 65 D.T.C. 5235, *rev'g in part*, *sub nom.* No. 494 v. M.N.R., 18 Tax A.B.C. 456 (1958) where a similar problem was considered. There the question arose in respect of gifts made by a corporation. That case may be distinguished from the one presently under consideration in that in this instance, the doctors could not have paid the money to themselves.

[248] *Supra* note 245, at 2048, 77 D.T.C. at 38.

[249] Bryden, *The Law of Dividends*, in Vol. 1, STUDIES IN CANADIAN COMPANY LAW 270, at 275 (J. Ziegel ed. 1967).

[250] *See* Mulder Bros. Sand & Gravel Ltd. v. M.N.R., [1967] Tax A.B.C. 761, 67 D.T.C. 475.

[251] ITA, s. 67.

[252] [1976] C.T.C. 2378, 76 D.T.C. 1289 (Tax Rev. B.).

for the sale of its products in Ontario. The Minister issued a direction that Jutan and Crown Radio Corporation be associated under what was then subsection 138A(2).[253]

The facts in the Minister's favour were that the shareholders of Jutan were experienced businessmen, aware of the tax implications; that they in fact negotiated the distributorship agreement; that the two corporations were conducted as one in day-to-day operations and in public identification such as telephone listings, staff and building. Neither wife did any substantial amount of work.

On the side of the taxpayers was that venerable Canadian institution, T. Eaton Co. Actually Eaton's played its role by refusing to purchase products from its competitors and it viewed Jutan as a competitor of its catalogue business. As Eaton's was the main purchaser of the products imported from Japan it was argued that business realities required the creation of a new corporation. In further support of the taxpayer's position there was evidence that the Japanese corporation required a four per cent interest in its distributors and that the distributor use the word "Crown" in its name.

The Tax Review Board accepted the evidence that the reason for the incorporation of the second company was to permit the company to deal with Eaton's. Having thus determined that the saving of tax was not the main reason for the incorporation, the Board went further and said that it was not a reason at all. Consequently, it was unnecessary to employ other existing tests of association.[254] As it appears that such tests would have resulted in association, the utilization of what is now subsection 247(2) may have been seriously limited.

Unfortunately, the instances in which a taxpayer can successfully argue that a new corporation had to be created solely for a business purpose and not for the purpose of tax reduction are limited. Indeed it would appear that with the demise of Eaton's catalogue sales, even Jutan and Crown Radio Corporation would be hard pressed to establish the necessary facts if the circumstances giving rise to the problem occurred today.

3. *Disposing of the Shares of the Corporation*

Shareholders who acquire shares eventually dispose of them. In 1962 the *Irrigation Industries*[255] case established in the minds of many that such a disposition would result in a capital gain or capital loss and not in income arising out of a transaction in the nature of trade. Consequently, under the provisions of section 38 only one-half of the capital gain would be subject to tax. Despite the existence of this authoritative Supreme Court of

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[253] R.S.C. 1952, c. 148 (*now* ITA, s. 247(2)).

[254] *See, e.g.*, Army and Navy Dep't Stores Ltd. v. M.N.R., [1953] 2 S.C.R. 496, [1953] C.T.C. 293, 53 D.T.C. 1185, *aff'g* [1952] Ex. C.R. 546, *rev'g* [1952] C.T.C. 277 (Tax A. B.); Yardley Plastics of Canada Ltd. v. M.N.R., [1966] Ex. C.R. 1027, [1966] C.T.C. 215, 66 D.T.C. 5183. *See* Note, 25 CAN. TAX J. 23 (1978)

[255] *Supra* note 105.

Canada decision, the judiciary continues to be faced with facts which give rise to the same problem.

In *Western Wholesale Drug Ltd. v. The Queen*[256] the shareholder attempted to purchase shares for a business reason. During the negotiations to purchase the shares the shareholder was also carrying on negotiations for their resale. In a matter of five months after completing the purchase the shareholder granted an option to a third party for the purchase of his holdings. The option was not exercised and shortly after the expiry of the option the shareholder sold his shares to another party, realizing a gain of $141,500. When the Minister assessed the gain as income the taxpayer appealed.

Mr. Justice Mahoney refused to disturb the assessment on the basis that "the possibility of their disposition at a profit was a motivating reason for the purchase".[257] Although he acknowledged that other business purposes may have existed, the result of the decision is to severely curtail the impact of the *Irrigation Industries* case. The only way to reconcile the cases is by examining the primary intention of the taxpayers when the purchase of the shares was first contemplated. It may be argued that in the *Irrigation Industries* case, resale was merely a secondary objective of the purchase, whereas in this instance it was a primary one.

There are numerous instances in which real life (or death) situations result in the transfer of shares from one owner to another. Rather than providing a reasonable degree of guidance the legislation refers vaguely to fair market value and then leaves the taxpayer and revenue collectors to their own devices. Needless to say, without some readily available reference, vast disparity in the values assigned frequently results. Indeed, even in the presence of a publicly recognized valuation guide, questions arise as to the moment at which the valuation should be determined.

In *Estate of Mastronardi v. The Queen*[258] shares were being transferred by reason of the death of a taxpayer. Subsection 70(5) declares that the taxpayer is deemed to have disposed of all his capital property "immediately before his death" and to have received proceeds of disposition equal to fair market value. In this case the corporation, of which Mr. Mastronardi was a shareholder, owned a life insurance policy on his life in the face amount of $500,000. Upon the death of the deceased the $500,000 was paid to the company.

On the assumption that "immediately before his death" was equivalent in meaning and intent to the instant of death and that an informed purchaser would pay a higher price for the company's shares if Mr. Mastronardi's death were taken into account, the Minister took into account the proceeds of the life insurance policy in valuing the shares. This caused an increase in price of the shares from $323.58 per share to $778.59 per share. Thus on appeal from the Minister's assessment the court had to

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[256] *Supra* note 107.

[257] *Id.* at 3, 77 D.T.C. at 5023.

[258] [1977] 1 F.C. 234, [1976] C.T.C. 572, 76 D.T.C. 6306 (Trial D.), *aff'g, sub nom.* The Queen v. Estate of Mastronardi, [1978] 1 F.C. 399 (App. D.).

determine whether the proceeds of the insurance policy should be used in the determination of the fair market value of the shares.

Mr. Justice Gibson determined that the valuation of the shares should occur without taking into account the proceeds of the life insurance policy. Valuation under subsection 70(5) "must be considered as having taken place at some other time rather than at the instant of death of the deceased and no premise of imminence of death of the deceased should form any part of the valuation".[259] No doubt this result will be viewed by many as sound in both logic and common sense. As the death of Mr. Mastronardi occurred suddenly and without notice the decision of Mr. Justice Gibson may be considered a logical decision on the facts, but not a principle of valuation.[260]

The implications of a situation in which the death of the prime manager of a corporation depresses the value of the shares (a reverse of the facts in *Mastronardi*) were pointed out by T. E. McDonnell in his comment on the case.[261] As he indicated, the value of the shares of a one-manager corporation will depend on the ability of that person. If the manager dies, the income-earning ability of the corporation and the value of its shares will drop significantly. It would thus appear that the victory for the taxpayer in a case such as *Mastronardi* will be a victory only if the corporation carried life insurance. In the absence of life insurance it would be to the benefit of the taxpayer to value the shares in light of the expected death of the manager, but valuation based on that expectation now appears to be prohibited. Not only will such a corporation not get life insurance proceeds but the estate of the deceased shareholder will have to cope with a deemed disposition at a price in excess of its real value after his death.

In *C.B.T. Investments Ltd. v. M.N.R.*[262] the value to be applied to shares was questioned even though there was a publicly quoted value for the shares. Mr. Prociuk of the Tax Review Board was asked to determine the value of shares as of valuation day. In doing so, he did not restrict himself to the provision of subsection 26(11) of the Income Tax Application Rules. Rather than utilize the publicly quoted value he chose to accept a value based on an offer made by a third party shortly after valuation day. As the case involved voting trusts and restrictions on sale it is possible that the judgment inaccurately reports the transaction being questioned. If the facts are correct, it establishes, contrary to earlier cases,

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[259] *Id.* at 239, [1976] C.T.C. at 576, 76 D.T.C. at 6308.

[260] One's mind turns to the interesting possibilities arising out of terminal illness, particularly if it is unknown to any other party. Also of interest is the question of what constitutes sudden death. *See* I. R. CAMPBELL, THE PRINCIPLES AND PRACTICE OF BUSINESS VALUATION 196-97 (R. Dickerson & R. Reid eds. 1975). The author suggests that it may be appropriate to value in one way for terminal illness and another way for unexpected death. Only in the former situation should the life insurance policies held by the business on an individual's life be considered in determining the fair market value.

[261] McDonnell, Note, 24 CAN. TAX J. 599 (1977). *See also* McDonnell, Note, 25 CAN. TAX J. 503 (1978).

[262] [1976] C.T.C. 2440, 76 D.T.C. 1318 (Tax Rev. B.).

that even if shares are publicly quoted the taxpayer may, if special circumstances exist, value the shares in light of those circumstances.

Similarly, in *Cattermole Timber Ltd. v. Minister of Finance of British Columbia*[263] the British Columbia Court of Appeal applied a special circumstances value as suggested above. One would normally assume the value of shares to be the consideration given for the purchase of those shares. In this case, however, although the shares were sold for $2,000,000, Robertson J.A. held that their intrinsic value was $189,000, having regard to the fact that the company's liabilities exceeded its assets threefold.[264]

B. *Statutory Changes*

Bills C-56[265] and C-11[266] were introduced in 1977. The reasons for the changes which they introduced have been summarized as follows:

> 1. The need to stimulate the economy, particularly the equity market. This resulted in the more generous dividend tax credit, the addition of taxable capital gains to the interest and dividend income deduction, and the increase to $2,000 of the amount of capital losses deductible against other income by individual taxpayers.
> 2. An acknowledgement that the 1971 amendments had not solved the surplus problem, particularly for larger Canadian private corporations accumulating business income taxed at high rates. The need for a future surplus bailout provision similar to that introduced in 1939, 1949, and 1971 was becoming apparent. The proposed enriched dividend tax credit, together with a maturing of the taxation of capital gains produced a much narrower gap between the taxation of capital gains and taxable dividends and thus permitted an acceptance in the system of shareholder choice as to the receipt of either capital gains or taxable dividends in virtually all situations where corporate earnings were being withdrawn. This permitted the repeal of the concepts of designated surplus, paid-up capital deficiency and debt limits.
> 3. An acknowledgement that, despite almost annual amendments to provide relief from the onerous penalties for improper or late-filed section 83 elections, taxpayers were still unable or unwilling to comply. This led to further relief in the form of the ability to carve one dividend into a series of dividends to meet the requirements for proper elections and by a reduction in the amount of the absolute penalty (which is tied in part to the enriched dividend tax credit).
> 4. A recognition that National Revenue could not reasonably administer the provisions in this area, partly as a result of the inability to audit properly cost base adjustments arising as a result of the proliferation of section 83 dividends and partly because of its reluctance to impose the very onerous penalties payable under the Act. This, in combination with all of the above points, presumably produced the decision to terminate the pre-1972 surplus

[263] [1978] 3 W.W.R. 121 (B.C.C.A.), *rev'g* [1976] 1 W.W.R. 214 (B.C.S.C.).

[264] The fact that the case involved valuation for the purpose of the Logging Tax Act, R.S.B.C. 1960, c. 225, *as amended by* S.B.C. 1969, c. 35 does not detract from its significance.

[265] 30th Parl., 3d sess., 1977-78 (passed June 2, 1978) (*now* An Act to amend the Income Tax Act, S.C. 1977-78, c. 32).

[266] 30th Parl., 3d sess., 1977 (passed Dec. 13, 1977) (*now* An Act to amend the Income Tax Act, S.C. 1977-78, c. 1).

accounts and the ability to pay subsection 83(1) dividends as at the end of 1978.

5. A desire to bring the tax concepts more in line with non-tax concepts. This turned the system back to one wherein paid-up capital, capital transactions and dividends, which have acknowledged meanings outside the tax world, can, in the large majority of cases, have the same meanings for income tax purposes. This may have led to the amendment reverting to a general use of statutory or stated capital as being paid-up capital for tax purposes, and together with the repeal of paid-up capital deficiencies and debt limits has substantially reduced the number of instances where capital transactions will give rise to deemed dividends.
6. Acceptance of the need to ease the ability of corporate groups to rationalize and reorganize without adverse tax implications. Having passed the hurdle of eliminating designated surplus, this led to a further easing of the corporate reorganization problems by providing for the continuity of control concept, despite movement of corporations within a group and the loss flow-through rules on amalgamations and liquidations.
7. An acknowledgement of the need to preserve aspects of the previous system, at least for some period of time, so as to not be overly harmful to taxpayers, or give them time to adjust, while at the same time continuing to protect the revenue where this was felt to be necessary. Presumably, this led, on the one side, to the phase-out of 1971 CSOH [capital surplus on hand] and TPUS [tax-paid undistributed surplus] distributions rather than their immediate repeal, elimination of the requirement to tax-pay 1971 UIOH [undistributed income on hand] before making 1971 CSOH distributions, the grandfathering of certain tax-deferred preferred share issues, the concept of pre-1972 capital surplus on liquidations; and on the other, to the reduction of paid-up capital for certain paid-up capital deficiencies and tainted debt situations, the introduction of limited anti-surplus stripping provisions — against V-Day values of Canadian corporations and in general by non-residents — and the exclusion of controlling non-resident shareholders from the general exception to the requirement to tax-pay 1971 UIOH before distributing 1971 CSOH.
8. The push for simplicity. The drive by taxpayers to simplify both the language and the concepts in the tax system has been accelerating in recent years and undoubtedly created a part of the favourable climate leading to the 1977 changes. While the amending bill is a complex document in itself, the resulting product, after the amendments are enacted and are in full force, should be simpler, easier to comply with and produce tax results more in line with what affected taxpayers might expect.[267]

Unfortunately, the last purpose, emphasized in the Budget Documents,[268] may not have been achieved.

1. *The Corporation and the Shareholder — What Happened to Integration?*

Tax Reform brought into existence full integration of the corporate and personal levels of taxation for investment income and small business income of Canadian-controlled private corporations. A basic premise of

[267] Cronkwright, Dart & Lindsay, *Corporate Distributions and the 1977 Tax Changes*, in 1977 TAX CONFERENCE REPORT, *supra* note 4, at 279.

[268] BUDGET DOCUMENT (The Hon. Donald S. Macdonald, Minister of Finance, Mar 31, 1977).

integration was that the total eventual tax liability on these two types of income should not vary by reason of the fact that it may have been funnelled through a corporation. In other words, the taxpayer who used a corporation should not be penalized for doing so.[269]

The concept of integration was affected from time to time as both the federal government[270] and the provinces[271] amended the system. The worst interference occurred when the various levels of government, in addition to permitting an increase in provincial personal income tax rates,[272] transferred four percentage points from the federal to the provincial governments.[273] Four percentage points translated, in the case of Ontario, to an effective provincial rate of forty-four per cent of the federal tax payable.

The policy makers in Ottawa, no doubt observing that a move in the direction of integration was worthwhile, proceeded to follow suit, overlooking the fact that the system had already gone beyond full integration and now acted in favour of the corporate vehicle. At present, when a shareholder receives a dividend from a corporation he shall include in his income the amount of the dividend and an additional amount (gross-up) equal to one-half of the amount of the dividend.[274] For example, assume that a corporation (a Canadian-controlled private corporation which is entitled to the preferential twenty-five per cent tax rate) earns $200 in business profits, and pays out all its after-tax cash as a dividend. The shareholder receives $150 but must include $225 in income by virtue of subsection 82(1). Upon receipt of the taxable dividend the shareholder is then entitled to a credit for taxes paid by a corporation; this credit however, is equal not to the amount of tax actually paid by the corporation (*i.e.*, $50) but to the amount of gross-up included in his income (*i.e.*, $75).[275] If we continue with the above example and assume

[269] The system was based on an assumed net corporate tax rate of twenty-five per cent on the income of the corporation. The remaining seventy-five per cent in after-tax dollars was grossed-up in the shareholder's hands when he received them in the form of a dividend by an amount equal to one-third of the dividend. The taxable income in the shareholder's hands thus equalled the full amount of the income originally taxed in the corporation. Upon receipt, the shareholder then received a dividend tax credit equal to the amount of the gross-up (and equivalent to the tax paid by the corporation). Integration thus existed as long as the total corporate tax rate was twenty-five per cent and the shareholder's tax rate was approximately thirty per cent.

[270] ITA, s. 125.1, *as amended by* S.C. 1974-75-76, c. 26, s. 82, S.C. 1977-78, c. 1, s. 60 which added a deduction from tax otherwise payable on manufacturing and processing profits.

[271] *See* the explanation given by Eddy, *Private Corporations and the 1977 Tax Changes*, in 1977 TAX CONFERENCE REPORT, *supra* note 4, at 124.

[272] The rates could go as high as forty per cent.

[273] *Supra* note 271.

[274] ITA, s. 82(1), *as amended by* S.C. 1977-78, c. 1, s. 36.

[275] ITA, s. 121, *as amended by* S.C. 1977-78, c. 1, s. 58, applicable to taxable dividends received after 1976. In effect the amount is three-fourths of the gross-up, *i.e.*, the amount calculated under s. 82(1)(b). However, as the provinces also allow a tax credit of one-fourth of the gross-up, there would be a credit for the full amount of the gross-up. The exact figures are dependent on the amount of provincial tax payable.

an effective tax rate for the individual of ten per cent we would find that the taxpayer was only required to pay tax of $22.50. As he was entitled to a credit of $75, he had thus overpaid his taxes by $52.50 which he may credit against taxes payable on other income. It should be noted that the taxpayer has not only received the dividend tax-free; he is in fact entitled, in the above example, to get credit against other taxes payable *greater* than the actual taxes paid by the corporation. Indeed a similar result occurs even if the effective tax on the dividends for the individual is as high as thirty per cent.

It thus appears that there is no longer a disincentive to use a corporation to earn active business income. Indeed, the use of the corporate vehicle is encouraged whenever possible.

2. *The Distinction Between Capital Gains and Dividends*

Prior to 1972 a taxpayer who could arrange his affairs in such a way as to receive his gains on investments in the form of capital gains paid no tax at all. Dividends received, however, were taxable. The 1971 Tax Reform[276] altered the situation by requiring an inclusion in the taxpayer's income of an amount equal to one-half of the capital gains. This partial inclusion was preferable to an inclusion of the entire amount, even considering the dividend tax credit.[277] In order to achieve a capital gain it was necessary to dispose of some of the investment. This procedure was easily accomplished by shareholders of public corporations as there was a ready open market for their shares.

For shareholders of private corporations the characterization of the receipts in this way was difficult as there was neither a ready market nor a desire on the part of the shareholder to reduce the percentage of his holdings. In addition, the advantage of capital gains treatment encouraged shareholders to enter into transactions which would give rise to the preferred tax treatment but which would not deprive them of their investment in the income-producing business. This was achieved by a sale of the investment property to a corporation which they or members of their family controlled. This solution, however, has long been blocked by a variety of anti-dividend stripping provisions.[278]

While the anti-stripping provisions — particularly the designated surplus concept[279] — achieved the required result in non-arm's length transactions, they became a problem when a legitimate sale had occurred. The new owners of the corporation were forced to work around the provisions. In recognition of the problem, special rules were enacted to allow the corporation to distribute the earnings acquired prior to change of control at special reduced tax rates.[280] Despite the fact that only taxpayers

[276] *See now* ITA, s. 38 *et seq*.

[277] *See* note 275, *supra*.

[278] *See, e.g.*, ITA, s. 247(1) whereby if the scheme was for the purpose of tax reduction by surplus stripping, a tax could be levied by the Minister.

[279] ITA, ss. 192, 193.

[280] ITA, s. 89(1)(k), *as added by* S.C. 1973-74, c. 14, s. 28(3).

paying tax at the highest marginal rates could have obtained an advantage by converting dividend income to capital gains, the designated surplus rules remained essentially unchanged until the introduction of the 1977 amendments. Indeed, the rules were reinforced by the introduction of the paid-up capital deficiency concepts.[281]

With the changes introduced by the 1977 amendments the distinction between capital gains and dividend income appears to have disappeared. First, the effective rate of tax on dividends has been substantially reduced.[282] This was achieved through the operation of the new tax-sharing agreement with the provinces which resulted in the transfer of some four percentage points to the provinces.[283] Another major cause of the reduced rate of taxation of dividends was the increase in the dividend tax credit provisions.[284] The combination of the two changes effectively reduces the tax differential between capital gains and dividend income to a maximum of approximately eight per cent. Secondly, the distinction between capital gains and dividend treatment has been eliminated by the repeal of the designated surplus[285] and capital deficiency provisions in arm's length transactions.[286]

3. *Corporate Tax Calculation*

Corporate tax rates, reduced to fifty per cent in 1971, have been reduced by one percentage point each year so that since 1976 the standard rate has been forty-six per cent.[287] The forty-six per cent rate applies, regardless of source or type of income, to all corporations except those which are otherwise given specialized treatment. While private corporations are given specialized treatment according to source of income and disposition of profits, public corporations continue to be restricted to specialized treatment only in respect of manufacturing and processing profits.[288] The tax rate on that source of income is forty per cent.

(a) *Active Business Income of the Private Corporation*

The tax system would be simplified if the Income Tax Act were to contain basic definitions necessary to the application of its provisions.[289]

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[281] ITA, s. 89(1)(d), *as amended by* S.C. 1974-75-76, c. 26, s. 53(3),(4),(5).

[282] *See* discussion at note 274 *et seq.*, *supra*.

[283] *See* text at note 273, *supra*.

[284] *Id.*

[285] ITA, ss. 192, 193 (*repealed by* S.C. 1977-78, c. 1, s. 88, applicable to dividends paid or received after March 31, 1977).

[286] ITA, s. 89(1)(d) (*repealed by* S.C. 1977-78, c. 1, s. 44(3), applicable after March 31, 1977).

[287] ITA, s. 123.

[288] ITA, s. 125.1, *as amended by* S.C. 1974-75-76, c. 26, s. 82, S.C. 1977-78, c. 1, s. 60.

[289] It appears that the proposed amendments to the Act may carry out this simplification and in the process severely limit the availability of the small business rate: *see* Bill C-37, cl. 38.

Where the Act is lacking, the judiciary must fill in the gaps. Such was the case in *The Queen v. Cadboro Holdings Ltd.*[290] Mr. Justice Gibson had to determine not only what constituted an "active business" within section 125 but also what quantum of activity was required to bring income within its provisions. In this respect he held that "any quantum of business activity that gives rise to income in a taxation year for a private corporation in Canada is sufficient to make mandatory the characterization of such income as income from 'an active business carried on in Canada' ".[291] In addition, Mr. Justice Gibson set out several propositions for the purpose of clarifying section 125:

> 1. Any business within the meaning of subsection 248(1) of the *Income Tax Act* or within the dictionary definition of business is a business.
> 2. Any business activity at all, of a private corporation in Canada, irrespective of the quantum of it, is sufficient to make mandatory the characterization of the income from such source for tax purposes as income from an "active business" within the meaning of section 125 of the Act.
> 3. There may be many types or sources of income from an active business within the meaning of section 125 of the Act. Such types or sources of income may be or from rents, interest, royalties, management fees and so forth. The relevant matter is whether from the particular type or source income arose which should be categorized as income from an "active business carried on in Canada" by a private corporation within the meaning of section 125 of the Act.
> 4. Investment income of a private corporation is certain income within the meaning of section 129 of the Act. Such investment income is any income from a source other than from "an active business carried on in Canada" within the meaning of section 125 of the Act, or from an "office" or "employment" (see subsections 3(1) and 248(1) of the Act), and includes income from "property". (See subsection 3(1) of the Act).
> 5. Part of the income of a private corporation in Canada can be income from an "active business" within the meaning of subsection 125(1) of the Act, and another part of its income can be income within the meaning of section 129 of the Act.
> 6. The asset which produces investment income within the meaning of section 129 of the Act, on its sale or disposition will be considered for tax purposes as a sale or disposition of a capital asset and not of an inventory asset.
> 7. The asset (if there is one) from or on account of which income arises which is categorized as income of a private corporation from "an active business in Canada" within the meaning of section 125 of the Act, may be a capital asset or an inventory asset within the meaning of the *Income Tax Act*. Which it is, in any given case, is a question of fact.[292]

Although the case appears to go far beyond the pronouncements set out in *Rockmore Investments*[293] the actual implication of the case will

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[290] [1977] C.T.C. 186, 77 D.T.C. 5115 (F.C. Trial D.), *aff'g* (Tax Rev. B. July 11, 1974). *See also* Interpretation Bulletins I.T.-72R2 and I.T.-73R2 for the Minister's view on what constitutes active business.

[291] *Id.* at 199, 77 D.T.C. at 5123.

[292] *Id.* at 199-200, 77 D.T.C. at 5123-24.

[293] The Queen v. Rockmore Invs., [1976] 2 F.C. 428, [1976] C.T.C. 291, 76 D.T.C. 6156 (App. D.), *aff'g* [1975] C.T.C. 324, 75 D.T.C. 5224 (F.C. Trial D.). The court held that the determination of whether an active business was being carried on was a question of fact having regard to the circumstances of the particular case. Some comment was made as

depend on the willingness of subsequent courts to accept it. In *Spence Building Ltd. v. M.N.R.*,[294] for example, the court avoided the problem of what constituted an "active business" by determining that the income (rent from a property leased by the corporation to its members) was income from property and not from business. Thus section 125 was inapplicable and no small business deduction was forthcoming. Moreover, the pressure by taxpayers to extend the instances in which the broad definition is applied will not be one-sided, as some taxpayers may desire refundable tax treatment rather than active business income treatment.

The introduction of preferential tax treatment for corporate active business profits was thought of as a concession to encourage small business activity. To ensure that the benefit was restricted to small corporations, limits were placed on the annual income and on the total amount entitled to the small business rate. From time to time these limits were raised; today they provide for an annual business limit of $150,000 and a total business limit of $750,000.[295]

Since the concession was intended to be granted only on limited amounts of retained earnings, it was necessary to provide a mechanism to reflect the fact that some or indeed all after-tax profits could and should be returned to the shareholders. This was achieved by permitting a reduction in respect of certain types of dividends paid out by the corporation.

(b) *Investment Income and Dividends*

When corporate and shareholder taxes were integrated in 1971, no limits were placed on the amount of investment income which could flow through the private corporation. The 1977 amendments have continued the special treatment accorded to investment income without applying a limit. However, because of the changes in dividend gross-up and the transfer of tax points to the provinces it was necessary to amend the investment income provision. The solution was to reduce the refundable dividend tax on hand calculation to two-thirds of the former amount[296] and to adjust the accounts as of December 31, 1977 by one-third.[297]

In addition to changing the method of calculating the refundable dividend tax on hand, the Budget of April 10, 1978 eliminated the Part IV tax on inter-corporate dividends in those cases in which the recipient held a ten per cent interest in the paying corporation.[298]

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to what constitutes a "business" within the section. In this respect, *see id.* at 430, [1976] C.T.C. at 293, 76 D.T.C. at 6157.

294 [1977] C.T.C. 2104, 77 D.T.C. 71 (Tax Rev. B.).

295 ITA, s. 125(2), *as amended by* S.C. 1974-75-76, c. 26, s. 81(1), S.C. 1976-77, c. 45, s. 49(1).

296 ITA, s. 129(3) (*repealed and replaced by* S.C. 1977-78, c. 1, s. 62(3), applicable to 1975 *et seq.*).

297 ITA, s. 129(3.1), *as added by* S.C. 1977-78, c. 1, s. 62(3).

298 ITA, s. 186(4)(b) (*repealed and replaced by* S.C. 1977-78, c. 1, s. 85(2), *as amended by* S.C. 1977-78, c. 32, s. 42(2), applicable to dividends received after April 10, 1978).

4. *The Corporate Accounts*

The various forms of earnings in a corporation which arise from a source which should not give rise to taxation at any point have created problems ever since Tax Reform. The tax-free half of capital gains, the portion of capital gains attributed to pre-1972 increases in value of assets and certain other pre-1972 earnings in a corporation should flow tax-free to shareholders, as they are amounts which are not subject to taxation if earned directly. This was achieved by creating a variety of special notional accounts[299] from which the payments could be made. To ensure that there was no confusion in the payment of these amounts the Act then set up rules to regulate the order of payment out of these accounts.[300] Compliance with the rules of payment out of the various accounts was ensured by the imposition of severe penalties.[301]

The 1977 amendments attempted to reduce the significance of the various notional accounts and to phase out some forms of special dividends provided for.[302] The special dividends have been phased out since December 31, 1978 and errors in calculation are now subject to a penalty of fifty per cent.[303]

The paid-up capital of corporations was originally defined as the paid-up capital for corporate law purposes.[304] In due course that definition was changed by adding contributed surplus to the components of paid-up capital.[305] The return of capital to the shareholders was allowed as long as it did not result in an impairment of capital for tax purposes. To determine whether or not capital was being impaired the concepts of "paid-up capital limits"[306] and "paid-up capital deficiency"[307] were incorporated into the Act.

The concept of paid-up capital also resulted in deemed dividends to shareholders in those cases in which shares of a corporation were issued without an increase in the assets of the corporation.[308] In 1974 the Act was amended so that deemed dividends would not arise in such a case. Instead the amounts were deducted from paid-up capital.[309]

Most recently, the 1977 amendments have attempted to simplify the entire area of paid-up capital by reinstating the corporate law definition of

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[299] *E.g.*, 1971 Capital Surplus, Tax-Paid Undistributed Surplus and Capital Dividend Account.

[300] ITA, s. 83(1) (*repealed and replaced by* S.C. 1973-74, c. 14, s. 24, *repealed by* S.C. 1977-78, c. 1, s. 37(1)).

[301] ITA, s. 83(1).

[302] ITA, s. 184(1) (*repealed by* S.C. 1977-78, c. 1, s. 83(1)).

[303] *See* Comment, *Excessive Elections*, in SUPPLEMENTARY BUDGET PAPERS 14 (The Hon. Donald S. Macdonald, Mar. 31, 1977).

[304] ITA, s. 89(1)(c).

[305] ITA, s. 89(1)(c), *as amended by* S.C. 1974-75-76, c. 26, s. 53(2).

[306] ITA, s. 89(1)(e) (*repealed by* S.C. 1977-78, c. 1, s. 44(3))

[307] ITA, s. 89(1)(d), *as amended by* S.C. 1974-75-76, c. 26, ss. 53(3),(4),(5)

[308] ITA, s. 84, *as amended by* S.C. 1977-78, c. 1, s. 38.

[309] ITA, s. 89(1)(c), *as amended by* S.C. 1974-75-76, c. 26, s. 53(2).

paid-up capital for tax purposes,[310] and by repealing the concepts of paid-up capital deficiency and paid-up capital limit.[311]

5. *The Shareholder Relationship*

While the administrators at Revenue Canada are actively discouraging the excessive use of corporations to minimize tax, another branch of government is actively encouraging investment in corporations. In addition to the elimination and reduction of taxes in respect of certain corporate receipts, the recent amendments have provided that the taxpayer may elect the treatment that he will receive in respect of dispositions of shares.[312] The result is that he now has the option, unless he is a dealer in securities, of determining whether his gains or losses will be considered to be on account of income or capital. There are certain "prescribed shares" which will not be eligible for the election but the regulations setting out the definition of prescribed shares have not been proclaimed.

Further encouragement to become involved in corporate ownership is provided in the stock option provisions added in 1977.[313]

V. INTERNATIONAL TAXATION

There have been a number of significant developments in the area of taxation of international income. In this Survey those developments are examined by looking first at Canada's treatment of income earned outside Canada and then by examining recent developments in the area of taxation of non-resident income. In addition a few comments will be made on the rationalization of international taxation.

A. *Income Earned Outside Canada*

In 1971 the Department recognized that the system then in force was subject to abuse and that residents of Canada were able to defer or avoid tax by exporting their capital to tax-haven countries. At the same time, however, the system, while subject to abuse, was basically fair and acceptable. Despite the abuses it was decided that the existing system should be continued, but that two basic changes should be made. The changes required that the exemptions in respect of dividend receipts be limited to those received from genuine foreign business activity in treaty countries and that a mechanism be developed to tax immediately income earned from property and non-active business income.

The 1971 Tax Reform provisions included the mechanisms to bring about the changes. Unfortunately, the actual provisions proclaimed at that

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[310] ITA, ss. 89(1)(c),(d),(e) (*repealed and replaced by* S.C. 1977-78, c. 1, s. 44(3)).

[311] ITA, ss. 192, 193 (*repealed by* S.C. 1977-78, c. 1, s. 88), ITA, s. 89(1)(e) (*repealed by* S.C. 1977-78, c. 1, s. 44(3)). There are still some transitional provisions in force.

[312] ITA, s. 39, *as amended by* S.C. 1977-78, c. 1, s. 16(2).

[313] ITA, s. 7, *as amended by* S.C. 1977-78, c. 1, s. 3(1). *See* the discussion *supra* under "Stock Options".

time were limited to amendments to the Act and did not include the detailed provisions necessary to make the sections operative. The detailed provisions were finally produced in 1976 with the proclamation of the Regulations under the Income Tax Act.[314] The final Regulations (following the draft rules, issued a year earlier) apparently reflect not only the views of the draftsmen and officials of Revenue Canada but also the concerns, inconsistencies and other problems raised by the few tax specialists who have some understanding of the area.

Following the appearance of the Regulations, the foreign affiliate and foreign accrual property income rules have now come into force.[315] While their operation was stayed pending the creation of the Regulations (which are essential to the operation of the provisions) it appears that the definitions and rules have retroactive effect to 1971 at least in so far as setting up corporate records are concerned.

At the present time the method by which foreign source income of residents of Canada is taxed is the same as that used for Canadian source income and requires no further comment. Similarly, the method of calculating income from property is well understood, although subdivision i of Division B (section 90 *et seq.*) adds specific rules which must be followed in respect of certain forms of foreign property income. First, the taxpayer must include in his income dividends received from foreign corporations[316] and secondly, he must include in his income something referred to as "the percentage of the foreign accrual property income of any controlled foreign affiliate of the [shareholder] . . . equal to [his] share's participating percentage".[317] To fall within the provisions of subsection 91(1) it is necessary for the taxpayer to own a share of something called a "controlled foreign affiliate". Owning a share in a controlled foreign affiliate, another of the new concepts, can best be summarized by stating that the taxpayer must in fact be a controlling person in a foreign corporation. Foreign accrual property income (FAPI) is defined as being all forms of income, including net taxable capital gains, from sources other than active business. The actual amount to be included in the taxpayer's income is his share of the foreign affiliate's earnings. Thus, under subsection 91(1), "in computing the income for a taxation year the taxpayer shall include as income his portion of the passive earnings of foreign corporations which he controls".[318]

The Regulations provide the detailed rules necessary to enable the sections of the Act to operate. For example, they provide that in calculating foreign income the foreign laws be used; they provide a method of resolving conflicts which may arise; and they provide rules for converting the foreign income into Canadian taxable terms.[319]

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[314] ITR, s. 5900 *et seq.*, *added by* S.O.R./76-704 (110 Can. Gazette, Part II, 2964)

[315] *Id.*

[316] ITA, s. 90 (*repealed in part by* S.C. 1974-75-76, c. 26, s. 55(1))

[317] ITA, s. 91(1), *as amended by* S.C. 1974-75-76, c. 26, s. 56(1).

[318] Balogh, *Taxation of Income Earned Outside Canada*, in ESSAYS ON CANADIAN TAXATION, *supra* note 60, at 696.

[319] ITR, s. 5907.

As the provisions accelerate tax on some forms of income, tax other types as they are earned and permit the tax-free international flow of still other types of income, it is necessary for the operation of the provisions to provide for source isolation of income. The result is a complex set of rules setting up the various accounts with appropriate adjustment to convert the income into the Canadian context. As was the case in the provisions dealing with the taxation of Canadian resident corporations, the Regulations also provide for the order of distribution of monies from the various types of accounts.

While one is tempted to say that the simplification in respect of corporate earnings in Canada was intended to allow the specialists more time to deal with the FAPI provisions, it must be observed that the FAPI and foreign affiliate provisions have very limited application. Indeed, the sections were intended to discourage certain types of transactions and it appears that if the policy behind the sections does not discourage the export of capital, the complicated mechanisms of compliance certainly might.

B. *Income Earned in Canada by Non-Residents*

As a significant source of income for non-residents arises from the ownership of shares in Canadian corporations, it was necessary to amend the provisions dealing with the taxation of non-residents as part of the major overhaul of the corporate tax provisions.[320] Such changes, however, are merely consequential and are intended simply to incorporate the appropriate corporate changes and thus require no further comment.

More significant perhaps is the amendment to specific provisions of section 212, intended to carry out specific government objectives. For example, there have been a number of amendments to the interest provisions[321] exempting certain forms of interest payments to non-residents from withholding tax. As well, mortgage interest on foreign property, a serious problem for Canadian residents owning real property abroad, is no longer subject to withholding tax.[322]

Because tax liability is placed on the Canadian resident who pays or credits the enumerated types of income to non-residents, questions as to whether or not specific types of payment fall within the taxable rules still arise. Thus in *Lebern Jewellery Co. v. M.N.R.*[323] Mr. Cardin, chairman of the Tax Review Board, decided that an amount payable as a result of late payment of an overdue account was not interest but rather a surcharge and as such was not subject to taxation.

The results were not as ideal for the Canadian resident in *Chilcott v. The Queen.*[324] There the Canadian taxpayer, a lawyer, paid out amounts from his trust account to a non-resident. The account had earned interest

[320] *See, e.g.*, ITA, ss. 212(2), 212.1.

[321] ITA, s. 212, *as amended by* S.C. 1977-78, c. 1, s. 92(1)-(4).

[322] ITA, s. 212(1)(b)(viii), *as added by* S.C. 1977-78, c. 1, s. 92(1)-(4), applicable to interest paid or credited after 1976.

[323] [1976] C.T.C. 2422, 76 D.T.C. 1313 (Tax Rev. B.).

[324] [1978] C.T.C. 152, 78 D.T.C. 6111 (F.C. Trial D.).

in a bank and the bank did not withhold tax as the investment was registered in the name of the lawyer "in trust". The finding against him on the basis of subsection 215(3) re-emphasizes that oversight, misunderstanding or error on the part of the Canadian resident who in fact makes the actual financial transfer to the non-resident will result, not in the taxation of the non-resident but rather in the taxation (and penalizing) of the resident.

In addition to the problems of determining whether amounts are included in the enumerated lists in section 212, the Canadian resident paying amounts to non-residents must also be conscious of the provisions of subsection 245(2). In *The Queen v. Immobiliare Canada Ltd.*,[325] in addition to arguing that a portion of specific payments was interest, the Minister argued that a benefit had been conferred. Having determined that the particular transaction was not one giving rise to a benefit of the type contemplated by the subsection, as it was not of a sufficiently tangible or identifiable nature, Mr. Justice Addy then considered whether the structuring (and resultant lack of tax liability) was itself a benefit. Having raised the problem he then found that the tax liability avoided was a benefit so that the potential tax saving was a benefit and was itself subject to tax.

Surprise must be expressed at this position as it would appear to give rise to a benefit in all instances where parties can elect to defer or transfer tax liability. The decision was in respect of the equivalent of subsection 245(2) but if the case is correct it should have equal application in other areas. As a minimum, it appears that residents of Canada who are parties to transactions with non-residents which are fashioned with tax consequences in mind, may be liable to further tax liability. At its worst the case represents another attack which, together with the concepts of sham, lack of business purpose and artificial transactions go toward refuting the statement that a man may arrange his affairs in such a way as to minimize his tax liabilities.

[325] [1977] C.T.C. 481, 77 D.T.C. 5322 (F.C. Trial D.), *rev'g in part* [1975] C.T.C. 2210, 75 D.T.C. 167 (Tax Rev. B.).