NEW FOREIGN AFFILIATE CAPITAL DISTRIBUTION ELECTIONS: QROCS AND REGULATION 5901(2)(B) DIVIDENDS

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The October 24, 2012 draft legislation released by the Department of Finance builds on and improves the original August 19, 2011 foreign affiliate distribution proposals in several important respects. There is a new election in subsection 90(3)1 that will permit taxpayers to elect to treat a foreign affiliate capital distribution as a “qualifying return of capital” (“QROC”) — the QROC election then overrides the new subsection 90(2) deemed dividend treatment of all pro rata foreign affiliate distributions. And in a related and welcomed change, Finance is extending the new “pre-acquisition surplus election” under Regulation 5901(2)(b), so that it will not be limited to top-tier foreign affiliate dividends paid to the Canadian corporate parent as initially proposed in the August 19, 2011 version; instead, the election will be available on a broader basis including for lower-tier foreign affiliate dividends paid to a foreign affiliate parent.2

These new capital distribution elections will provide taxpayers with increased flexibility to strategically manage foreign affiliate distributions within their corporate groups. The extended Regulation 5901(2)(b) election in particular will allow taxpayers to sidestep the historical surplus ordering rules and may help to reduce the compliance costs of maintaining ongoing surplus balances. Under the current surplus ordering rules (as they are proposed to be amended), foreign affiliate dividends are deemed to be paid first out of exempt surplus, then out of hybrid surplus, then out of taxable surplus, and only thereafter out of pre-acquisition surplus treated effectively as capital distributions that reduce basis. However, under the new Regulation 5901(2)(b), a corporation may elect to treat any foreign affiliate distribution — top-tier or lower-tier — as a pre-acquisition surplus dividend taxed effectively as a capital distribution that will first deplete the shareholder’s basis and then automatically access underlying surplus balances. These changes will further enhance the superiority of basis over surplus in the hierarchy of foreign affiliate tax attributes.

This article discusses these new election proposals and considers some of the tax-planning implications for taxpayers with foreign affiliate groups.

New Subsection 90(3) QROC Election

The August 19, 2011 draft legislation proposed new subsection 90(2) that would deem any pro rata foreign affiliate distribution to be a dividend, other than a distribution made in the course of a liquidation and dissolution, or on a redemption, acquisition, or cancellation of foreign affiliate shares. This helped to resolve the previously uncertain Canadian tax treatment of particular types of foreign affiliate share distributions under some foreign jurisdictions, such as distributions of share premiums distinct from legal share capital or profits. Moreover, it helped to level the playing field between
jurisdictions whose corporate law provides for a return of capital and jurisdictions where no such concept exists.

However, this proposed mandatory dividend treatment was criticized for eliminating the opportunity to effect capital distributions under foreign corporate law that would be treated as a reduction of the shareholder’s adjusted cost basis under subparagraph 53(2)(b)(ii), thereby avoiding the elevation of surplus balances. This was a particular concern for individual and other non-corporate taxpayers owning foreign affiliates, because they were not provided any opportunity similar to Regulation 5901(2)(b) to elect out of the mandatory dividend as a “tax-deferred” pre-acquisition surplus dividend — the Regulation 5901(2)(b) election was (and remains) available only to corporations.

The October 24, 2012 proposals have addressed these concerns with the introduction of the QROC election. Subsection 90(3) will treat a foreign affiliate distribution as a QROC if (i) it is a reduction of the paid-up capital of the foreign affiliate and would otherwise be deemed under subsection 90(2) to be a dividend (i.e., it is a pro rata distribution made in respect of all shares of a particular class), and (ii) the taxpayer (and all “connected persons or partnerships” of which the distributing corporation is a foreign affiliate) elects to treat the distribution as a QROC.

Where the foreign affiliate distribution is electively treated as a QROC, it is excluded from mandatory dividend treatment under subsection 90(2) and preserves its status as a reduction of capital that reduces the shareholder’s basis of the foreign affiliate shares.

As the explanatory notes observe, the QROC election will likely be most useful for non-corporate taxpayers (i.e., those not eligible to elect under Regulation 5901(2)(b)) who receive capital distributions from foreign affiliates and who wish to preserve the historical “basis reduction” treatment of such distributions. The new mandatory dividend rule in subsection 90(2) and the elective QROC exception in subsection 90(3) are both proposed to be effective for distributions made after August 19, 2011. However, if a (corporate) taxpayer elects to apply the new Regulation 5901(2)(b) election retroactively to December 20, 2002, the mandatory dividend rule (but not the QROC election) will also apply to foreign affiliate distributions made after December 20, 2002.

For a foreign affiliate distribution to be eligible for a QROC election, the distribution must be a return of capital under the relevant foreign corporate law. Accordingly, unlike the Regulation 5901(2)(b) election, the characterization of the distribution under foreign corporate law remains relevant to a taxpayer making a QROC election. Moreover, the foreign corporate law characterization will continue to remain relevant for distributions by a non-resident corporation that is not a foreign affiliate of the taxpayer.

**Extended Regulation 5901(2)(b) Pre-Acquisition Surplus Election**

Proposed Regulation 5901(2)(b) provides that, where a valid election is made, a foreign affiliate dividend that would otherwise be deemed to have been, in whole or part, paid out of the exempt surplus, hybrid surplus, or taxable surplus of the foreign affiliate, in respect of a Canadian corporation, is instead deemed to have been paid out of the pre-acquisition surplus of the foreign affiliate. The election must be made by the Canadian corporate parent and each other related Canadian corporation, if any, of which the foreign corporation is a foreign affiliate (under a special reading rule). The election is not available where any shareholder in the chain of ownership is a partnership of which a related corporation (or a foreign affiliate of such a corporation) is a member, and no election is available where any one of the relevant group of related persons has made a QROC election in respect of the distribution.

This election is potentially very powerful because it allows a corporation to access the basis in the foreign affiliate shares before accessing the surplus balances of those foreign affiliates. This effectively permits a Canadian corporation to elect out of the traditional surplus ordering rules in Regulation 5901(1). The foreign affiliate distribution that is deemed to be a pre-acquisition surplus dividend by virtue of the election is treated first effectively as a capital distribution due to the reduction in the shareholder’s adjusted cost base under subsection 92(2). If the deemed pre-acquisition surplus dividend exceeds the shareholder’s adjusted cost basis, subsection 40(3) (which is also being amended) deems the excess (the “negative” amount resulting from the basis grind) to be a gain from a disposition of the share.

A subsection 40(3) deemed gain then in turn engages the amended subsection 93(1) election mechanism, effectively accessing the “tax-free surplus balance” (“TFSB”) in the relevant foreign affiliate group. In particular, proposed subsection 93(1.1) deems an automatic subsection 93(1) election under subsection 93(1.11), either (i) where the dividend is paid by a lower-tier foreign affiliate to another foreign affiliate shareholder that is deemed to have a subsection 40(3) capital gain, regardless of the excluded property status of the shares deemed disposed of, or (ii) where the dividend is paid by a top-tier foreign affiliate to the Canadian parent corporation that is deemed to have a
subsection 40(3) gain, resulting either from a Regulation 5901(2)(b) election or a QROC election. The effect of the automatic subsection 93(1) election is to deem a portion of the gain prescribed by Regulation 5902(6) to instead be a dividend paid by the underlying foreign affiliate, thereby accessing the surplus balances of the dividend-paying foreign affiliate after first depleting the shareholder’s basis. The prescribed amount of the surplus accessed through the automatic subsection 93(1) election pursuant to Regulation 5902 is determined in the same manner used to determine the proposed TFSB calculation in Regulation 5905(5.5), with a notional elevation of underlying net surplus balances in lower-tier foreign affiliates below the dividend-paying foreign affiliate.

The pre-acquisition surplus dividend election in Regulation 5901(2)(b) is proposed to apply to foreign affiliate dividends paid after August 19, 2011, the date when the election was first proposed. However, Finance is allowing taxpayers to retroactively access this alternative regime for foreign affiliate dividends paid after December 20, 2002 (in the August 19, 2011 version the elective retroactive application of Regulation 5901(2)(b) was only to post-February 27, 2004 dividends). The one-time opportunity to apply Regulation 5901(2)(b) retroactively to any particular historical foreign affiliate dividends must be made by electing on or before the later of one year following Royal Assent and the filing due date for the electing corporation’s tax year in which Royal Assent occurs.

**Implications of the New Foreign Affiliate Capital Distribution Elections**

For many, if not most, taxpayers with foreign affiliate groups, the adjusted cost base of their foreign affiliate shares is a more certain and cost-effectively determined tax attribute than the surplus balances of their foreign affiliates. Surplus balances are cumulative calculations tracked over the foreign affiliate ownership period and accordingly change continually over time. Surpluses depend in the first instance on earnings computed under foreign income tax laws, which can give rise to language and interpretational uncertainties and then must potentially be adjusted under Regulation 5907. In contrast, the adjusted cost base of foreign affiliate shares is generally fixed based on the one-time acquisition of the shares; while there are also basis adjustments required in some circumstances, the exercise is generally simpler and less costly for taxpayers.

The new QROC and Regulation 5901(2)(b) capital distribution elections proposed by Finance will give taxpayers the opportunity to access the basis in their foreign affiliate shares before dipping into their surplus balances. In the many cases where the taxpayer can more easily and reliably determine the basis of foreign affiliate shares in respect of a distribution, taxpayers can ease their compliance burden and reduce the risk of unintended consequences by strategically electing capital distribution treatment. On the other hand, if a disposition of the shares is imminent or if the distributing foreign affiliate has positive exempt surplus that the taxpayer fears may be eroded by future losses, the taxpayer might prefer the default surplus ordering rules in Regulation 5901(1) in order to preserve basis or access exempt surplus while that attribute exists. The point is that the new elections offer taxpayers additional planning flexibility with respect to foreign affiliate distributions.

Moreover, taxpayers may now use these capital distribution elections to defer the elevation of undesirable surplus attributes, such as hybrid surplus or taxable surplus with insufficient underlying foreign tax. If there is a risk that historical transactions may have given rise to any such “bad” surplus balances in a lower-tier foreign affiliate, and the foreign affiliate makes a distribution up the chain, the capital distribution elections can be used to ensure that the “good” attributes — basis and exempt surplus — are accessed first, before the distribution dips into, and elevates, the possible “bad” attributes.

In addition, the ability to retroactively apply the Regulation 5901(2)(b) election to foreign affiliate distributions made after December 20, 2002 means that taxpayers can now advantageously clarify the consequences of past foreign affiliate distributions. For example, if a prior foreign affiliate distribution was effected as a purported reduction of paid-up capital, but the nature of the distribution under the foreign corporate law was ambiguous or there was confusion due to historical conflicting Canada Revenue Agency commentary, the corporate taxpayer may now elect retroactive application of Regulation 5901(2)(b). In such a case, the proposed mandatory dividend rule in subsection 90(2) would also apply retroactively to the distribution, but the taxpayer could then further elect under Regulation 5901(2)(b) to deem the particular distribution to be a pre-acquisition surplus dividend that reduces basis, thereby restoring with certainty the intended capital distribution treatment that previously may have been uncertain.

From a group structure perspective, taxpayers may also wish to capitalize on the enhanced superiority of basis over surplus by reorganizing their foreign affiliate groups to consolidate basis in one or more holding company foreign affiliates. The new capital distribution elections, and particularly the Regulation 5901(2)(b) election, prompt a twist on
the historical “surplus mixer” strategy. Now, since basis can routinely be accessed first, basis is the attribute most advantageously to be maximized by a Canadian parent corporation with respect to its shares of a top-tier holding company foreign affiliate. For example, the Canadian parent corporation could transfer its top-tier foreign affiliates into a single “basis consolidator” foreign affiliate holding company, on tax-deferred share-for-share exchanges under subsection 85.1(3). The effect is to aggregate and consolidate the basis in those transferred top-tier foreign affiliate shares into the basis of the newly issued top-tier foreign affiliate holding company shares held directly by the Canadian parent corporation. Future distributions sourced from the various underlying chains could then ultimately be paid to the Canadian parent by the top-tier foreign affiliate “basis consolidator” as dividends electively deemed by Regulation 5901(2)(b) to be pre-acquisition surplus dividends. In this manner, the potential adverse consequences from elevating possible “bad” hybrid surplus or taxable surplus from the underlying foreign affiliates could be deferred to the greatest extent. Moreover, by strategically electing under Regulation 5901(2)(b) in respect of those lower-tier foreign affiliate distributions, it may be possible to defer the elevation of any such “bad” hybrid surplus or taxable surplus up the chain.

From a bigger picture perspective, the extended Regulation 5901(2)(b) election and the QROC election further cement the equivalency of surplus and basis attributes within foreign affiliate groups — and since basis can generally be determined more reliably and cost-effectively than surplus, this enhances the importance of provisions in the ITA affecting the basis of foreign affiliates.

Taxpayers are likely to rely and focus increasingly on the rules establishing and modifying the adjusted cost base of their foreign affiliate shares. On acquisitions of control of Canadian target corporations with foreign affiliates, the potential paragraph 88(1)(d) bump of the adjusted cost base of the target’s top-tier foreign affiliates may become even more strategically important than has historically been the case.\(^4\) The paragraph 95(2)(f.1) carve-out rule acts analogously to a bump of the adjusted cost base of lower-tier foreign affiliate shares and may be relied on increasingly with the extension of the Regulation 5901(2)(b) election to lower-tier foreign affiliate distributions.

Taxpayers may also consider the surplus and basis adjustments under the proposed “fill-the-hole” rules in Regulations 5905(7.1) to (7.7) addressing “out-from-under” transactions where foreign affiliates with positive surplus balances (i.e., TFSB) are extracted out from under foreign affiliates with exempt deficits. One of the consequences of such a transaction, under proposed Regulation 5905(7.6), is the conversion of the underlying TFSB into basis in the shares of the foreign affiliate that is extracted out from under the deficit affiliate. With Regulation 5901(2)(b) now applying to lower-tier foreign affiliate distributions, the conversion of surplus into basis under these rules may be a manageable implication, and in some circumstances even a desirable outcome.

In summary, the new capital distribution elections have the potential to provide taxpayers with increased flexibility and planning opportunities with respect to their foreign affiliate distributions and the resulting allocation of surplus and basis tax attributes within foreign affiliate groups. Finance is to be commended for extending this flexibility retroactively by allowing taxpayers to elect to apply Regulation 5901(2)(b) to post-December 20, 2002 foreign affiliate dividends. Canadian parent corporations should consider reviewing the last 10 years of their foreign affiliate distribution history and potentially electing to confirm or improve the consequences of past distributions.

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Notes:

1 All statutory references are to the Income Tax Act (the “ITA”) and the Regulations thereunder.


3 Historically, the main adjustments to foreign earnings have been those in Regulation 5907(2), essentially to conform foreign earnings calculations to Canadian income principles. Now, in addition, proposed Regulation 5907(2.02) can apply to non-arm’s length dispositions of property giving rise to exempt earnings in circumstances amounting to an “avoidance transaction” within the meaning of subsection 245(3). Where Regulation 5907(2.02) applies, the exempt earnings amount will be reclassified as taxable earnings.

4 A previous article explored the proposed grind in the bump amount under Regulation 5905(5.4) and subparagraph 88(1)(d)(ii). Finance intends by this proposal to ensure the bumped basis of the target’s top-tier foreign affiliate shares plus the TFSB in respect of those shares does not exceed the fair market value of those shares at the acquisition of control time. The practical problem for taxpayers under this proposed bump grind is that the historic surplus attributes in the acquired foreign affiliates survive the acquisition of control, creating a compliance burden that in some cases can be very significant. Finance could alleviate this compliance burden and still achieve the policy objective by permitting taxpayers to elect a “fresh start” surplus reset in respect of target foreign affiliates and, as a corollary, allowing a full tax cost bump to fair market value under paragraph 88(1)(d). In other words, since basis is generally easier for taxpayers to determine, and since basis and surplus are effectively equivalent (an equivalency further cemented by the extended Regulation 5901(2)(b) election). Finance could permit taxpayers to electively preserve basis by achieving a full bump and disregard historical surpluses generated before the taxpayer acquired control of the foreign affiliates. See Geoffrey S. Turner, “The Acquisition of Control Surplus/ACB Trade-Off in the August 27, 2010 Foreign Affiliate Proposals”, Tax Topics No. 2026, pp. 1–6 (January 6, 2011) (CCH).
DISCRETIONARY DIVIDEND SHARES — APPLICATION OF ANTI-AVOIDANCE RULES

The Canada Revenue Agency (the “CRA”) was asked if the transaction described below could be subject to anti-avoidance rules:

- X holds 100% of the shares issued by the operating company Opco. Those shares are 100 Class A voting and participating shares with a fair market value (“FMV”) of $5 million, a paid-up capital (“PUC”) of $100, and an adjusted cost base (“ACB”) for X of $100. Opco adds $500,000 of liquidities to its balance sheet every year.
- X would create the holding company Holdco and subscribe to 100 Holdco shares for a consideration of $100.
- X would then exchange his Class A Opco shares for five million Opco preferred shares (“freeze shares”) with an FMV of $5 million, a PUC of $100, and an ACB of $100.
- Opco would then issue 100 new Class A shares to X for a consideration of $1 a share and 100 discretionary dividend shares to Holdco, also for a consideration of $1 a share.
- Opco would pay a dividend on its discretionary dividend shares to protect its $500,000 annual liquidities. The dividend would not reduce the redemption value of the five million freeze shares held by X.

Assuming that the discretionary dividend shares were issued by Opco to Holdco in the course of a planning exercise whose objective was to secure the assets of Opco, the CRA was asked if the exercise could result in the application of certain anti-avoidance rules.

The CRA confirmed that, depending on the circumstances, three anti-avoidance provisions could apply in the above situation:

- Subsection 15(1) of the Income Tax Act (the “Act”) could apply if Holdco bought the discretionary dividend shares from Opco for less than their FMV, thus receiving a shareholder benefit from Opco under subsection 15(1) upon the issuance of the shares.
- Paragraph 110.6(7)(b) of the Act could also apply to prevent X from claiming a capital gains deduction under subsection 110.6(2.1) if the gain realized on the eventual disposition by X of his new Opco Class A shares was part of a series of events or transactions under which Holdco bought the discretionary dividend shares for less than their FMV at the time of purchase.
- Finally, subsections 245(2) and 245(4) of the Act could apply, depending on the circumstances and the facts of the situation, and taking into account that paragraph 85(1)(e.2) prevents a taxpayer from granting a benefit to a related corporation other than a wholly owned subsidiary.

— Association de planification fiscale et financière (APFF), 2012 Conference, Federal Taxation Round Table — Question 12, October 5, 2012, Document No. 2012-0454181C6 (French document)

AUDIT OF HIGH NET WORTH INDIVIDUALS

The Canada Revenue Agency (the “CRA”) was asked to comment on the progress of its Related Party Initiative (“RPI”), which consists of auditing high net worth individuals (“HNWIs”). The CRA stated that the population under review included taxpayers who fit the following criteria:

- They are individuals with a net worth of at least $50 million (including related economic entities);
- Their related groups consist of at least 30 entities; and
- Entities in their related groups are not already included in the CRA’s Large Files Program.

The CRA confirmed that several audits throughout Canada were at various stages of completion and that it continues to develop the RPI by doing the following:

- Improving its ability to identify HNWIs;
- Enhancing risk assessment of RPI groups by assigning them to specialized audit teams;
Revising the CRA questionnaire to make it more relevant to the CRA and less burdensome to tax professionals and advisers;

Exploring ways to communicate with HNWIs to convince them to co-operate; and

Continuing to co-operate with the OECD to identify HNWIs.


RECENT CASES

Taxpayer held vicariously liable for tax owing by husband when he made cash deposits into her bank account

At a time when the taxpayer’s husband, W, owed tax, the couple renegotiated the mortgage on the matrimonial home. At the mortgagee’s suggestion, W transferred his interest in the home to the taxpayer on January 13, 1994, the new mortgage was registered on title, and the husband guaranteed it. On January 14, 1994, the proceeds of the new mortgage were used in part to pay off the existing mortgage, and in part to pay W’s tax owing of $47,115.31. Between January 2, 1998 and November 5, 2002, W deposited funds totalling $58,794.77 into the taxpayer’s bank account to enable her to make the mortgage payments. During this time, the taxpayer’s earned income was very little. As of August 11, 2004, W owed tax of $116,816.81. The Minister assessed the taxpayer vicariously under subsection 160(1) for $58,794.77. On appeal to the Tax Court of Canada, the taxpayer argued that the $58,794.77 was never actually transferred to her, or if it was, she had given consideration for it. Such consideration was said to have consisted of: (a) paying W’s tax owing; (b) providing services to W’s law firm and to him in the form of maintaining the home; and (c) providing him with accommodation in the home as a tenant paying her rent consisting of the deposits into her account.

The taxpayer’s appeal was dismissed. When W made the deposits into the taxpayer’s bank account, he was not the primary obligor under the mortgage, but only the guarantor, and he had not been called upon to meet that guarantee. The taxpayer had full control over the monies deposited, and benefited from them to the extent that her equity in the home increased. There was therefore a “transfer” of funds into the bank account under subsection 160(1). There was no consideration for this transfer. Prior to making the deposits into the taxpayer’s account starting in January 1998, W had more than repaid her for paying his tax of $47,115.31. There was no evidence of the taxpayer ever having provided W with services, or of charging him rent as a tenant. The Minister’s assessment was affirmed accordingly.

¶48,290, MacLeod, 2013 DTC 1010

Minister justified in recalculating taxpayer’s ACB of rental property and reducing resulting terminal loss claimed

In 2004, the taxpayer disposed of a rental property she had acquired from her father at less than fair market value, and in a portion of which she had permitted her father to live rent-free. On reassessment, the Minister recalculated the taxpayer’s adjusted cost base (“ACB”) of the property, reducing the terminal loss that she had sought to deduct for 2004. The taxpayer died in 2010, and her estate appealed to the Tax Court of Canada.

The estate’s appeal was dismissed. The taxpayer had erroneously used, in computing the capital cost of the property, its fair market value at the time of acquisition from her father, rather than its actual cost to her, which is what she should have used. She had also erroneously sought to capitalize, as part of her capital cost, a series of non-deductible personal expenses incurred with respect to the portion of the property her father occupied rent-free. The Minister was therefore justified in rectifying these errors by recalculating the ACB of the property. Although the taxpayer alleged that she had made her calculations based on what turned out to be erroneous advice from a Canada Revenue Agency assessor, this allegation could have no bearing on the outcome of her appeal, because of the Court’s lack of jurisdiction to grant equitable relief.

¶48,291, Estate of Suzie Brousseau, 2013 DTC 1011
GAAR applied to loss on disposition of shares to family trust

The corporate taxpayer was incorporated by M to invest in credit facilities and private placements. Allegedly to obtain creditor protection, the taxpayer subscribed for common shares of a new subsidiary (“Newco”) for $5,600,250. Newco then issued a stock dividend in the form of preferred shares to the taxpayer, with a paid-up capital of $56 and a redeemable value of $5,600,250, which reduced the value of the Newco common shares to a nominal amount. As “window dressing”, Newco subsequently issued additional common shares to the taxpayer for $200,000 to give Newco’s total common shares outstanding some value. The taxpayer later sought to deduct, as a business loss for 2001, the $5,600,194 loss it sustained on its subsequent non-arm’s length disposition of its Newco common shares for $200,000 to a family trust whose beneficiaries were M and his family members. All of the relevant transactions took place near the end of September 2001, which was the taxpayer’s taxation year end. Relying on the general anti-avoidance rule (“GAAR”), the Minister disallowed the taxpayer’s loss deduction claim. On appeal to the Tax Court of Canada, the Minister did not allege that the taxpayer had misused sections 3, 4, 9, or 111 in computing the business loss deduction in issue. The Minister argued, however, that the object and spirit of these provisions as a whole is to prevent the deduction of artificially created non-economic business losses of the type involved in this case so that there was abusive tax avoidance here. In allowing the taxpayer’s appeal, the Tax Court concluded, in essence, that: (a) the transactions in issue were “avoidance transactions”, the primary purpose of which was to achieve a tax benefit, albeit through a series of highly artificial transactions involving a “shuffle of paper” with no real economic loss; but (b) the Minister failed to establish abusive tax avoidance, because there is no general policy in the Income Tax Act (the “Act”) preventing the deduction of artificially created business losses (2011 DTC 1350). On appeal to the Federal Court of Appeal, the Crown argued that: (a) the spirit or purpose of sections 3, 4, 9, and 111 is to allow the deduction of business losses, only to the extent that they reflect an underlying economic loss reflecting an actual reduction in wealth; (b) incorporating the former subsection 245(1) into the GAAR reflected Parliament’s intention to maintain a general statutory assumption against transactions that produce artificial losses; (c) the taxpayer did not acquire Newco’s common shares as inventory or as part of an adventure in the nature of trade, so that the loss from their disposition should not be deductible under section 9; and (d) the Newco shares were capital property in the taxpayer’s hands, so that the capital loss deduction provisions of the Act became applicable, as did the reasoning of the Federal Court of Appeal in two other decisions, in which the Court applied the GAAR to disallow capital losses in transactions similar to those in this case.

The Crown’s appeal was allowed. Most of the arguments raised by the Crown were not raised by the Minister in making his reassessments, nor in arguing his appeal in the Tax Court. The Crown’s new arguments that Newco’s shares were not inventory but capital property in the taxpayer’s hands were prejudicial to the taxpayer and were not supported by any evidentiary groundwork in the Tax Court. These arguments therefore had to be disregarded. The Crown’s remaining new arguments, however, were based on the existing evidentiary record in the Tax Court, and therefore were permitted under subsection 152(9). That said, the Crown’s handling of this GAAR litigation, with its ever-changing arguments and positions that were sometimes contradictory to its previous positions, simply could not be condoned and created additional costs for the taxpayer. Costs of the appeal in this court and in the Tax Court, therefore, should be awarded to the taxpayer at the high end of Column V of Tariff B, regardless of the outcome of the Crown’s appeal. The key issue in this appeal was the object, spirit, or purpose of sections 3, 4, 9, and 111. Accordingly, former subsection 245(1), which was raised by the Crown, was of little relevance. Nor did the Crown offer support for its suggestion that the rationale applicable to capital losses should be applied in determining the object or purpose of sections 3, 4, 9, and 111, since the capital loss and business loss provisions of the Act are distinct from each other. Reading the specific wording in sections 3, 4, 9, and 111, moreover, led to the conclusion that these provisions are not intended to apply to all business losses, but only to those involving an air of economic or business reality. In this case, the claimed losses were artificial and resulted from a value shift involving a paper shuffle without any air of economic or business reality. The transactions generating them, therefore, constituted abusive tax avoidance, which defeated the rationale underlying sections 3, 4, 9, and 111. The Minister’s GAAR reassessments were accordingly justified.
Whether Minister correct in characterizing fee as ordinary business income

The corporate taxpayer was engaged in a takeover bid of Acanthus Real Estate Corporation ("Acanthus"). The directors of Acanthus agreed to support the taxpayer's final bid of $9 per share, and Acanthus agreed to pay the taxpayer an additional $3 million break fee if it withdrew its support for its final bid, which it did upon receiving a higher competing bid. Acanthus had already paid the taxpayer a $4.7 million break fee after failing to support one of its previous bids. Upon reassessment, the Minister characterized the entire $7.7 million the taxpayer received during 2002 from Acanthus as income, although it had been originally reported and assessed by the Minister as a capital gain. In dismissing the taxpayer's appeal, the Tax Court of Canada concluded that the $7.7 million was income from its normal business activities, which included acquisitions and takeovers (2012 DTC 1099). On appeal to the Federal Court of Appeal, the taxpayer argued that the Tax Court erred in concluding that it was in the business of making acquisitions and takeovers and, as a matter of law, the acquisition of capital properties cannot be a business in itself.

The taxpayer's appeal was dismissed. The conclusion that the taxpayer received the break fee on income account was consistent with the principles set out by the Supreme Court of Canada in *Ikea Ltd. v. The Queen* (98 DTC 6092), which was the main case on which the Tax Court relied. The Tax Court judge correctly characterized this case as the leading case dealing with extraordinary or unusual receipts in the business context. Given the facts as he found them, moreover, it was open to him to conclude that the taxpayer did receive the break fee on income account. In addition, the case law has not established any general proposition of law to the effect that making capital acquisitions cannot be a business, despite the taxpayer's argument to the contrary. The Minister's reassessment was affirmed accordingly.

¶ 48,294, *Morguard Corporation*, 2013 DTC 5009