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Tax Planning With Losses in Canada

by Steve Suarez

Unlike many other industrialized nations, Canada's federal income tax regime has no system of consolidation or group relief whereby the income or gains of group members can be offset against the losses of other group members (or at least those in the same country) simply by filing tax returns on that basis. While it is possible in many cases to achieve results comparable to those obtainable under a formal group relief system, considerable planning is required to achieve the optimal use of losses within a corporate group. This article reviews the basic elements of the Canadian tax system dealing with losses (including rules that deny recognition of losses in some cases), describes the different sets of statutory rules and administrative policies that make up the general loss utilization framework, and offers examples of the kind of loss utilization planning undertaken in Canada.

I. Losses: Categorization and Realization

A. Types of Losses

The Income Tax Act (Canada) (ITA) distinguishes between items of profit (that is, income) and capital gain. Income from a business or investment is fully taxable, whereas only 50 percent of capital gains are subject to tax. While distinguishing between income and capital gains is a highly judgmental issue that probably generates more disputes between taxpayers and the Canada Revenue Agency (CRA) than any other, in very general terms capital gains typically arise from the disposition of property (capital property) acquired for producing income from holding or using the property (for example, production equipment), as opposed to a property held to make a profit on reselling the property (for example, inventory).[1]

Losses are similarly divided between capital losses and losses from a business or investment. A capital loss typically arises on a disposition of a capital property when the sale proceeds are less than the taxpayer's cost of the property and any expenses of disposition, while a business or investment loss generally arises in a particular year when the expenses associated with the business or investment in the year exceed the income it generates.

Each business or investment of the taxpayer is treated as a separate source of income with a separate computation of profit or loss. A taxpayer computes its overall income for the year by aggregating the profit (or loss) from each business or investment.[2] As such, a loss from one business or investment is deductible against income from another within the same year.[3]

Each year, the taxpayer totals 50 percent of any capital gains realized in the year (taxable capital gains) and subtracts 50 percent of any capital losses realized in the year (allowable capital losses).[4] If the net amount is positive, that excess (net taxable capital gains) is added to the taxpayer's overall income for the year. However, if allowable capital losses exceed taxable capital gains, the excess is *not* deductible against business or investment income in computing overall income.[5] Instead, it is treated as the taxpayer's net capital loss for the year, which,

[1] The same property can be either capital or noncapital property depending on its use (for example, land acquired to build a production facility versus land acquired for resale).

[2] For Canadian residents, the income or loss from each business or investment is included, while nonresidents generally include only income or losses from businesses carried on in Canada that are not protected from Canadian tax under the terms of a relevant tax treaty.

[3] Some special types of business or investment losses (losses from some farming activities and "limited partnership losses") are not freely deductible against other business or investment income; those special types of losses are not discussed.

[4] Again, for Canadian residents all capital gains and losses are included. Conversely, nonresidents generally include only capital gains and losses from some specified forms of Canadian-situs capital property ("taxable Canadian property") that are not exempt from Canadian capital gains tax under a tax treaty.

[5] *See* scenario 2 of Table 1. One particular form of capital loss (an "allowable business investment loss" or ABIL) is deductible against business or investment income. An ABIL arises on some dispositions of shares or debt of Canadian-controlled private corporations all or substantially all of whose assets are used in active businesses carried on in Canada.

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subject to some limitations, may be applied against net taxable capital gains of other years as described below.

If the taxpayer's losses from businesses and investments for the year exceed the sum of the taxpayer's income from businesses and investments plus net taxable capital gains, that excess is the taxpayer's noncapital loss for the year.[6] The taxpayer's noncapital loss for a particular year may be applied against income (or net taxable capital gains) in other years, subject to various restrictions as described below. Hence, the taxpayer's net capital loss and noncapital loss can be thought of as excess losses for a particular year that can be used in other years. Table 1, on the following page, contains simplified numerical examples of the operation of those rules.

The distinction between capital losses and business/investment losses is an important one for various reasons:

- only 50 percent of a capital loss (the allowable capital loss) is recognized by the tax system;
- capital losses are only deductible against capital gains, whereas business/investment losses can be deducted against any income or taxable capital gain;
- excess business/investment losses for a year (that is, noncapital losses) have different rules for application in other years than excess capital losses for a year (net capital losses); and
- as is discussed below, a corporation's capital losses are treated differently from its noncapital losses on an acquisition of control of the corporation.

A taxpayer's noncapital loss for the year may be carried back and applied against the taxpayer's overall income in any of its three immediately preceding tax years or carried forward and used in any of its 10 immediately subsequent tax years. It expires if not used within that period. A taxpayer's net capital loss for the year may be used against the taxpayer's net taxable capital gains (but not business or investment income) in any of the taxpayer's three immediately preceding tax years or any later year. In both cases, unexpired losses of earlier years must be used before those of later years.[7] As discussed below, a corporation's ability to use its noncapital losses or net capital losses in another year may be affected by a corporate reorganization or an acquisition of control of the corporation.

B. Recognition of Losses

Canada's tax system does not recognize all losses that a taxpayer may incur. The ITA contains rules that deny or suspend recognition of losses or reduce the amount of the loss recognized. A brief summary of some of the most important of those "stop-loss" rules is useful.

1. General Requirement for Profit Motive

For business or investment losses, the tax authorities have for many years been concerned with losses generated from activities that are not motivated exclusively by profit-making considerations. The classic example is a part-time farming operation carried on by a taxpayer largely motivated by maintaining a country lifestyle rather than generating a profit. Canadian tax authorities are concerned with allowing losses from what are essentially personal hobbies to be used to offset income from the taxpayer's primary business activities.

Until relatively recently, the Canadian tax jurisprudence required that, for a business or investment loss to be recognized by the tax system, the loss-generating activity must be carried on with a "reasonable expectation of profit" (REOP). The REOP test was meant to separate activities with at least a realistic potential to generate a profit from those that never will, with losses from the latter being denied recognition for tax purposes. A few years ago, however, the Supreme Court of Canada handed down a pair of decisions[8] that fundamentally revised the role of the REOP test. It ruled that, when there was no personal element to the taxpayer's activities, losses from those activities would be recognized whether or not the REOP test was met. Only when some personal element to the activity exists will the REOP test be relevant (and only then as one factor to be considered) in considering whether the loss arises from a "business" or "investment" so as to be recognized for tax purposes.

In response to those and other judicial developments, the government introduced legislative proposals on October 31, 2003, to limit the recognition of losses in various circumstances.[9] The essence of those draft proposals would have required a year-by-year analysis of whether, in each particular year, it is reasonable to expect that the taxpayer will realize a *cumulative* profit from the relevant business or investment activity (that is, not only will it

[6] *See* scenario 3 of Table 1.

[7] The rules dealing with loss carryforwards and carrybacks are largely contained in section 111 ITA. The carryforward period for noncapital losses was recently extended from 7 years to 10 years. ABILs (*see* footnote 5) are included in the taxpayer's noncapital loss. If they remain undeducted at the end of the carryforward period, they are transferred to the taxpayer's net capital loss (which has no carryforward expiration).

[8] *Stewart v. The Queen*, 2002 DTC 6969, and *Walls v. Canada*, 2002 DTC 6960.

[9] *See* Department of Finance Release No. 2003-055.

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Table 1

	Scenario 1		Scenario 2		Scenario 3	
Business 1: Income (Loss)	$100		$50		($40)	
Investment 1: Income (Loss)	($60)		$20		($100)	
Subtotal: Net Business/Investment Income (Loss)		$40		$70		($140)
Capital Property 1: Capital Gain (Loss)	$80		$20		$120	
Taxable Capital Gain (50%)	$40		$10		$60	
Capital Property 2: Capital Gain (Loss)	($60)		($50)		($20)	
Allowable Capital Loss (50%)	($30)		($25)		($10)	
Subtotal: Net Taxable Capital Gains (Losses)		$10		($15)		$50
Overall Income (Loss)		**$50**		**$70**		**($90)**
Noncapital Loss		-		-		($90)
Net Capital Loss		-		($15)		-

be profitable in the future, but all losses from earlier years will be recouped). Losses in a year in which the relevant activity failed to meet that test would be disallowed. Moreover, for that purpose cumulative profit would not include capital gains realized on the ultimate disposition of property.

The tax community expressed great concern over those proposals on the basis that they represented a significant change in tax policy that would have unanticipated and disruptive results.[10] In response to those concerns, the Department of Finance announced in its 2005 budget that the October 2003 proposals would be scaled back to "a more modest legislative initiative" and that alternative proposals would be released for comment "at an early opportunity." Finance reiterated that intention on May 9, 2005, at the meeting of the Canadian branch of the International Fiscal Association, indicating that a net profit test would be proposed.

2. Loss Suspension on Affiliated Person Transactions

A general stop-loss concept that manifests itself in several places in the ITA is that losses on the disposition of property should generally not be recognized when the taxpayer or an affiliate continues to own the property or an identical substituted property. The basis for this principle is that no true economic loss arises until the relevant property ceases to be held within the affiliated group. For that purpose, the rules typically use the status of "affiliated" persons as the relevant degree of relationship. In some cases those stop-loss rules delay recognition of the seller's loss until neither the seller nor a person affiliated with the seller holds the relevant property. Less frequently, the rules simply deny the loss to the seller and effectively transfer it to the affiliated purchaser as an accrued loss on the acquired property, to be realized on a subsequent disposition.

[10]*See, e.g.,* the submission of the Joint Committee on Taxation of the Canadian Bar Association and the Canadian Institute of Chartered Accountants dated Feb. 19, 2004. Among the problems cited were that the year-by-year cumulative profit test denies the recognition of losses from a wholly commercial activity that has simply become unsuccessful, which is inappropriate from a tax policy perspective. Also, the year-by-year test does not adequately take into account that in many cases taxpayers incur multiyear obligations at the outset of a business or investment. It is thereby inconsistent with other provisions of the ITA that permit ongoing deductibility of expenses originally incurred with a reasonable expectation of profit. Moreover, the proposals are inconsistent with commercial decisionmaking. For example, if a taxpayer reasonably expects that continuing an unprofitable business would recoup some but not all of the previous losses, the "cumulative profit" test would deny recognition of subsequent losses even though the taxpayer has acted in a commercially logical way.

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The concept of "affiliated" persons is somewhat involved, but can be summarized as follows. A natural person is "affiliated" with his spouse, but not any other natural person (that is, children, parents, and siblings). A corporation is affiliated with any person (including another corporation) who controls the corporation, any member of a group of affiliated persons that controls the corporation, and the spouse of any of those persons. A corporation is also affiliated with another corporation if: (1) each is controlled by the same person; (2) each is controlled by a single person and those two persons are affiliated; (3) one is controlled by a single person, the other is controlled by a group of persons, and the single person is affiliated with each member of the group of persons; or (4) both corporations are controlled by groups of persons and every member of both groups is affiliated with at least one member of the other control group. For that purpose, "control" refers to de facto control of a corporation,[11] rather than the narrower, more typical de jure test of having sufficient shares to elect a majority of the corporation's board of directors. Analogous rules govern the affiliation status of partnerships and trusts.

While there are separate stop-loss rules dealing with different types of property, they generally operate along similar lines. The operation of those rules can be illustrated by describing the stop-loss rules applicable to dispositions of nondepreciable capital property by a corporation, partnership, or trust. The rules suspend recognition of the taxpayer's loss if some conditions apply, and (when applicable) go on to prescribe the circumstances in which a suspended loss will be unsuspended and recognized for tax purposes. Briefly, a loss from the disposition of nondepreciable capital property (the disposed-of property) by a corporation, partnership, or trust (the transferor) is deemed to be nil when:

- the disposition of the disposed-of property is not an excepted disposition;[12]
- the transferor or an affiliated person acquires a property (the acquired property) within the 61-day period that begins 30 days before and ends 30 days after the date of the disposition;
- the acquired property is either the disposed-of property itself or property identical to the disposed-of property; and
- at the end of the 61-day period, the transferor or an affiliated person owns the acquired property.

Thus, for example, simply transferring ownership to an affiliated person or disposing of property and buying it (or an identical property) back within 31 days will cause the loss to be suspended under this rule. The suspended loss will be recognized at the beginning of the first 30-day period following the disposition in which neither the transferor nor an affiliated person owns the acquired property or a property that is identical to the acquired property and was acquired within the 30 days preceding the start of the 30-day period.[13] Thus, the loss could be unsuspended because the acquired property has been sold outside the affiliated group or because the owner of the acquired property has ceased to be affiliated with the transferor.

3. Specific Stop-Loss Rules

In addition to the more general rules dealing with the recognition of losses, a number of specific provisions reduce or deny the recognition of losses in particular circumstances. For example:

- in some circumstances a loss realized on the disposition of a share is reduced by the amount of particular dividends received on the share;[14] and
- losses from the disposition of a debt are generally denied unless the debt was acquired by the creditor to gain or produce income or is a balance of sale owing on a disposition of capital property to an arm's-length person.[15]

II. Loss Transfers Between Entities

Having briefly summarized the principles applicable to the computation, categorization, and realization of losses, we now turn to the rules in the ITA governing the transfer of losses between entities. As those rules are largely directed toward the losses of corporations, the discussion that follows focuses on

[11]De facto control means effective control of a corporation, such as may occur when (for example) one large shareholder holds less than 50 percent of a corporation's shares but the remainder are widely held among the public.

[12]Excepted dispositions include some dispositions deemed to occur by the ITA and a disposition by a corporation that has undergone an acquisition of control in the 30 days following the disposition.

[13]Some events and dispositions deemed to occur under the ITA (including an acquisition of control of a corporation) will also un-suspend the loss. The rules are contained in subsections 40(3.3)-(3.7) ITA and in some circumstances deem property to be identical to other property (for example, shares acquired in certain tax-free exchanges) or deem persons to own property.

[14]Sections 112(3)-(7) ITA. The basic principle behind the rule is that tax-free dividends that have been received on a share represent a tax-free recovery of cost that should reduce the amount of any loss from a sale of the share.

[15]Subparagraph 40(2)(g)(ii) ITA. As a result, interest-free loans can be problematic in that regard.

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corporate taxpayers, although other entities like partnerships and trusts can be highly useful in loss utilization planning.

From the perspective of Canadian tax authorities, the fundamental distinction to be drawn between acceptable and unacceptable loss transfers is based on the "affiliated person" concept (for that purpose, "affiliated" is a modified version of the same "affiliated" definition used in the stop-loss rules noted above).[16] In general terms, transactions that have the effect of transferring losses between affiliated persons are viewed as acceptable from a tax policy perspective, while loss transfers between unaffiliated persons are not and are much more likely to be challenged by tax authorities.[17] The basis for that view is derived from the overall thrust of various statutory provisions that restrict the use of losses, in particular:

- *Acquisition-of-control rules*. Those rules apply to the acquisition of control of corporations by "unrelated" persons (discussed in detail below). Generally speaking, they crystallize accrued but unrealized losses immediately before the acquisition of control and prohibit or restrict the corporation's use of pre-acquisition-of-control losses in the post-acquisition-of-control period and vice versa.
- *Affiliated person rules*. The antiavoidance rules in subsections 69(11)-(13) apply when a disposition of property occurs at below fair market value sale proceeds for tax purposes (that is, a rollover) as part of a series of transactions and it is reasonable to consider that one of the main purposes of the series is to use the deductions or losses of someone unaffiliated with the vendor on a subsequent disposition of the property within three years.[18] When applicable, those rules deem the transferor to have received fair market value sale proceeds on the original disposition for tax purposes.

Loss utilization transactions designed to circumvent the acquisition-of-control rules or the affiliated person restrictions described above will typically be considered to be avoidance transactions by the CRA to be challenged by the ITA's general antiavoidance rule applicable to tax-motivated transactions that result in a misuse of specific provisions of the ITA or an abuse of the ITA as a whole. These provisions, along with related provisions that govern the use of losses following some corporate reorganizations, such as amalgamations and windups, form the statutory framework within which to consider transfers of losses between corporations.

In addition to those statutory restrictions, the CRA has a number of other administrative concerns that it will consider in determining whether to grant an advance tax ruling on a loss utilization transaction (if the taxpayer has requested one) or to challenge a loss utilization transaction on audit (whether under the general antiavoidance rule or otherwise). For example:

- transactions designed to effectively import into Canada losses from outside the Canadian tax system are viewed very negatively;[19] and
- when losses (such as noncapital losses) have a specific time limit to be used, a transaction that replaces those losses with new losses with longer time periods for use (loss refreshing) is considered abusive unless the new losses will be used within the remaining life of the existing losses (that is, the extra utilization time is not used).[20]

As such, loss utilization transactions must be designed to take into account both the various sets of loss restriction rules in the ITA and (for taxpayers

[16]For purposes of the rules restricting loss transfers (as opposed to the stop-loss rules), the "control" element of the "affiliated person" definition described earlier is the narrower de jure control (that is, ownership of sufficient shares, directly or indirectly, to elect a majority of the corporation's board of directors), not the de facto control concept relevant to the affiliated person definition in the context of the stop-loss rules.

[17]Hence, while for loss *realization* purposes a disposition to an affiliated person is generally denied recognition under the stop-loss rules on the basis that it does not represent a true realization of the loss, for loss *utilization* purposes only transfers of losses among affiliated persons are generally considered acceptable by the CRA.

[18]For example, that rule would apply to the transaction described below in Section II.C.2. and illustrated in Figure 4 (Property Sale via Lossco) if Lossco and Gainco were not affiliated, to prevent the tax-deferred transfer of the gain asset to Lossco. It should be noted that the degree of relationship used in the acquisition-of-control rules ("related") is not quite the same as that used in the loss transfer rules ("affiliated"). However, the modified version of affiliated based on the de jure control standard is very similar to the related test so that, in many (but not all) cases, related persons will also be affiliated. The difference between the two is less relevant in the public company context and more pronounced for family-owned corporations.

(Footnote continued in next column.)

[19]*See, e.g.,* the comments of a senior CRA official at the 2002 Canadian Tax Foundation Annual Conference, *Interest Deductibility: Where From, Where To, Where Now?* 2002 Conference Report, at 11:11: "If there is a way to import losses, I would think that the tax policy would be that we would again use whatever tools we have available to challenge it."

[20]*See, e.g., Income Tax Technical News,* No. 25, Oct. 30, 2002.

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seeking an advance tax ruling or who have lower risk tolerance) the nonstatutory administrative policies of the CRA.[21]

A. Windups and Amalgamations

It is useful to briefly summarize the rules governing the use of loss balances (that is, unused noncapital losses and net capital losses from other years) on an amalgamation of two or more corporations or the winding-up of one corporation into another. Those rules apply in addition to any other loss utilization rules otherwise applicable. For example, an amalgamation (that is, merger) of two corporations to form a single corporation may also constitute an acquisition of control of one of the amalgamating corporations, in which case the acquisition-of-control rules described below would also apply.

1. Windups

A windup describes a corporate procedure whereby a corporation ceases to exist and its remaining property (after paying its debts) is distributed to its shareholders on the cancellation of the wound-up corporation's shares. Because losses attach to a particular entity, the loss balances of a wound-up corporation are eliminated in the absence of statutory rules to the contrary.

An exception to that general rule exists when one Canadian corporation (the parent) owns 90 percent or more of the shares of each class of shares of another Canadian corporation (the subsidiary) and any remaining subsidiary shares not owned by the parent are owned by persons dealing at arm's length with the parent. In those circumstances, the parent generally acquires the subsidiary's property at its tax cost (as such, inheriting any accrued but unrealized gains and losses). Any unused loss balances of the subsidiary at the time of its windup may be used by the parent in future parent tax years, beginning in the parent's first tax year following the windup.[22] The parent may not carry the subsidiary's loss balances back to any prewindup parent tax year. The parent is free to carry its own loss balances forward or backward against its own income, subject to the usual time limits.

2. Amalgamations

An amalgamation of two or more corporations is a specific form of corporate merger, which results in the creation of a new corporation for tax purposes that is the successor of the two amalgamating corporations. An amalgamation of two Canadian corporations occurs on a tax-deferred basis if the new corporation acquires all of the property and assumes all of the liabilities of the amalgamating corporations and the shareholders of the amalgamating corporations receive shares in the new corporation in exchange for their shares of the amalgamating corporations.[23] As such, on a qualifying amalgamation the new corporation acquires the property of the predecessor corporations at tax cost and inherits any accrued but unrealized gains and losses.

On a qualifying amalgamation, the new corporation acquires the loss balances of the amalgamating corporations and may use them in postamalgamation tax years (subject to the same restrictions that would have applied to the amalgamating corporation that incurred them).[24] Conversely, losses incurred by the new corporation may not be carried back to preamalgamation tax years of any amalgamating corporation, with one exception. The exception arises when one amalgamating corporation (the top corporation) owns all of the shares of the other (the bottom corporation). In that circumstance, the new corporation is permitted to carry postamalgamation losses it incurs back into the top corporation's preamalgamation tax years (subject to the normal three-year carryback limitation). As such, on a vertical amalgamation of the bottom corporation into the top one, the tax result is essentially the same as occurs on the windup of a wholly owned subsidiary into the parent.

Amalgamations and windups are useful elements of corporate loss planning because, if structured properly, they allow accrued losses and loss balances to be moved into a profitable entity (or accrued gains or future income to be moved into a loss entity) on a tax-deferred basis. For example, a simple loss utilization technique might be to amalgamate a corporation that has loss balances with a corporation that has a profitable business and use the loss balances against the postamalgamation income of the business. As noted above, however, it would be necessary to consider whether on the facts, the acquisition-of-control rules or subsection 69(ii) affiliated person restrictions create additional constraints on using the loss corporation's losses. The basic rules governing the use of loss balances on windups and amalgamations are depicted in Figure 1.

[21]Figure 5 (Overview of Loss Utilization Rules, discussed at the conclusion of this article) attempts to visually illustrate the network of relevant provisions at a conceptual level.

[22]Subsection 88(1.1) and (1.2) ITA. The parent's ability to use the subsidiary's losses is subject to any restriction that the subsidiary itself was under (for example, remaining number of years permitted for carrying noncapital losses forward).

[23]Subsection 87(1) ITA. Shares and debt of one amalgamating corporation held by the other are ignored for that purpose.

[24]Subsection 87(2.1) ITA. The amalgamation itself causes a deemed tax year-end, aging the loss balances by one year.

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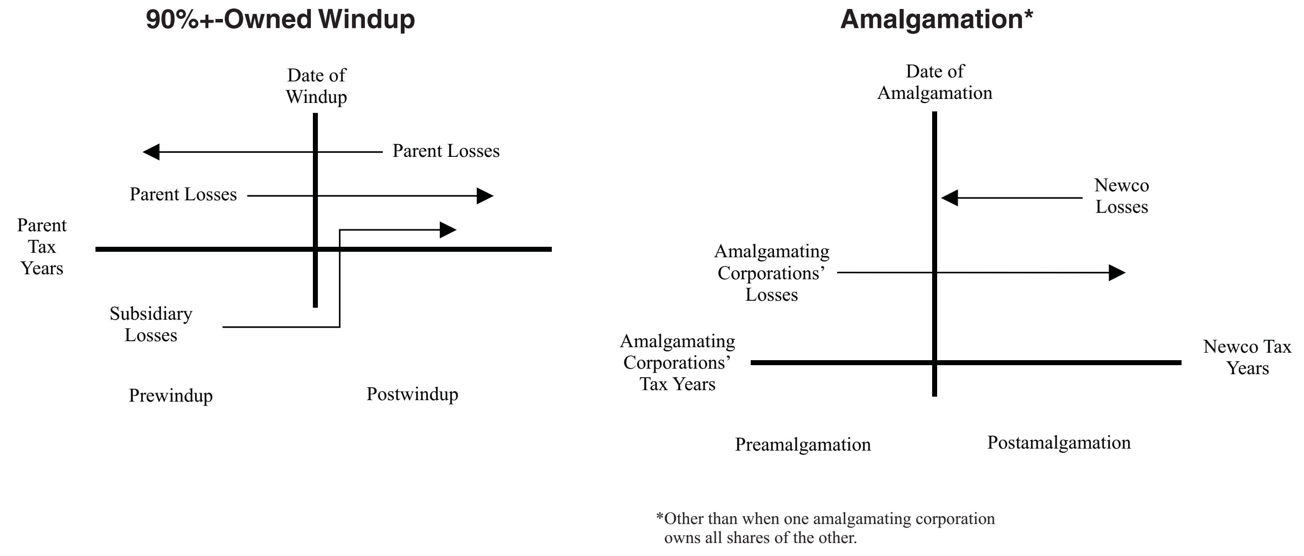
Figure 1. Permitted Use of Losses on Windups and Amalgamations



B. Acquisition of Control

The rules applicable to the acquisition of control of corporations are a key element of the statutory scheme of loss utilization restrictions. When a change in the shareholdings of a corporation (directly or indirectly) meets a particular threshold defined as an "acquisition of control," a variety of rules apply to the corporation, including rules that: (1) deem the corporation's tax year to have ended; (2) trigger the realization (immediately before the acquisition of control) of its accrued losses; and (3) prohibit or restrict the use of preacquisition-of-control losses (including unused losses from (2)) in the postacquisition-of-control period and vice versa. As such, understanding and managing the acquisition of control rules is an integral part of corporate loss utilization planning.

1. Meaning of "Acquisition of Control"

The concept of corporate "control" is not a precise one for Canadian tax purposes. The basic test is the ownership of sufficient shares of a corporation that gives the holder de jure control of the corporation, generally meaning the ability to elect a majority of the corporation's board of directors. In some cases agreements among shareholders to vote shares a particular way or limit the powers of the corporation's directors may also be relevant to determining de jure control. Control can be held by a "group of persons" if the members of the group act in concert to direct the affairs of the corporation or vote their shares jointly. In many cases (for example, with widely held companies), no person or group of persons has de jure control of the corporation. A person or group of persons that controls a corporation will also be considered to control any corporations that are controlled by the first corporation. Consequently, an acquisition of control of a corporation results in an acquisition of control of any other corporations it controls.

Not all changes in shareholdings that result in a different person or group of persons having de jure control of a corporation constitute an "acquisition of control" for tax purposes. A number of rules operate to deem a transaction that would otherwise be an acquisition of control not to be an acquisition of control, in particular when the change in de jure control arises because a person has acquired shares either from a person who is related to the acquiror, or of a corporation to which the acquiror was already related.[25] As such, transactions that do not result in

[25]Subsection 256(7) ITA (which also deems an acquisition of control to occur in some circumstances, such as on some amalgamations). The related test in section 251 ITA is similar (but not identical to) the modified affiliated test described with reference to the affiliated person loss transfer restrictions in subsection 69(11) ITA, in particular because both are based on de jure control. A natural person is related to his or her spouse and blood relatives (children, parents, siblings, etc.). A corporation is related to a person who controls it, to any person related to that controlling shareholder, and to each member of a group of related persons who controls it (and to anyone related to any of those members). Two corporations will be related if one controls the other, if both are

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an unrelated person acquiring de jure control of a corporation generally will not constitute an acquisition of control of the corporation. In that sense, the related person test plays a role in the acquisition-of-control rules similar to that of the modified affiliated person test in the loss transfer rules in subsection 69(11) ITA and the CRA's administrative policy, in that the relevant loss restrictions generally will not apply on intragroup transactions.

2. Effect of Acquisition of Control

The tax year of a corporation that has undergone an acquisition of control is deemed to end immediately before the acquisition of control.[26] To the extent that the corporation has various kinds of accrued but unrealized losses (for example, on capital property, inventory, or receivables, and so on), they are deemed to be realized immediately before the deemed tax year-end and the tax cost of the relevant property is written down to its fair market value.[27] In that way, accrued losses are prevented from being carried over to the postacquisition-of-control period and are instead crystallized before the deemed tax year-end to be either used in the tax year ending on the acquisition of control or (as net capital losses or noncapital losses for that year) made subject to the rules described below governing the carryover of losses on acquisitions of control. Note that because under many of the stop-loss rules an acquisition of control is typically an event that unsuspends a loss, the acquisition of control may also result in the effective realization of losses previously suspended under the stop-loss rules.

Most importantly, the acquisition of control rules also restrict the use of net capital losses and noncapital losses as follows:

- *Net capital losses*. Net capital losses of the corporation from years before the acquisition of control cannot be carried forward and used in postacquisition-of-control tax years. Essentially, they become worthless if they cannot be used in the preacquisition-of-control period.[28] Similarly, net capital losses from years following the acquisition of control cannot be carried back and used in preacquisition-of-control years.
- *Noncapital losses — Investments*. Noncapital losses from an investment (as opposed to from a business) are in the same position as net capital losses. Preacquisition-of-control losses cannot be carried into the postacquisition-of-control period (and vice versa) and effectively expire if they cannot be used before the acquisition of control.[29]
- *Noncapital losses — Business*. Noncapital losses from a business (the loss business) arising from the preacquisition-of-control period may be carried forward and used in the postacquisition-of-control period (and vice versa), if two conditions are met. First, throughout the year in which the corporation is trying to use the loss, it must carry on the loss business itself with a reasonable expectation of profit. Second, the loss can only be used in that year to the extent of income from the loss business or from another business substantially all of the income from which comes from selling similar properties or rendering similar services as were sold or rendered in the loss business.[30]

Thus, the acquisition-of-control rules are meant to prevent losses from one business from being carried forward or back through the acquisition of control and used against income from a significantly different business. They also prevent investment losses and capital losses from being carried forward or back through an acquisition of control at all. Figure 2 is a visual depiction of the loss restriction rules on an acquisition of control.

C. Examples of Permissible Loss Transfers

Loss utilization planning can take many forms and a detailed discussion of all of the potential planning opportunities for using corporate losses is beyond the scope of this article. However, it is instructive to conclude by describing a couple of the

under common control, or if each is controlled by a person or group of persons that are sufficiently related to one another.

[26]Subsection 249(4) ITA.

[27]The relevant rules include subsection 111(4) ITA (for nondepreciable capital property), subsection 111(5.1) ITA (for depreciable capital property), subsection 111(5.2) ITA (for cumulative eligible capital), subsection 10(1) ITA (for inventory), and subsection 111(5.3) ITA (for receivables). A number of other tax attributes are subject to similar rules.

[28]Subsection 111(4) ITA. To alleviate some of the harshness of that rule, the corporation can make a one-time election to effectively use any otherwise unusable preacquisition-of-control capital losses against any accrued but unrealized capital gains on its property that exist immediately before the acquisition of control, thereby increasing the tax cost of (and reducing the accrued gain on) the gain property.

(Footnote continued in next column.)

[29]Subsection 111(5) ITA. ABILs (*see* footnote 5) included in the taxpayer's noncapital loss are similarly treated.

[30]Subsection 111(5) ITA. Whether a business is the "same business" as the loss business and whether property sold or services rendered are "similar" to those sold or rendered in the loss business can be a matter of some judgment. The different treatment of noncapital losses from a business and noncapital losses from an investment makes it important to determine whether a particular activity is a business or an investment. Corporations are generally presumed to carry on all but the most passive activities as a business.

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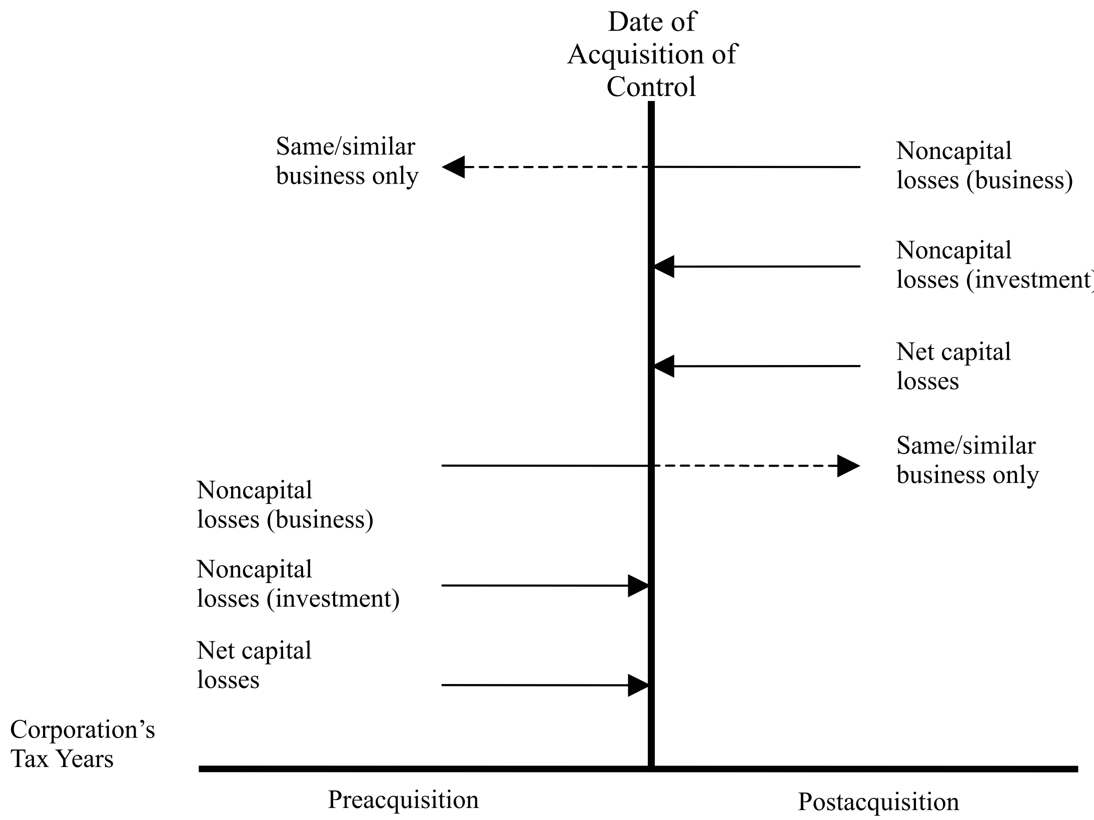
Figure 2. Acquisition-of-Control Loss Restrictions



more common loss utilization techniques that exemplify the kind of planning that can be done to effect a consolidation of losses within a corporate group.

Many loss utilization strategies rely on a few basic elements of the Canadian tax system to achieve the desired results. Those essential elements of the loss utilization toolkit include the following:

- the deduction for interest expense incurred on money borrowed to gain or produce income from a business or investment;[31]
- the deduction that allows a Canadian corporation to receive dividends on the shares of another Canadian corporation free of tax;[32] and
- most property with accrued gains can be transferred to a Canadian corporation in exchange for shares of that corporation without realizing the accrued gains when a joint election is made under subsection 85(1) ITA.

The two loss utilization examples described below illustrate the use of those provisions in the context of an affiliated group of corporations.

1. Simple Operating Loss Consolidation

When one member of a corporate group has available noncapital losses, the most common form of loss

[31]Paragraph 20(1)(c) ITA. Interest on an unpaid balance of sale owing on the acquisition of an income-earning investment or property used in a business is also deductible.

[32]Subsection 112(1) ITA. There are some limited exceptions to that intercorporate dividend deduction and, in some situations, taxes under Parts IV, IV.1, and/or VI.1 ITA must also be considered.

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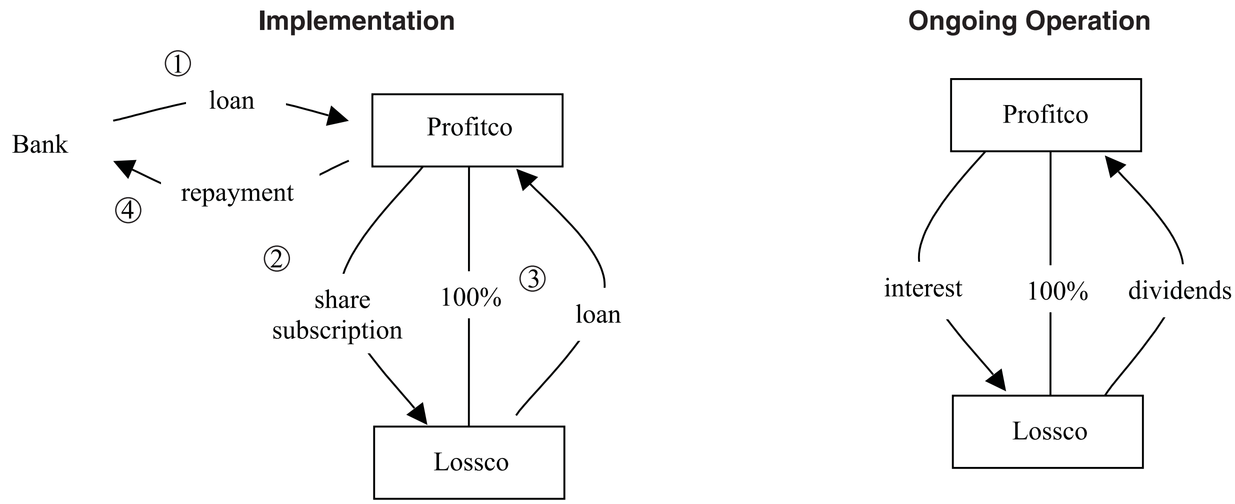
Figure 3. Basic Loss Consolidation



consolidation involves a transaction between the loss corporation (Lossco) and a corporation with taxable income (Profitco) that creates a deduction in Profitco and a corresponding income inclusion in Lossco (to be offset with Lossco's losses). Figure 3 depicts a simple version of such a transaction that the CRA has ruled favorably on many times, which creates taxable interest income in Lossco and deductible interest expense in Profitco that effectively transfers Lossco's losses to Profitco. The steps of that transaction (all of which occur on the same day) are as follows:

1. Profitco obtains a loan from a financial institution;
2. Profitco uses the borrowed funds to subscribe for shares of Lossco;
3. Lossco uses the share subscription proceeds to make an interest-bearing loan to Profitco; and
4. Profitco uses the money borrowed from Lossco to repay its daylight loan in 1.

The result is that Profitco pays interest to Lossco on the loan in 3 and claims a deduction from income for that interest on the basis that the money borrowed from Lossco replaced another loan (the loan in 1 that was incurred to produce income (dividends on the Lossco shares acquired with the borrowed money). The interest deduction reduces Profitco's income and the interest income in Lossco is absorbed by its losses. The rate of interest on the Lossco-Profitco loan reflects a commercially appropriate rate based on the relevant facts and is often structured to be slightly less than the expected dividends on the Lossco shares acquired by Profitco in 2 to make clear that Profitco will earn positive net dividend income even after subtracting its interest expense owing to Lossco. Lossco can distribute surplus cash to Profitco as a dividend (which Profitco will generally receive tax-free).

There are numerous variations on this simple structure (particularly if there are insolvency law concerns regarding any arm's-length creditors of Lossco), but the basic version illustrates the essential concepts.[33] As noted earlier, the CRA has various administrative concerns (for example, loss refreshing and importation of foreign losses) that it will apply in scrutinizing loss utilization transactions. In the context of that particular form of loss consolidation, the CRA will also typically insist that the amount of the Lossco-Profitco loan not exceed the amount that could have been borrowed from an arm's-length lender on an ongoing basis.[34] The CRA has also expressed concerns when Lossco has no source of funds to pay dividends other than the interest received from Profitco (that is, when Profitco is itself funding the dividends it expects to

[33]In a number of cases, a third corporation is included in the structure for corporate law reasons.

[34]The CRA's concern is that larger amounts meant to generate more interest expense faster to accelerate the use of Lossco's losses are artificial.

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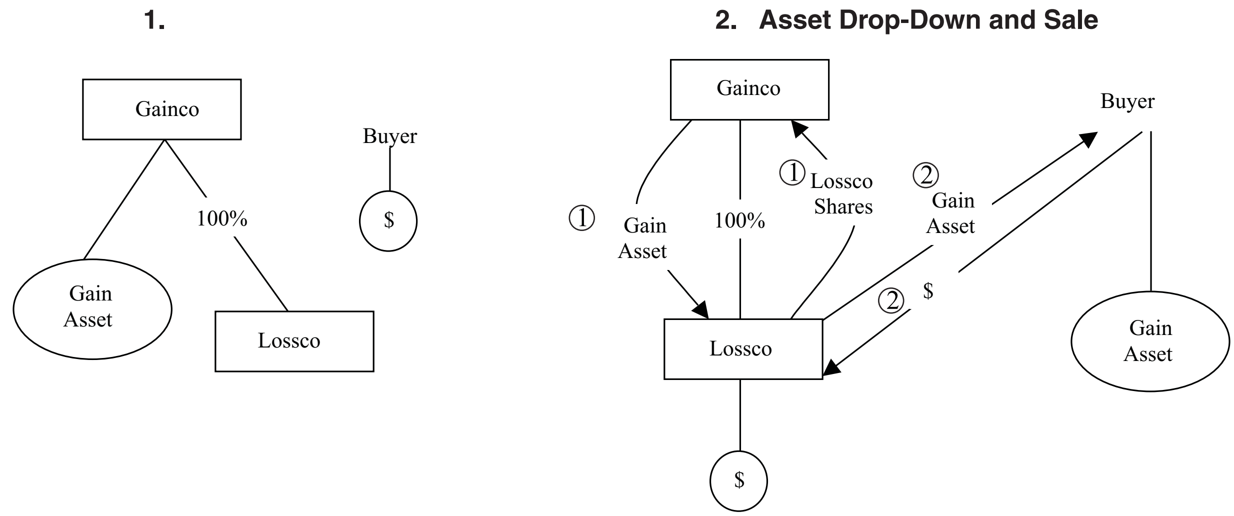
Figure 4. Property Sale via Lossco



receive on the Lossco shares it subscribed for). The CRA greatly prefers that Lossco be able to pay its dividends without having to use the interest received from Profitco.[35]

2. Property Disposition via Loss Corporation

Another form of basic loss consolidation deals with accrued gains on property to be sold. The sale of a property with accrued gains owned by one corporation (Gainco) is routed through an affiliated corporation with offsetting losses (Lossco). The essence of that structure involves a tax-deferred transfer of the property by Gainco to Lossco in exchange for shares of Lossco using a subsection 85(1) ITA election whereby Gainco's proceeds of disposition and Lossco's tax cost of the property are deemed to be Gainco's tax cost of the property (that is, no gain is realized and Lossco inherits the accrued gain). Lossco then sells to the third-party buyer at fair market value, thereby realizing the accrued gain. The gain is then absorbed by Lossco's losses. If desired (and assuming there are no corporate law or insolvency law issues), Lossco can distribute the sale proceeds to Gainco as a dividend (which Gainco will typically receive tax-free). This form of loss consolidation is depicted in Figure 4.

Again, while there are several variations of the basic structure, the CRA has expressed its approval of those transactions on numerous occasions, subject to the general concerns expressed earlier on loss utilization transactions (for example, the subsection 69(11) affiliated person restrictions).[36] In addition to any corporate or insolvency law issues that may be relevant to any particular situation, consideration must also be given to whether the additional disposition to Lossco creates any incremental sales or transfer tax issues.

III. Conclusion

It is by now apparent that many restrictions govern the recognition and use of losses in the Canadian tax system. Indeed, the tax regime in Canada governing losses can best be thought of as a number of distinct sets of rules overlaid on one another, producing a loss utilization system that is largely but not entirely consistent.[37] Indeed, there may be multiple layers of relevant loss utilization restrictions in any situation. Figure 5 attempts to

[35]The concern is whether Profitco can legitimately claim to have borrowed money for an income-earning purpose (as required for a paragraph 20(1)(c) ITA interest deduction) when the income to be earned is dividends that can only be funded with the very interest Profitco will pay on the borrowed money.

[36]If Gainco and Lossco were not affiliated, subsection 69(11) ITA would prevent the tax-deferred transfer of the gain property to Lossco in the first step, crystallize the gain in Gainco, and defeat the plan.

[37]For example, the use of the affiliated standard (based on either de facto or de jure control) in some provisions and the related standard in others. That reflects the development and enactment of the various different sets of rules at different times, rather than as a unified and comprehensive scheme.

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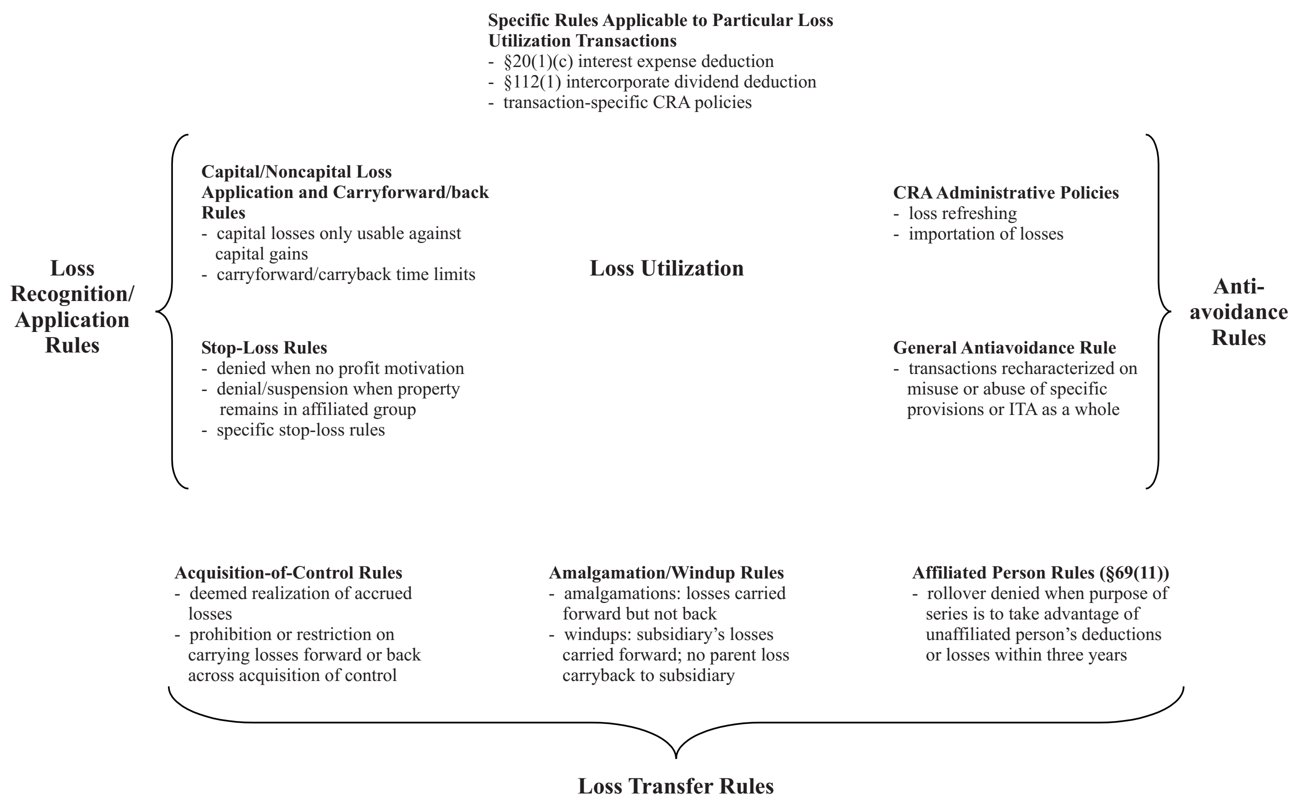
Figure 5. Overview of Loss Utilization Rules



visually depict the principal sets of rules that must be considered in Canadian loss utilization planning.

Making optimal use of losses in Canadian tax planning is not a simple matter because of the numerous rules in the ITA (and CRA administrative policies) that are potentially relevant and the absence of a formal loss consolidation regime. However, loss utilization planning is an accepted and important part of the Canadian tax system, in particular within an affiliated group (since Finance and the CRA have both expressed a willingness to accommodate planning that replicates the results that may be had under a formal group relief system elsewhere in other countries). With a good understanding of the rules, appropriate planning, and careful execution of the relevant transactions, excellent results can be achieved. ◆

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