

Using Tax Losses Within a Canadian Group of Companies

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PRACTITIONERS' CORNER

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Steve Suarez is with Borden Ladner Gervais LLP in Toronto.

Businesses need to make the best use possible of any tax attributes available to them to offset taxable income or gains they may have. Planning to allow one Canadian corporation to use tax losses of a related Canadian corporation (including Canadian subsidiaries within a multinational group) is especially important because the Income Tax Act (Canada) does not contain rules for group relief that simply consolidate one corporation's losses against income of a related corporation.

Types of Losses

Canadian tax law distinguishes between capital losses and noncapital losses. Noncapital losses arise from operating a business or an investment property (that is, the tax version of an operating loss). A noncapital loss represents the excess of allowable expenses over revenues for the year, as calculated under the ITA. Generally, the noncapital loss for a year can be applied against any income from other sources (including capital gains) realized by the taxpayer in the same year, the three preceding tax years, or the 20 following tax years.

A capital loss arises from a disposition of capital property, when the taxpayer's cost of the property plus any sale expenses exceed the sale proceeds. A capital loss realized in a year may be deducted against any capital gains realized in that year, the three preceding tax years, or any later tax year. Capital losses may only be deducted against capital gains.¹

¹An exception is a special form of capital loss (an "allowable business investment loss") arising from the disposition of shares

(Footnote continued in next column.)

Accrued losses on a capital property are generally realized only when there has been a disposition of the property (that is, a sale or other transfer). As a general rule, the ITA denies or suspends recognition of capital losses on transfers of property between related parties, or when the taxpayer (or a related party) acquires an identical property within 30 days before or after the time the loss property is disposed of. The principle is that losses should only be recognized for tax purposes when there is a disposition of the relevant property outside the corporate group. Specific loss denial rules also apply to property such as shares on which the taxpayer has received some tax-advantaged dividends or loans not made for the purpose of earning income.²

Intragroup Loss Planning

Broadly, the Canada Revenue Agency considers tax planning to use losses between related parties to be acceptable, while planning to allow one taxpayer to use the losses of an unrelated taxpayer is viewed as contrary to the scheme of the ITA and as impermissible. This reasoning is based on the existence of various rules in the ITA that allow losses to be used in some

or debt of a Canadian-controlled private corporation all or substantially all of whose property is used in an active business carried on in Canada.

²For more on loss categorization and realization, see Suarez, "Tax Planning With Losses in Canada," *Tax Notes Int'l*, Aug. 1, 2005, p. 451, *Doc 2005-11065*, or *2005 WTD 148-12*.

circumstances and not others, and on the restrictions on losses that apply to a corporation that undergoes an acquisition of control.³

This means that there are significant opportunities for two or more related Canadian corporations⁴ to maximize the use of losses within the group. In 2010 the federal government announced its intention to study the idea of introducing a loss transfer system or consolidated filing procedure for corporate groups (such as exists in the U.S. and many other countries), whereby entities within a related group can simply use one another's losses without having to take any steps to actually shift income or gains from one corporation to another.⁵ However, historically such proposals have gone nowhere (a previous initiative in the 1980s died) and it is uncertain at best if this attempt will be any different.

There are various ways in which Canadian corporations within a related group can optimize the use of the group's available tax attributes such as losses. While such planning is not per se offensive to the CRA, there are some aspects of particular strategies that the CRA does object to, and a number of technical tax issues must also be considered to ensure that the desired results are obtained without tripping up. It is useful to review the most common techniques for enabling a Canadian corporation with income or gains (Profitco) to access the accumulated losses of a related Canadian corporation (Lossco) and to understand the limitations and technical issues associated with these strategies.

Windups and Amalgamations

In some cases the desired results can be achieved by winding up Lossco into Profitco or amalgamating

³For example, the Department of Finance Technical Notes to section 245 ITA (the general antiavoidance rule) note the following:

Another example involves the transfer of income or deductions within a related group of corporations. . . . There are explicit exceptions intended to apply with respect to transactions that would allow losses, deductions or credits earned by one corporation to be claimed by related Canadian corporations. In fact, the scheme of the Act as a whole, and the expressed object and spirit of the corporate loss limitation rules, clearly permit such transactions between related corporations where these transactions are otherwise legally effective and comply with the letter and spirit of these exceptions.

⁴For example, one corporation controls the other, or both are controlled by the same person or group of persons.

⁵See the Department of Finance website at <http://www.fin.gc.ca/activity/consult/tcc-igs-eng.asp>. For prior coverage, see Suarez, "Canada's 2010 Budget Heavy With Major Tax Initiatives," *Tax Notes Int'l*, Mar. 22, 2010, p. 1021, *Doc 2010-4813*, or 2010 *WTD 45-1*.

Lossco and Profitco. The loss utilization rules applicable to qualifying windups and amalgamations are depicted in Figure 1.

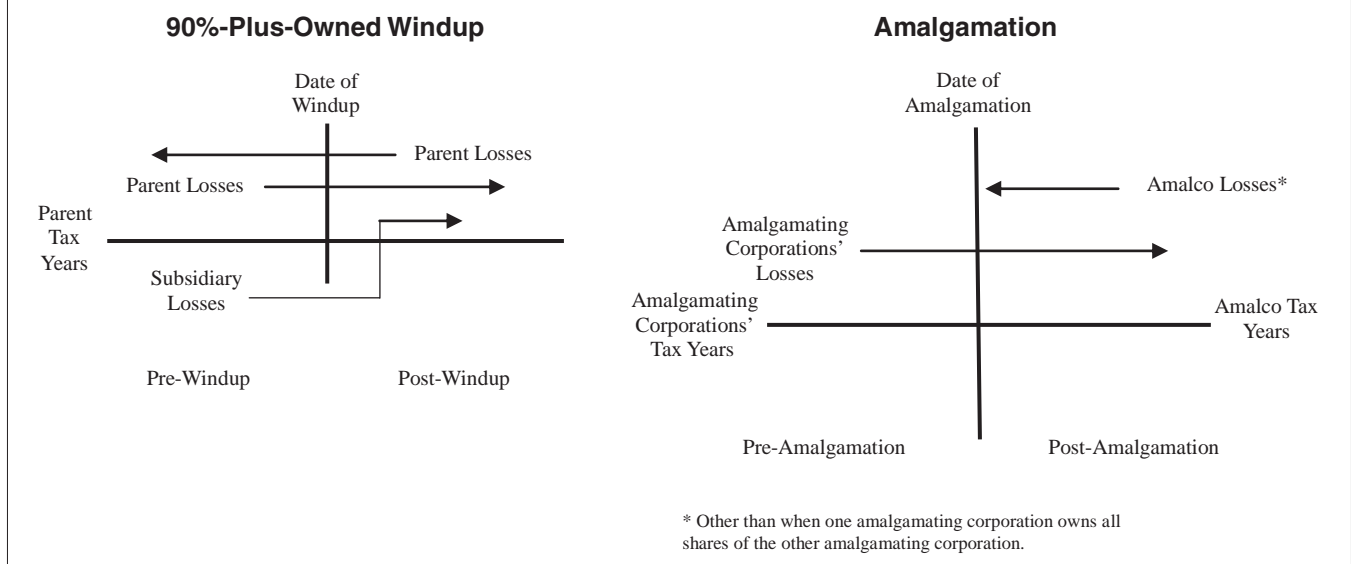
Normally when a Canadian corporation is wound up, its losses cease to exist. An exception is when one Canadian corporation owns all of the shares of the Canadian corporation that is winding up. In those circumstances, the subsidiary's capital and noncapital loss balances may be used by the parent corporation following the wind-up, but the parent corporation cannot use the subsidiary's loss balances in any pre-windup parent tax year. The parent can of course carry any of its *own* losses forward or back against its own taxable income, subject to the usual three-year carryback limit. A windup of Lossco into Profitco allows Profitco to carry forward Lossco's accumulated losses against Profitco's future income or gains.

Canadian corporations can also be amalgamated on a tax-deferred basis, and when they are related, no acquisition of control (and associated loss use restrictions) should arise. The new corporation resulting from the amalgamation (Amalco) can use the loss balances of its predecessors (Profitco and Lossco) in post-amalgamation periods, but losses incurred by Amalco cannot be carried back and used in pre-amalgamation periods of its predecessors. The only exception is when one amalgamating corporation owns all the shares of the other: In those circumstances Amalco can carry post-amalgamation losses back against pre-amalgamation income of the parent corporation (but not the subsidiary) subject to the usual three-year carryback limit, that is, the same result as a windup above. An amalgamation of Lossco and Profitco is another way of allowing Lossco's accumulated losses to shelter Amalco's post-amalgamation income from Profitco's assets.

Business Transfers Involving Lossco

In some cases merging entities or winding them up is undesirable. There are other ways of allowing Lossco's losses to be used against Profitco's income or gains. For example, Profitco can sell a business or income-producing asset to Lossco, such that the income generated by the business or asset is absorbed by Lossco's accumulated losses. Lossco may pay for the business or asset by issuing shares of itself to Profitco (if the transfer needs to be tax deferred so that Profitco realizes no gain or income) or with non-interest-bearing debt (such that Profitco is not being taxed on interest income).

When there are concerns about exposing Profitco's assets to Lossco's liabilities, Profitco and Lossco may form a partnership. Profitco transfers the business to the partnership on a tax-deferred basis in exchange for an interest in the partnership, and Lossco transfers other valuable consideration (existing assets, dividends received from a subsidiary, property received from its shareholder on a share subscription, and so forth) into the partnership in exchange for a partnership interest.

Figure 1. Permitted Use of Losses on Windups and Amalgamations

This structure allows a portion of the partnership's income to be allocated to Lossco commensurate with the value of Lossco's contribution to the partnership. While Lossco realizing only part of the business's income is less tax efficient than having Lossco realize all of that income, in appropriate circumstances this may still be a useful form of planning.

Routing Gains Through Lossco

If Profitco is proposing to sell assets outside the corporate group in a transaction that will produce capital gains or recaptured depreciation for tax purposes, it is usually possible to structure the sale so that the assets are transferred first to Lossco in exchange for Lossco shares on a tax-deferred basis. The gain assets are then sold by Lossco to the arm's-length third party. This results in the gains or income being realized within Lossco, where they can be sheltered by its losses. The sale proceeds are then typically distributed to Profitco as a dividend, or retained in Lossco and used to generate further taxable income that can be sheltered with losses. (See Figure 2.)

Lossco Asset Sale

To the extent that Lossco has valuable assets that are not generating significant taxable income (for example, shares of a subsidiary), these can be sold to Profitco in exchange for interest-bearing debt. So long as Profitco is acquiring the property for the purpose of gaining or producing income (which may not necessarily be immediate income) and the rate of interest is commercially reasonable, interest on the debt should be deductible to Profitco, and Lossco can absorb the interest income with its losses.

Intercompany Charges

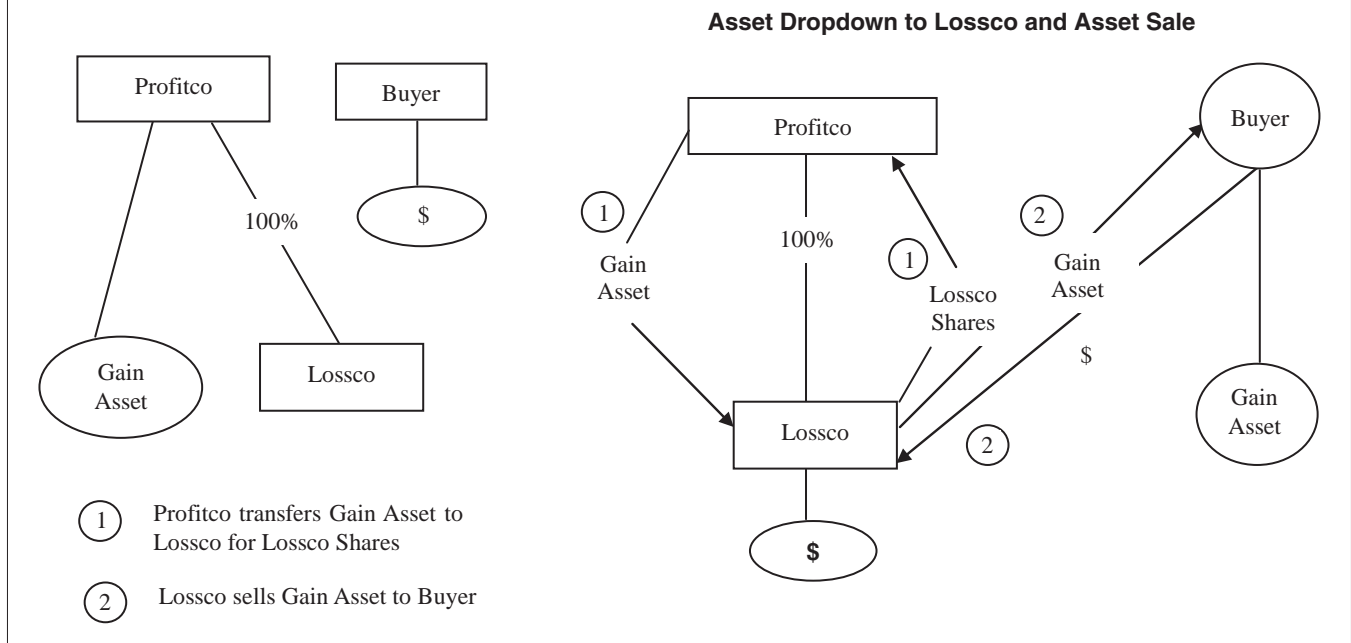
There may be opportunities in some cases for Lossco to provide services or property to other members within the corporate group. For example, Lossco may have (or can acquire) property that could be leased or licensed to other members of the corporate group for bona fide use in their businesses (for example, real estate or intellectual property), or the necessary personnel can be hired by Lossco to provide management, finance, or other services to group members. Commercially reasonable fees for services or property should be deductible expenses for the other group members, and Lossco's losses offset the fee income.

Lossco Debt Refinancing

When Lossco has external interest-bearing debt, Profitco can borrow money from a bank and subscribe for common shares of Lossco. Lossco in turn uses the subscription funds to repay its external debt. If there is a reasonable (but not necessarily immediate) prospect of Profitco earning dividends from its new Lossco shares, interest on Profitco's new debt should be deductible to it, and the refinancing effectively shifts Lossco's interest expense deductions to Profitco.

Interest/Dividend Loss Consolidation

A somewhat more complex form of loss consolidation planning involves generating interest expense deductions in Profitco through a circular intragroup subscription for shares of Lossco. This form of planning does not transfer property out of Profitco, but rather leaves the existing income there and creates deductions within Profitco. The key elements of such planning are

Figure 2. Routing Gains Through Lossco

that generally (1) dividends received by one Canadian corporation from another Canadian corporation are 100 percent deductible in computing taxable income (that is, are received tax free), and (2) interest on debt incurred to purchase shares of a corporation is tax deductible so long as there is a reasonable prospect of earning dividend income on those shares.

In its simplest form (when Profitco owns all the shares of Lossco), this type of loss consolidation is achieved as follows (see Figure 3):

- using funds borrowed from a bank under a “day-light loan” (that is, repaid the same day), Profitco subscribes for preferred shares of Lossco that pay dividends at a predetermined annual rate (for example, 5.05 percent);
- Lossco uses the funds received to make an interest-bearing loan back to Profitco at a rate of interest that is slightly less than the dividend rate on the Lossco preferred shares (for example, 5 percent), such that Profitco is earning a positive spread on its preferred share investment; and
- Profitco uses the loan proceeds to repay the day-light loan.

The result is that Profitco has incurred debt to acquire shares; the debt satisfies the interest deductibility test of having been incurred for the purpose of producing income, since it earns dividend income on its investment even net of interest expense. Preferred share dividends are received by Profitco tax free because of the intercorporate dividend deduction in subsection

112(1) of the ITA. Lossco earns interest income, which is absorbed by its losses. Effectively, a portion of Lossco’s losses have been shifted to Profitco.

There are other variations of this structure: For example, when Lossco is the parent corporation, it is usually necessary to employ a three-corporation structure in order to meet corporate law requirements. (See figures 4 and 5.) There are also variations that result in losses being accumulated in a new corporation over a number of years, which are then amalgamated into Profitco for use in future years. However, the basic technology remains the same: the making of interest-bearing loans to subscribe for dividend-paying shares within a circular intragroup structure.

Numerous technical issues and CRA administrative concerns must be observed in creating and operating these kinds of tax-driven structures. These include:

- *Interest rate:* The rate of interest on the Lossco loan to Profitco must be commercially reasonable in the circumstances.
- *Borrowing capacity:* To prevent situations in which huge amounts of intragroup debt and preferred shares are created in order to speed up the generation of deductions in Profitco, the CRA limits the amount of interest-deductible debt that may be created in these structures to an amount reflecting the external borrowing capacity of the corporate group.
- *Foreign loss importation:* The CRA objects to any structure that amounts to importing foreign losses into Canada.

Figure 3. Basic Loss Consolidation

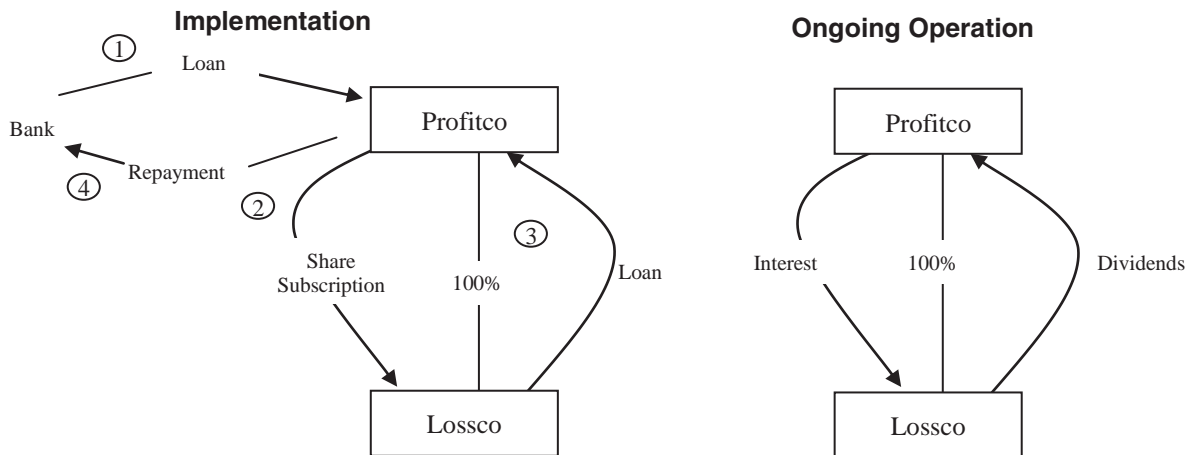
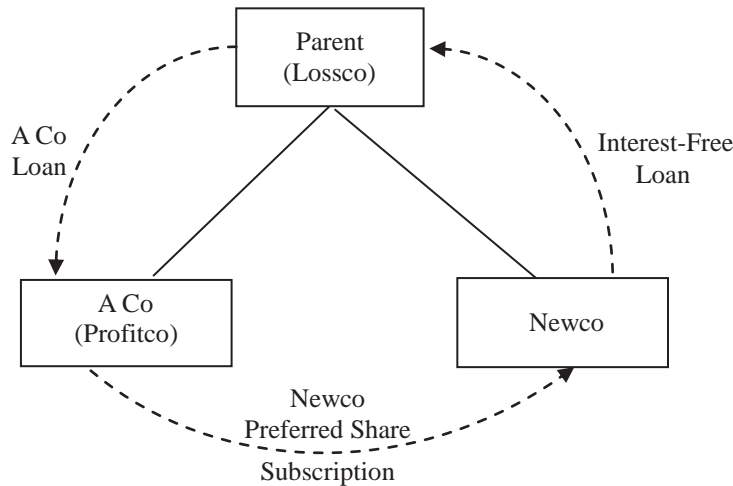


Figure 4. Three-Party Loss Consolidation: Implementation

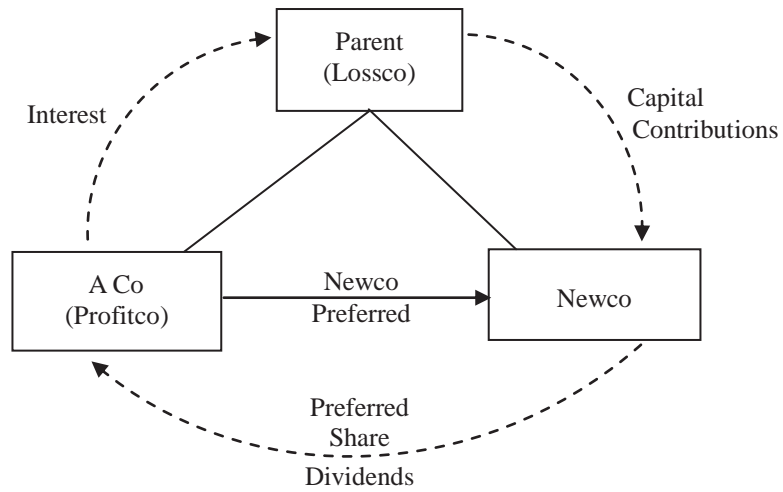


- Interprovincial effects:** In situations when these structures result in a significant shift of taxes from one province to another because of differences in the interprovincial income allocation of Profitco and Lossco, the CRA and provincial revenue authorities have raised concerns in the past. Indeed, provincial objections have historically been a major impediment to the creation of a formal loss transfer system.

While in concept these loss consolidation structures appear simple, there is often considerable work involved in using them properly. These transactions must

be planned, implemented, documented, and eventually unwound in a way that meets all relevant legal requirements, is consistent with the relevant CRA administrative practices, and does not create unintended tax consequences. Often the facts of a particular case raise unique or unusual concerns or issues, and understanding the CRA's views on such matters and planning accordingly is essential. The CRA's policies on various aspects of these loss consolidations have changed over time, and there are a number of subtle issues that are easy to overlook. In appropriate cases, an advance tax ruling from the CRA may be advisable.

Figure 5. Three-Party Loss Consolidation: Ongoing Operation



Conclusion

Canadian corporations are well advised to make the best possible use of their tax attributes. For Canadian corporate groups (including groups of Canadian sub-

sidiaries of foreign multinationals), intragroup loss planning is an essential element of legitimate tax minimization. ◆