TAXADVISOR

Challenging the GAAR

Following the rules foils the CRA

COURT REPORT

BY JAMIE GOLOMBEK

The taxpayer is on a roll – at least as far as winning GAAR cases goes. It's only been a few months since the Supreme Court of Canada released its monumental twin decisions (*Canada Trustco Mortgage Co. v. Canada* (2005 SCC 54) and *Mathew v. Canada* (2005 SCC 55)) on the application of the General Anti-Avoidance Rule or the GAAR, yet there have now been five reported decisions involving this rule, with the score: Taxpayer 4, Canada Revenue Agency 1.

One of the most interesting GAAR decisions in which the taxpayer was victorious paves the way for a unique planning opportunity when it comes to paying back shareholder loan accounts within private corporations. The case, *Overs v. The Queen*, 2006 TCC 26, was decided in January.

On Sept. 28, 1999, Michael Overs owned all the shares of Tesari Holdings Ltd., which was fast approaching its fiscal year-end of September 30. This posed a particular problem for Overs since the prior year, 1998, he "borrowed" $2.3 million from Tesari by way of a shareholder loan.

Under the *Income Tax Act*, shareholders are generally taxable on amounts received from a corporation, such as salary or dividends. As a result, there are specific rules in the *Tax Act* to prevent shareholders from "borrowing" money from their corporations for an indefinite term in the guise of a loan, with no real intention of ever paying the loan back.

The specific rule states that any shareholder loan (with only a few specific exceptions) that is not repaid by the end of the corporation's second tax year following the year in which the loan was made must be included in the shareholder's income.

As a result, Overs had to come up with $2.3 million by Sept. 30, 1999 to avoid having this amount included in his income. While he could borrow this money from the bank, if he did so, his interest expense would not be tax-deductible since he didn't borrow to purchase shares, but to repay a shareholder loan.

Instead, he came up with a plan where he had his wife, Lilian, borrow the $2.3 million from the Bank of Montreal on Sept. 29, 1999. Overs then proceeded to sell his wife $2.3 million of his Tesari shares. With the proceeds received from his wife, he repaid the shareholder loan and thus avoided having to include the amount in his income. Tesari then used the $2.3 million to invest in BMO term deposits, which were pledged as security for Lilian's loan with the bank.

The trick behind the above plan, however, was that under the *Tax Act*, shares transferred between spouses are automatically transferred at adjusted cost base. As a result, not only did Overs not have to pay tax on his disposition but in addition, there would be future attribution of all income, gains or losses on Lilian's shares back to Overs – which is actually what he wanted.

In 1999 and 2000 combined, Lilian Overs paid more than $225,000 in interest expense and guarantee fees. This amount was then claimed on her husband's return as a loss from investing in shares – a loss attributed back to him from his wife. In other words, he was using the attribution rules to his benefit!

Needless to say, the CRA attacked this scheme and sought to apply the GAAR to this series of transactions and thereby deny Overs his tax deduction.

The Tax Court judge restated the Supreme Court's three-step approach as to when the GAAR applies: "The first step is to determine whether there is a 'tax benefit' arising from a 'transaction'…. The second step is to determine whether the transaction is an avoidance transaction . . . in the sense of not being 'arranged primarily for bona fide purposes other than to obtain the tax benefit.' The third step is to determine whether the avoidance transaction is abusive . . . . All three requirements must be fulfilled before the GAAR can be applied to deny a tax benefit."

> **5** THE NUMBER OF **GAAR** decisions SINCE October 2005
>
> **1** THE NUMBER OF **CASES** WON BY THE CRA

The Tax Court judge found that, in fact, there were three tax benefits, namely: avoiding including the shareholder loan income, avoiding paying immediate capital gains tax on Overs' sale of the shares to his wife and using the attribution rules to permit Overs to deduct the interest expense on the loan.

The second step was to determine whether any of the above tax benefits resulted in "avoidance transactions." On the shareholder loan issue, the judge felt that Overs "followed the rules outlined in (the Act)" and therefore determined this was not an avoidance transaction.

On the transfer of his shares to his wife at ACB and the avoidance of immediate capital gains tax, again the judge concluded that Overs "followed the rules outlined in (the Act) . . . to facilitate the transfer of property to his wife."

Finally, on the application of the attribution rules to allow Overs to deduct the interest expense, the judge concluded that the "plain meaning as outlined in [the Act] would apply and the loss on the transactions would be attributed back to [him]."

As a result, since none of the three benefits resulted in an avoidance transaction, the judge concluded that the GAAR did not apply. This opens up a new planning opportunity for owner-managers and puts another nail in the coffin of the GAAR.

The Crown has decided not to appeal. AER

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Not Quite Creditor-Proof

Proposed bankruptcy amendments still expose RRSPs

BY KATE McCAFFERY

In the final days of the Liberal government, Members of Parliament and the Senate pushed through an interesting bit of legislation that could have a significant effect on retirement planning strategies for business owners.

The *Wage Earner Protection Program Act* was given royal assent on Nov. 25, 2005, without public consultation or amendments, just two days before a non-confidence motion collapsed the minority Liberal government.

The bill was passed so quickly that the Senate standing committee returned the bill, without amendments, on the condition that it would not go into effect until June 30, 2006 in order to allow time to study the bill and hold public consultations on related regulation proposals.

"It went through the house very quickly because it was a very popular bill," says Ralf Hensel, Investment Funds Institute of Canada's senior counsel. "The theory behind it is good."

Among other things, the act amends the *Bankruptcy and Insolvency Act* and the *Companies' Creditors Arrangement Act*, the Canadian equivalent of Chapter 11 in the United States, to protect unpaid employee wages in the event a company declares bankruptcy.

Most notable for financial planners, however, is the fact that the bill also makes RRSPs and RRIFs exempt from the list of assets that can be seized by creditors in bankruptcy.

The act blocks any premeditated sheltering on the part of anyone about to declare bankruptcy. The clawback provision says any assets transferred into the RRSP in the year preceding the bankruptcy declaration are not protected from creditors.

Along with this clawback, the act included two anti-avoidance proposals, including a cap on how much could be sheltered in an RRSP in the event a client declares bankruptcy and possible "locking-in" mechanisms that could be added into regulations at a later date, once the Senate has the chance to review them. The details of both proposals – whether the cap is a "hard cap," a figure set out in regulations, or one based on a mathematical formula, and the rules outlining how clients could unwind locked-in assets – have not been determined.

This review is expected to begin this spring. In February, IFIC submitted a letter to the Standing Senate Committee on Banking, Trade and Commerce to outline its position, endorse the act and make recommendations regarding the proposed regulations.

IFIC says the act "begins the process of putting all registered retirement savings plans and registered retirement income funds on the same level-playing field as both employer-sponsored registered pension plans and insurance based products like segregated funds and insurance-based deposit RRSPs and RRIFs. That being said, we are concerned that the act, in its present form, does not go far enough."

In its list of recommendations, the fund industry group says all RRSPs and RRIFs should be exempt from seizure generally and the exemption should not be restricted to situations when the debtor is bankrupt.

Hensel admits that of the recommendations, this first provision likely won't be addressed in the consultation process. "The only one in our letter that isn't going to be dealt with too quickly, I think, is the first [recommendation], which is where we think protection should be extended to cover non-bankruptcy insolvency situations," he says. "But that's a provincial matter. To what extent does the Senate have authority to influence the provinces? We put it in there because we want to make sure that it's understood that pensions and insurance products still have greater protections."

The remaining two recommendations address the proposed locking-in requirements – a move that IFIC says is unnecessary and creates a huge administrative burden that will result in added costs.

Still, as Hensel points out, this is simply a proposal. "It may get added into the regulation, it may not," he says, although he thinks it's likely the federal government will opt to leave things the way they are – and that would be fine by him. Between the fraudulent conveyance, preference and reviewable transaction rules, he believes there is enough general bankruptcy creditor protection.

"We think that any potential abuse by debtors is already adequately covered by that," he says, noting there aren't any mutual funds or banking products out there now that could be locked in this way. "You would need to create a whole new set of products," Hensel says. "It's just too much of a hassle." AER