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Financing Foreign Affiliates: The Term Preferred Share Rules and Tower Structures

by Elizabeth J. Johnson and James R. Wilson

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This article discusses an issue that frequently arises in the context of the cross-border financing structure commonly known as a "tower." The effectiveness of a tower structure depends on the favourable tax treatment of dividends received by an entity in the structure. Where the corporate group includes a "specified financial institution" the term preferred share rules in the *Income Tax Act* must be considered and, in particular, the availability of the exception for dividends on shares not acquired in the ordinary course of the business of the dividend recipient.

The authors examine the history and context of the term preferred shares and the related jurisprudence, and the reasons why the exception should normally be considered available.

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FINANCING FOREIGN AFFILIATES: THE TERM PREFERRED SHARE RULES AND TOWER STRUCTURES***

*Elizabeth J. Johnson and James R. Wilson*****

Cross-border financing techniques have changed over the years as the tax laws have changed to curtail particular forms. However, one form of cross-border financing that has had a relatively long life and continues to endure is the so-called tower structure. The effectiveness of a tower structure depends on the favourable tax treatment of dividends received by an entity in the tower structure. Tax advisers might be expected to provide an opinion that such dividends are deductible pursuant to subsection 112(1) or 113(1) of the Income Tax Act. Unfortunately, if the entity in receipt of a dividend is a "specified financial institution," in certain cases the rules in subsections 112(2.1) and 258(3) may make dividends received on "term preferred shares" non-deductible. The authors argue that shares acquired in a typical tower structure should meet the exception that is provided for dividends on shares that are not acquired in the ordinary course of a taxpayer's business, and that this conclusion is consistent with the language, context, and purpose of the term preferred share rules. The authors examine the history and context of the term preferred share rules, the relevant tax jurisprudence, and the Canada Revenue Agency's historical and recent administrative positions on the scope of the "not acquired in the ordinary course of business" exception.

KEYWORDS: CROSS-BORDER ■ TERM PREFERRED SHARES ■ TOWER STRUCTURES ■ ORDINARY COURSE OF BUSINESS

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INTRODUCTION

Not surprisingly, cross-border financing techniques have changed over the years as tax laws have changed to curtail particular techniques.[1] However, one form of financing that has had a relatively long life and continues to endure is the so-called tower structure. The tax objectives of these forms of cross-border financing, including the tower structure, are plain enough: to achieve a tax deduction for the same expense payment, usually interest, in two (or more) jurisdictions—a so-called double dip.

In a typical tower structure that might be used by a Canadian multinational ("Canco") to finance the business activities of its US subsidiary ("USco"), Canco and its wholly owned Canadian subsidiary ("Cansub") form a partnership ("Partnership") under the state law of Delaware, Arizona, or another US state. Canco is the sole limited partner and is entitled to a 99.9 percent share of Partnership's income and loss. Cansub is the sole general partner and is entitled to the remaining 0.1 percent of such income or loss. Partnership is intended to be treated as a partnership for Canadian tax purposes and, under the US check-the-box tax provisions, elects to be treated as a corporation for US tax purposes. Partnership borrows money from an unrelated lender and uses the borrowed money to acquire all the common shares in

1 For an excellent summary of the structures that have been used to provide cross-border financing on a tax-effective basis—usually a basis that ensures at least a double tax deduction for the same payment (normally interest)—see Robert Couzin, "Some Challenges in Transactional Tax Advice," in *Report of Proceedings of the Fifty-Seventh Tax Conference*, 2005 Conference Report (Toronto: Canadian Tax Foundation, 2006), 3:1-25; and Carl Steiss, "International Tax Developments," in *Report of Proceedings of Fifty-Fourth Tax Conference*, 2002 Conference Report (Toronto: Canadian Tax Foundation, 2003), 2:1-14. For a discussion of some of the US pitfalls of double-dip structures that involve the United States, see Peter A. Glicklich and Michael J. Miller, "Appeals Court Invalidates US-Netherlands 'Double-Dip' Financing Structure," Selected US Tax Developments feature (2001) vol. 49, no. 4 *Canadian Tax Journal* 1076-86; and Peter A. Glicklich, Sanford H. Goldberg, and Anthony C. Infanti, "Laidlaw Taxpayer Crashed and Burned, Losing Billion-Dollar Debt-Equity Case," Selected US Tax Developments feature (1998) vol. 46, no. 6 *Canadian Tax Journal* 1380-86.

the capital stock of an Alberta or Nova Scotia unlimited liability corporation (ULC). For Canadian tax purposes, ULC is treated as a corporation; for US tax purposes, it is a disregarded entity that is effectively treated as a branch of Partnership.[2] ULC invests the subscription proceeds to acquire all the common securities in the capital of a US limited liability corporation (LLC) that is incorporated under the state law of Delaware. LLC is intended to be treated as a US corporation (and foreign affiliate) for Canadian tax purposes and as a disregarded entity for US tax purposes. LLC lends the money to USco, and it is used by USco in its active business in the United States.

This structure, illustrated in figure 1, relies in substantial part on the hybrid (or "reverse hybrid") Canadian and US tax treatment of Partnership, ULC, and LLC, and is intended to achieve a tax deduction for Canadian and US purposes for interest on the external debt of Partnership. Subject to several important reservations, the Canada Revenue Agency (CRA) seems to accept that a tower structure works—that is, that the requirements for an interest deduction under paragraph 20(1)(c) are met, and that subsection 245(2), the general anti-avoidance rule (GAAR), should generally not apply to deny the interest deduction.[3] The CRA's reservations are not with respect to the interest deduction per se, but instead relate to other tax aspects of tower structures, including, in certain circumstances, the potential application of paragraph 95(6)(b). As well, the CRA has noted that because "outbound financing tower structures are complicated and raise many issues, it is strongly recommended that Canadian corporations consider an advance income tax ruling before implementing such an arrangement."[4] In our experience, however, taxpayers seldom obtain rulings as part of the implementation of a tower structure: instead, they rely on opinions from their tax advisers respecting the structure's Canadian and US tax treatment.

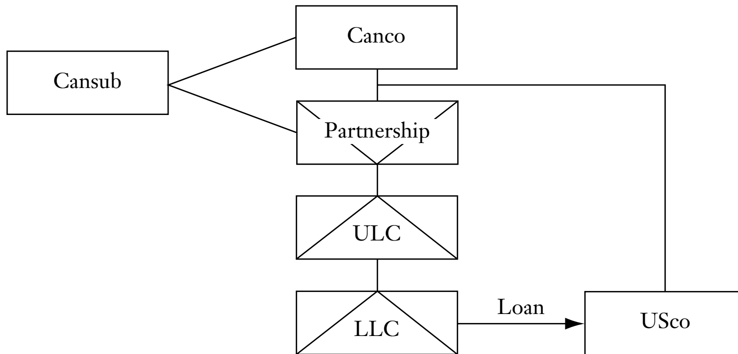
In relation to the typical tower structure, tax advisers might be expected to provide an opinion that in respect of any dividend received on the common shares of ULC held by Partnership, each of Canco and Cansub, in computing its taxable income, should be entitled to deduct an amount equal to its share of the dividends

2 Before the enactment of section 93.1 of the Income Tax Act, RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act") in 2001, the interposition of a ULC ensured the application of subsection 113(1) to dividends received on the common securities of an LLC. Notwithstanding, a ULC continues to be interposed in most tower structures to avoid the issue of the partnership earning foreign accrual property income. See Eric Lockwood, Michael J. Maikawa, and Nick Pantaleo, "Proposed Technical Amendments to the FAPI and Foreign Affiliate Rules," International Tax Planning feature (2000) vol. 48, no. 2 *Canadian Tax Journal* 456-76; and Paul L. Barnicke, "Faulty Tower Structure" (2005) vol. 13, no. 4 *Canadian Tax Highlights* 1. Unless otherwise noted, statutory references in this article are to the Act, and each technical tax term used herein has the meaning ascribed to that term in the Act.

3 In "Paragraph 95(6)(b)," a draft *Income Tax Technical News*, March 14, 2005 (unpublished) outlining the CRA's proposed administrative positions on the proper interpretation of subsection 95(6), a specific anti-avoidance rule, the CRA seems to conclude that the provision has no application to a "classic double dip," including one involving a tower structure, provided that it does not involve the importation of an existing debt to Canada.

4 CRA document no. 2002-0136855, May 13, 2002.

FIGURE 1 A Typical Tower Structure



and, further, that ULC, in computing its taxable income, should be entitled to deduct an amount equal to the amount of any such dividend received on the common securities of LLC under paragraph 113(1)(a).[5] These opinions can be given only if the dividends on the common shares of ULC are not subject to subsection 112(2.1), which denies the intercorporate dividend deduction under subsection 112(1), and if the dividends on the common securities of LLC are not subject to subsection 258(3), which treats certain dividends as interest for the purposes of subsection 113(1).[6]

Unfortunately, the provision of any opinion respecting the availability of such treatment is complicated by the potential application of the term preferred share rules; relatively recent statements from the CRA seem to extend the rules far beyond the

5 Subsection 112(1) provides that in computing its taxable income, a corporation that has received a taxable dividend from a taxable Canadian corporation (such as ULC in the structure illustrated in figure 1) may deduct an amount equal to the amount of the taxable dividend. The operation of this provision is not as clear as it should be in the context of a partnership (such as Partnership) that has corporate partners and that receives a taxable dividend. Notwithstanding, the most reasonable reading of the Act—and, happily, a reading that is consistent with the well-established administrative practice of the CRA—is that where a partnership receives a taxable dividend, the full amount of the taxable dividend is considered to be received by its partners (in accordance with their respective shares) for the purposes of the Act, including the application of subsection 112(1). The CRA's administrative position was confirmed in *Interpretation Bulletin* IT-138R, "Computation and Flow-Through of Partnership Income," January 29, 1979 (which has been cancelled), but the position was reaffirmed by the CRA in document no. 2001-0111675, September 6, 2002; in CRA guide T4068E, "Guide for the Partnership Information Return"; and in a recent technical interpretation (CRA document no. 2003-0027745, September 18, 2003). In *CSI Development Corp. v. The Queen*, 99 DTC 1139, the Tax Court of Canada held that a similar CRA administrative position that permitted the non-taxable portion of capital gains of a partnership to be included in the capital dividend account of its corporate partners was a "common sense conclusion."

6 This paper does not deal with the potential application of the other preferred share rules, notably subsections 112(2.2) and 258(5). When the term preferred share rules were introduced in 1978,

stated mischief at which they were aimed. The rules should generally be of concern in the first instance only if there is a specified financial institution (SFI) within the corporate group. The definition of "specified financial institution" in subsection 248(1) includes, in paragraphs (a) through (e.1), certain special types of corporations that are normally thought of as financial institutions—for example, banks, trust companies, insurance corporations, and corporations whose principal business is lending money to arm's-length persons. Paragraphs (f) and (g) generally extend the definition to corporations controlled by or related to one or more such corporations. Many tower structures are implemented by financial institutions, such as banks and insurance companies that have substantial US operations. However, even a corporate group that does not include a conventional financial institution may find that its members fall within the SFI definition because the definition includes any insurance corporation, whether or not it is primarily involved in insuring arm's-length risks. Thus, any corporation that is part of a corporate group that includes a "captive" insurance company will be characterized as an SFI.[7]

The main source of uncertainty is paragraph (b) of the "term preferred share" definition in subsection 248(1). This paragraph extends the scope of the definition (which otherwise is principally concerned with shares that have debt-like features) to include common shares held by an SFI in a corporation that the SFI (or a partnership that includes the SFI) controls, such as the common shares of ULC held by Partnership and the common securities of LLC held by ULC. The result is that the application of subsections 112(1) and 258(3) to such shares and securities hinges primarily on whether they fall within an important exception for shares acquired by

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they had to be extended to deal with circumstances where shares with debt-like attributes were acquired by a non-SFI that was not subject to subsection 112(2.1), but an SFI provided certain financial guarantees to the non-SFI in relation to the shares. In such an arrangement, the SFI effectively bore the financial risks of ownership of the term preferred shares, but a non-SFI was the actual owner that received the dividends on the shares. Subsection 112(2.2) (the "guaranteed share" rule) was intended to preclude these arrangements, which circumvented the term preferred share rules, but an exception from the application of the provision was provided for certain shares that are not acquired by the holder in the ordinary course of its business, where the issuer, the holder, and the provider of the financial guarantee are related. Subsection 258(5) is a companion rule to subsection 112(2.2) for dividends received by a Canadian corporation on guaranteed shares of a foreign affiliate. In such a case, the dividends are recharacterized as interest and, as a consequence, the Canadian corporation is denied the benefit of any deductions under subsection 113(1). Subsection 258(5) provides that the deeming rule in subsection 258(5) does not apply if the holder of the share has a "substantial interest" in the issuing corporation within the meaning of section 191. For this purpose, a shareholder is considered to have a substantial interest in any related corporation.

7 It is not clear why, as a tax policy matter, the existence of a captive insurance company within a corporate group should result in each member of that group being an SFI, when members of a group having a captive group financing company are not tainted with SFI status. Financing activities make a corporation an SFI only if they are primarily conducted with arm's-length parties. See paragraph (e) of the SFI definition in subsection 248(1).

a taxpayer that were "not acquired in the ordinary course of its business."[8] The modest purpose of this article is to make the case that shares acquired in a typical tower structure should meet the exception on the grounds that they should not be considered to be acquired in the ordinary course of business, and that this conclusion is consistent with the language, context, and purpose of the term preferred share rules.

SUBSECTION 112(2.1) PROHIBITION AND SUBSECTION 258(3) RECHARACTERIZATION

In circumstances where each of Canco, Cansub, and ULC is an SFI for the purposes of the Act, an important tax issue is whether the favourable Canadian tax treatment that is accorded dividends under Canadian tax law is available.[9] Specifically, is the intercorporate dividend deduction under subsection 112(1) available for dividends paid on the shares of ULC, or is it denied by virtue of subsection 112(2.1), and are the deductions under subsection 113(1) available for dividends paid on the shares of LLC, or are such dividends treated as interest by virtue of subsection 258(3)?

If subsection 112(2.1) applies to either of Canco or Cansub in respect of its share of any dividends received by Partnership on the common shares of ULC, Canco's or Cansub's share of the dividend will be included in computing its income under the Act pursuant to subsection 82(1), but Canco or Cansub will be denied a corresponding deduction for that amount under subsection 112(1). In general, subsection 112(2.1) will apply to Canco or Cansub in respect of its share of the dividend if all of the following conditions are met: (1) Canco or Cansub is an SFI for the purposes of the Act (which, for the purposes of this paper, we assume to be the case); (2) the common shares of ULC are "term preferred shares," as defined in the Act, at the time the dividend on the shares is paid by ULC; and (3) the shares are acquired in the ordinary course of the business carried on by Canco or Cansub.

Subsection 258(3) provides that any dividend on a term preferred share received in a taxation year by an SFI from a corporation not resident in Canada is deemed to be interest received and not a dividend on the share. Subsection 258(4) provides

8 For a discussion of the background to the addition of paragraph (b) of the "term preferred share" definition, see Robert Couzin, "Term Preferred and Other Shares," *Canada Tax Letter*, no. 311 (Toronto: De Boo, February 11, 1980), 1-6, at 4, where the minister of finance said that the paragraph was intended to address "the problem of financial institutions securing their investments not directly by guarantee but indirectly by controlling the corporation issuing preferred shares." As Couzin perceptively noted, however, "[i]t may well do that. The difficult question is what else it does." Unfortunately, we are still wrestling with that question more than 25 years later.

9 The many tax issues that must be dealt with in relation to a typical tower structure have been canvassed by others. See, for example, Shawn D. Porter, "Tax Aspects of Foreign Exchange," paper presented to the International Fiscal Association (Canadian branch), May 9, 2005; Shawn D. Porter, "Canadian Tax Consequences of Unwinding a Tower Structure" (2003) vol. 11, no. 4 *International Tax Planning*; and Albert Anelli and Marcel Guilbault, "Financing and Interest," in *Journée d'études fiscales 2003* (Toronto: Canadian Tax Foundation, 2003), tab 2E.

that the deeming rule in subsection 258(3) does not apply if the share on which the dividend is paid is not acquired in the ordinary course of the shareholder's business. If subsection 258(3) applies in the case of dividends received by ULC on the common securities of LLC, the deemed interest will be included in ULC's income in the taxation year received, and ULC will thereby be denied the expected paragraph 113(1)(a) deduction in respect of such dividends. Subsection 258(3) will apply to ULC in respect of the dividends it receives on the common securities of LLC if three key requirements are met: (1) ULC must be an SFI (as noted above, for the purposes of this article, SFI status is assumed); (2) the securities are "term preferred shares" (as defined in the Act); and (3) the securities were acquired by ULC in the "ordinary course of its business."

In *The Queen v. Canada Trustco Mortgage Co.*,[10] the Supreme Court of Canada, in addition to dealing with GAAR, endorsed guidelines for determining the proper interpretation of a taxing provision. The court confirmed that as a general rule, "[t]he interpretation of a statutory provision must be made according to a textual, contextual and purposive analysis to find a meaning that is harmonious with the Act as a whole."[11] However, the court acknowledged that "the particularity and detail of many tax provisions have often led to an emphasis on textual interpretation" because, "[w]here Parliament has specified precisely what conditions must be satisfied to achieve a particular result, it is reasonable to assume that Parliament intended that taxpayers would rely on such provisions to achieve the result they prescribe."[12] In its recent decision in *Placer Dome Canada Ltd. v. Ontario (Minister of Finance)*, the court confirmed this interpretive approach, noting that it was an approach

> informed by the level of precision and clarity with which a taxing provision is drafted. Where such a provision admits of no ambiguity in its meaning or in its application to the facts, it must simply be applied. Reference to the purpose of the provision "cannot be used to create an unexpressed exception to clear language."[13]

In *Placer Dome*, however, the court stated that

> [w]here, as in this case, the provision admits of more than one reasonable interpretation, greater emphasis must be placed on the context, scheme and purpose of the Act. Thus, legislative purpose may not be used to supplant clear statutory language, but to arrive at the most plausible interpretation of an ambiguous statutory provision.[14]

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10 2005 DTC 5523 (SCC).

11 Ibid., at paragraph 10.

12 Ibid., at paragraph 11. The court referred with approval (ibid., at paragraph 12) to the following passage from Peter W. Hogg and Joanne E. Magee, *Principles of Canadian Income Tax Law*, 2d ed. (Toronto: Carswell, 1997), 475-76: "It would introduce intolerable uncertainty into the Income Tax Act if clear language in a detailed provision of the Act were to be qualified by unexpressed exceptions derived from a court's view of the object and spirit of the provision."

13 2006 SCC 20, at paragraph 23.

14 Ibid.

In the balance of this article, we argue that the favourable treatment accorded dividends under subsections 112(1) and 113(1) should be available with respect to dividends received as part of a typical tower structure and, in particular, that subsections 112(2.1) and 258(3) should not apply to such dividends. We believe that this position is consistent with the language, context, and purpose of the relevant provisions, and in particular with the ordinary meaning of the language used in the "not in the ordinary course of business" exception. However, even if this is not the case and the words are ambiguous and capable of more than one ordinary meaning, our position is also consistent with a contextual and purposive analysis of the exception. This is not a case where the purpose of the relevant tax provisions is elusive.

DEFINITION OF "TERM PREFERRED SHARE"

The definition of "term preferred share" in subsection 248(1) is divided into two parts. The first branch deals with shares that have debt-like features. Thus, paragraph (a) of the definition includes, among other things, any share if, under its terms or conditions or those of an agreement related to the share, (1) the holder of the share may cause it to be redeemed, acquired, or cancelled or its paid-up capital to be reduced; (2) the issuer of the share or any other person or partnership is or may be required to redeem, acquire, or cancel the share or to reduce its paid-up capital or provides or may be required to provide any form of guarantee, security, or similar indemnity or covenant with respect to the share; or (3) the share is convertible or exchangeable, other than (in general terms) into or for another share that, if issued, would not be a term preferred share. In the typical tower structure, the common shares of ULC (and the common securities of LLC) normally do not contain such features, nor are there usually any agreements that would cause such shares to be "term preferred shares" under the first branch of the SFI definition.

The second branch of the definition is more problematic. Paragraph (b) of the definition generally deems any share to be a term preferred share if the owner is a corporation that is an SFI, or a partnership or trust of which an SFI is a member or beneficiary, where that owner (either alone or together with any other such corporation, partnership, or trust) controls the issuer or has a future right, either absolute or contingent, to control the issuer.

The Act contemplates two types of "control"—de jure (legal) control and de facto (factual) control. In the context of the SFI definition, it is clear that "control" means de jure control and not de facto control.[15] The courts have interpreted de jure control to mean ownership of shares that have sufficient voting power to elect a majority of

15 Certain provisions of the Act use only the term "control" (including the usual variations, such as "controlled by," or "directly or indirectly controlled by"). Where the term "control" is so used, it is clear, from jurisprudence at the highest levels, that the term means de jure control and not de facto control. On the other hand, where the phrase "controlled, directly or indirectly in any manner whatever," is used, this expression, is, by statute, given a broader meaning, which is intended to be the equivalent of de facto control.

the board of directors.[16] Further, the courts have narrowed the circumstances in which de jure control is affected by collateral agreements, such as shareholders' agreements that are not part of the constating documents of the issuer. In the typical tower structure, the effective control of the affairs of each of ULC and LLC normally resides with its board of directors, and thus indirectly with its shareholders, and there is no related agreement that contains provisions to the contrary.

Accordingly, the common shares of ULC (and the common securities of LLC) will typically be "term preferred shares" under the second branch of the SFI definition because Partnership, either alone or together with one or more SFIs, will have de jure control of ULC, and ULC, either alone or together with one or more SFIs, will have de jure control of LLC.

HISTORY AND CONTEXT OF THE RULES

The mischief at which the term preferred share rules are aimed is clear.[17] The normal rule that applies in the absence of subsection 112(2.1) is that dividends received by a Canadian corporation, including an SFI, on shares of another Canadian corporation are not subject to tax in the hands of the recipient by reason of the intercorporate dividend deduction in subsection 112(1). This result is achieved through the inclusion of the dividend in the corporate recipient's income under subsection 82(1) and the availability of a deduction in computing taxable income under subsection 112(1).

16 In *Duha Printers (Western) Ltd. v. The Queen*, 98 DTC 6334 (SCC), the Supreme Court of Canada confirmed the basic Canadian tax principle that where the term "control" is used in the Act, it means de jure control—that is, the right of control that rests in ownership of such a number of shares as carries with it the right to a majority of the votes in the election of the board of directors. This general rule is based on the principle that under the governing corporate and commercial law, the effective control of the affairs of the corporation rests with its board of directors and thus indirectly with the majority shareholder who has sufficient votes to elect the board of directors.

17 The purpose and nature of the preferred share rules have been well reviewed. See, for example, Robert Couzin and Robert J. Dart, "The New Preferred Share Rules," in *Report of Proceedings of the Thirty-Ninth Tax Conference*, 1987 Conference Report (Toronto: Canadian Tax Foundation, 1988), 18:1-37, particularly at 18:3-8; Donald M. Sugg, "Preferred Share Review: Anomalies and Traps for the Unwary," in *Report of Proceedings of the Forty-Fourth Tax Conference*, 1992 Conference Report (Toronto: Canadian Tax Foundation, 1993) 22:1-31; Arthur R.A. Scace, "Term Preferreds and Income Debentures," in *Report of Proceedings of the Thirty-First Tax Conference*, 1979 Conference Report (Toronto: Canadian Tax Foundation, 1980), 492-508; Geoffrey J.R. Dyer, "Preferred Share Financing," in *Income Tax Considerations in Corporate Financing*, 1986 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1986), 20-47; Douglas S. Ewens, "Impact of Tax Reform on Preferred Share Financing," The Taxation of Corporate Reorganizations feature (1987) vol. 35, no. 4 *Canadian Tax Journal* 1004-29; Douglas S. Ewens, "Impact of Tax Reform on Preferred Share Financing—The December 16, 1987 Changes," The Taxation of Corporate Reorganizations feature (1987) vol. 35, no. 6 *Canadian Tax Journal* 1511-32; and David Downie and Tony Martin, "The Preferred Share Rules: An Introduction," in *Report of Proceedings of the Fifty-Fifth Tax Conference*, 2003 Conference Report (Toronto: Canadian Tax Foundation, 2004) 52:1-45.

The tax policy rationale underlying the tax-free movement of intercorporate dividends is that the earnings out of which such dividends are paid have normally been subjected to corporate-level tax payable by the dividend payer.[18] The government recognized early that there were instances in which these rules could be used to the detriment of the fisc. A corporation that had tax losses, and thus no use for an interest deduction, might negotiate with a putative lender for funds to be provided by way of a preferred share investment rather than a conventional loan. The dividend rate would typically be lower than a normal interest rate, to reflect the tax saving, and both parties would benefit.

The term preferred share rules were introduced to curtail the tax revenue loss that would otherwise result from such after-tax financing arrangements. The rules preclude an SFI from converting interest into tax-free intercorporate dividends by providing financing through a share investment that, although properly characterized as equity financing as a matter of law, has a term or other debt-like features that make it the economic or commercial equivalent of debt financing.

That this was the mischief at which the rules were aimed was recognized by the Tax Court of Canada in *Société d'Investissement Desjardins v. MNR*,[19] the only case in which the "not in the ordinary course of business" exception in subsection 112(2.1) has been considered. The court discussed the background to the provisions, which obviously informed its approach to the interpretation of the exception:

> Therefore, what might the object of subsection 112(2.1) of the Act be? This provision is geared primarily to preventing a corporation called a "specified financial institution," which may be a lending institution or a corporation controlled by or associated therewith, from claiming the deduction resulting from the receipt of dividends on term preferred shares (s. 112(2)). This prohibition applies when it is clear that the said shares were acquired in order to set up a tax-exempt administrative mechanism that would nevertheless provide them with a return that is at least as advantageous as the loans usually made to their customers. The legislative background (par. 4.01.2) of subsection 112(2.1) seems to show that the abuse of such a mechanism, which causes the government enormous tax losses, is the situation that Parliament wished to remedy.[20]

And:

> This Court is accordingly of the opinion that the circumstances surrounding this case and the particular status of SID make it possible to state that the acquisition of the term preferred shares in Sico met the intention behind the exception in subsection 112(2.1)

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18 For a summary of the tax policy considerations behind the intercorporate dividend deduction, see Canada, *Report of the Technical Committee on Business Taxation* (Ottawa: Department of Finance, April 1998), chapter 7; and Canada, *Report of the Royal Commission on Taxation*, vol. 4 (Ottawa: Queen's Printer, 1966).

19 91 DTC 393 (TCC).

20 Ibid., at 400.

> of the Act. In fact, this provision was clearly enacted to avoid the improper use by lending institutions of shares similar to loans the dividends on which were tax-free while the interest on the sums loaned had to be included in the income of these corporations. The malice rule that emerges from this provision is accordingly the abuse of this tax-free transaction. However, an exceptional situation that might at a pinch be described as accidental should not suffer from application of the principle in subsection 112(2.1) of the Act.[21]

The history of the rules was also discussed in *The Queen v. Citibank Canada*,[22] a decision of the Federal Court of Appeal. The "ordinary course of business" issue was not before the court; the question was whether the shares were even caught by the definition. The court held that they were not.[23]

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21 Ibid., at 410.

22 2002 DTC 6876 (FCA).

23 The court described the background of the rules as follows (ibid., at paragraphs 20-22):

> The record in this case reveals that in the 1970s, certain corporations, which for various reasons were non-taxable, could obtain needed capital at a lower cost if they issued preference shares to a lending institution. These shares carried annual dividends about one percent greater than the after-tax portion of interest paid on borrowed money. The capital could be obtained by the corporation at a cost lower than standard interest rates, and the lending institution gained a benefit as well, since it could earn slightly more than if it had lent at prevailing annual interest rates. The scheme was successful where dividends from the preference shares were free from tax in the hands of the lending institution, and the deduction of interest on borrowed money was irrelevant to the corporation because it was not taxable.
>
> By 1978, this method of after-tax corporate financing had become prevalent in Canadian capital markets and Parliament attempted to curtail it by excluding subsection 112(2.1) dividends received by a financial institution on a "term preferred share," thus greatly reducing the benefits to be obtained from such financing schemes. As Mogan J. T.C.C. notes, Arthur R.A. Scace, a leading tax practitioner, described the context in which the definition of "term preferred share" arose. At the 1979 Annual Conference of the Canadian Tax Foundation, Mr. Scace outlined the purpose of the new term preferred share:
>
>> My topics today are the new concept of a term preferred share and the changed definition of an income debenture. These represent the government's response to a form of financing which had become particularly widespread during the 1970s. Thereby, corporations which were unable to utilize an interest deduction because of losses, deductible dividends, capital cost allowance or resource write-offs would issue either a retractable preference share or an income debenture to a bank or other financial institution. Although any dividend or interest paid on such securities was not deductible to the payor, it was also not taxable to the recipient because a deduction was provided under section 112 or subsection 138(6) of the *Income Tax Act*. Consequently, lenders were prepared to offer a rate which was substantially less than the normal interest cost (often 1 per cent or 2 per cent above ½ of prime). This not only increased the lender's rate of return; at the same time, it improved the borrower's cash flow. Therefore, on the face of

That the purpose of the rules was as described in these decisions explains their application only to a corporation that is an SFI, a category that generally includes conventional financial institutions and corporations related to or controlled by such institutions. It also explains the formulation of the definition of a "term preferred share," which, as we have seen, is primarily concerned with shares that have one or more debt-like features.

The obvious reason for extending the definition of "term preferred share" to any share owned by an SFI (or other parties referred to in paragraph (b)) that controls the issuer is that control is presumed to put the owner in the same position to require the share to be redeemed as it would be if the share were, by its terms, retractable. Without an extension of the definition, the rules could easily be circumvented.

However, it was also clear that not every share owned by an SFI that is a term preferred share, under either branch of the definition, should result in a denial of the intercorporate dividend deduction. Otherwise, SFIs could not make investments in any corporation without being treated punitively relative to other corporate shareholders.

The solution adopted by Parliament was to deny the application of the normal rule only where the shares in question were considered to have been acquired in the "ordinary course" of the SFI's business. More precisely, the dividend deduction denial rule, which is itself an exception to the normal intercorporate dividend deduction in subsection 112(1), contains its own exception that makes the denial rule inapplicable if the shares in question are *not* acquired in the ordinary course of the SFI's business. The meaning of "business" in this context is not made explicit by any definition. If, for example, the word referred to a business of the nature contemplated by any of paragraphs (a) through (e.1) of the SFI definition, the scope of the provision would be much clearer. Alternatively, if the bright-line test that is used to exclude shares of a related corporation from part IV.1 tax, part VI.1 tax, and the application of subsection 258(5) had been used—that is, the "substantial interest" test—it would be clear that subsection 112(2.1) (and, as we shall see, subsection 258(3)) was of no application to such dividends. Unfortunately, neither approach was adopted. While much of the analysis that follows focuses on the scope of this exception, it is fair to observe that given the history of the rules, as noted in *Société d'Investissement Desjardins*, the legislative drafters likely had in mind an "ordinary course" business of providing

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> the transaction, everyone benefited with the possible exception of the Department of National Revenue. . . .
>
> Under Bill C-17, both financial institutions and certain non-financial institutions are subject to the new regime which, essentially, is enforced by the non-deductibility of certain dividends under section 112 . . .

Thus, the definition of "term preferred share" was clearly designed to combat a particular activity prevalent among specific actors in a specific setting, that is, financing transactions between a small group of specified financial institutions as defined in subsection 248(1) and corporations which were, for a variety of reasons, unable to utilize interest deductions provisions.

financing to customers, which, in the absence of the rules, could be conducted on a more tax-advantaged basis by substituting share investments for loans.

In the balance of this article, we consider the potential application of subsections 112(2.1) and 258(3) to a typical tower structure involving SFIs.

SFI STATUS

We have assumed that each of Canco, Cansub, and ULC is an SFI for the purposes of the Act at the time that ULC pays dividends to Partnership on the ULC common shares held by Partnership or LLC pays dividends to ULC on the LLC common securities held by ULC. However, we have also assumed that Canco, Cansub, and ULC are SFIs not because of their own activities but only because another corporation within the Canco group carries on the type of financial activity that is described in one or more of paragraphs (a) through (e.1) of the SFI definition.[24]

EXCEPTION FOR SHARES NOT ACQUIRED "IN THE ORDINARY COURSE OF THE BUSINESS"

In the case of the typical tower structure illustrated in figure 1, where each of the common shares of ULC held by Partnership and the common securities of LLC held by ULC are term preferred shares, dividends received on the shares should still be entitled to favourable treatment under subsections 112(1) and 113(1) if it can be established that such shares were not acquired in the ordinary course of the business of Canco and Cansub (for dividends on the common shares of ULC) and of ULC (for dividends on the common securities of LLC).[25]

Other than what can be gleaned from a contextual and purposive analysis, the Act contains no guidance regarding the meaning of the phrase "in the ordinary course of the business carried on" by a particular corporation. Further, the very limited jurisprudence on the point confirms, as might be expected, that it is a question of fact and circumstances whether, in a particular case, shares might be said to be acquired in the ordinary course of a business carried on by a taxpayer.

24 In some cases, a corporation that carries on such a financial activity is the Canco in the structure. While this may complicate the analysis somewhat, it should not normally make it impossible to conclude that the shares of ULC held by Partnership should not be considered to have been acquired in the ordinary course of the business of Canco.

25 In this connection, the Canadian courts have held in a number of cases, including *The Queen v. Robinson et al.*, 98 DTC 6065 (FCA), that each partner (including a limited partner) of a general or limited partnership is considered for the purposes of the Act to be carrying on any business that is carried on by the partnership of which it is a member. This is consistent with the CRA's administrative position, as confirmed in CRA document no. 2000-0059145, December 7, 2000; CRA document no. 2000-0005475, May 10, 2000; and CRA document no. 2002-0148217, July 4, 2002. On that basis, each of Canco and Cansub will be considered for the purposes of subsection 112(2.1) to be carrying on any business that is carried on by the partnership. It is assumed that Cansub carries on no business, other than such business as it might be considered to carry on by virtue of its being a general partner in the partnership.

Absent unusual facts, we believe that subsection 112(2.1) should not apply to Canco and Cansub in respect of dividends on the common shares of ULC, and that subsection 258(3) should not apply to ULC in respect of dividends on the common securities of LLC, on the basis that the shares were acquired other than in the ordinary course of the business carried on by each of Canco, Cansub, and ULC. This conclusion is based on two points: first, the source of the dividends is not, in the first instance, a "business" within the meaning of that term as it is used in the Act, and therefore such shares should not be considered to have been acquired in the course of a business for the purposes of the Act; and, second, and in any event, even if such shares are acquired in the course of a business, such a share investment should not normally be considered to have been made in the "ordinary course" of that business. On the second point, it seems likely that a court would give the words their plain meaning, having regard to the mischief at which the rules are aimed, and that this interpretive approach would provide a basis on which to conclude that long-term investment in the nature of permanent capital in a corporation that is wholly owned by the corporate group of which the investor is a part—even if made through a partnership whose business for partnership law purposes consists of acquiring shares of, and providing financing to, related corporations—is outside the ordinary course of that business.

TAX JURISPRUDENCE

As noted, only one Canadian tax case has considered the proper interpretation of the phrase "not in the ordinary course of the business" in the context of subsection 112(2.1). In *Société d'Investissement Desjardins v. MNR*,[26] the Tax Court considered whether term preferred shares issued by a Canadian-resident corporation were acquired in the ordinary course of the business carried on by an SFI. In 1975, the taxpayer (SID) made a loan to a particular corporation (Sico) as part of the taxpayer's business, which involved providing debt and equity financing to new ventures. In 1976, SID changed its business method of financing new ventures from providing loan capital to providing equity capital. When new ventures were financed by loans, the loans were made through a wholly owned subsidiary. At the time that its method changed, SID acquired shares of Sico representing 49.9 percent of the voting shares and some convertible debentures issued by Sico. Between 1977 and 1982, SID acquired additional shares, which gave it more than 50 percent of the votes. In late 1982, the share capital of Sico was reorganized, the debentures were amended to accelerate the conversion deadline, and Sico exercised various conversion rights, resulting in SID's acquisition of redeemable preferred shares. The evidence was that, at the relevant time, Sico's usual strategy was to acquire only minority interests; therefore, this was an unusual investment. Further, the various steps that resulted in SID's accelerated conversion of the debentures and the acquisition of the preferred shares took place in the context of a restructuring of the share capital of Sico to give the employees of

26 Supra note 19.

Sico greater equity participation in the company. Sico immediately redeemed the preferred shares acquired on the early conversion of the debenture, resulting in a dividend for Canadian income tax purposes that the CRA asserted should not be eligible for the special deduction available for dividends received from other Canadian corporations. At issue in the case was whether the preferred shares acquired on the conversion of the debentures were acquired in the ordinary course of the business carried on by SID.

The Tax Court of Canada held that the preferred shares were not acquired in the ordinary course of SID's business. Although its business included investing in companies, the circumstances in which these particular shares were acquired indicated that the acquisition of the shares was an isolated transaction not carried out in the normal or usual course of that business. The court reasoned that the loan was converted and the preferred shares acquired because of external factors and not as part of the ordinary business of the taxpayer. Although SID had previously carried on lending activities, such activities were no longer part of SID's core business. Its primary activity at the time the shares were acquired was investing in minority interests in investee companies by acquiring participating shares with a view to a high rate of return. SID's acquisition of the preferred shares, which were immediately redeemed, was not consistent with the way it ordinarily carried on its business. Further, the court noted that the preferred shares were not a loan alternative (the mischief at which the basic rule deeming dividends on term preferred shares to be the equivalent of interest was aimed) but rather had arisen because of unexpected events that were not caused by the acquiror.

The court's approach to the interpretation of the term preferred share rules in *Société d'Investissement Desjardins* is instructive. It seems to support the proposition that for a court to find that the preferred share rules apply to a particular share—given the technical nature of the rules, the specificity and sophistication with which they were drafted, the mischief at which they were aimed, and the punitive impact of their application—it must be demonstrated that the rules unambiguously apply to that share. Further evidence of the courts' reluctance to give an expansive interpretation to the rules when their punitive effect is considered is found in the *Citibank* case.[27]

27 In that case (supra note 22), it was argued that the shares had been designed to technically escape the scope of the "term preferred share" definition in subsection 248(1), but to achieve a purpose that was within the broader policy objectives of the provisions. As discussed above, paragraph (a) of the definition includes shares that have certain debt-like features—in particular, a share in respect of which any guarantee, security, or similar indemnity or covenant has been given with respect to the share by the issuer or any other person. Paragraph (a) also applies to a share that is convertible into any other share; however, if the share is convertible only into a share that, if issued, would not be a term preferred share, such a conversion right does not make the share a term preferred share. Citibank had acquired shares of an issuer that were convertible into common shares of the issuer, but on the basis that the fair market value of the common shares obtained on the conversion would be equal to the amount that Citibank had paid for the shares. In other words, the conversion formula ensured that Citibank would receive value, as a

CRA INTERPRETATIONS

The CRA's position on whether term preferred shares are acquired in the ordinary course of a taxpayer's business has evolved somewhat over the years. The "not in the ordinary course of business" exception was added in 1979, when subsection 112(2.1) was enacted. It seems clear from the explanations given by Department of Finance officials at that time concerning the language of the provision that the reason for including shares of a corporation controlled by an SFI in the definition of "term preferred share" was to prevent financial institutions from doing indirectly what they could not do directly.[28] At the same time, however, it was acknowledged that the Department of Finance clearly did not intend to prevent a bank from investing in shares of a subsidiary or related company to the bank, and it was thought that the "not in the ordinary course of business" exception was the appropriate means of ensuring that such investments were not inadvertently caught.[29] In 1982, when amendments to the subsection were proposed, officials of the Department of Finance once again reiterated that the purpose of the exception was "to allow financial institutions to obtain shares in the course of re-organizations within the family group and acquisitions of shares by a financial institution in an arm's length take-over transaction."[30] The Department of Finance further stated that it did not see any need to elaborate on the meaning of the term, because there was no indication from the public or from the CRA that any difficulty was being experienced with understanding and applying the administrative positions of the CRA.[31]

consequence of exercising the conversion feature, approximately equal to its original investment. Many such transactions were done by public companies during the same period. The minister took the position that the conversion feature amounted to a guarantee, security, or similar indemnity or covenant and, in effect, that only a conversion feature involving economic risk was outside the scope of the rules. The Tax Court held, and the Federal Court of Appeal agreed, that it was inappropriate to give these words any meaning other than their legal or commercial meaning. The court refused to view the conversion feature as tantamount to a guarantee or form of security or covenant, when a conversion (into shares that were not themselves term preferred shares) was clearly permitted and contemplated by the rules. In the words of the Court of Appeal (at paragraph 22): "[I]t is clear that the definition of 'term preferred share' arises from a narrow and particular context and applies to a specific and sophisticated segment of taxpayers. Therefore, the Tax Court Judge was correct, in my opinion, to conclude that the legal or commercial understandings of the disputed words are the appropriate contexts in which to interpret them."

28 See Canada, *Proceedings of the Standing Senate Committee on Banking, Trade and Commerce*, 31st Parl., 1st sess., issue no. 8, November 22, 1979, 8:18.

29 Testimony of Al Short in Canada, *Proceedings of the Standing Senate Committee on Banking, Trade and Commerce*, 31st Parl., 1st sess., issue no. 6, November 15, 1979, 6:30.

30 Testimony of B. Bryson, Senior Tax Policy Officer, Department of Finance, in Canada, *Proceedings of the Standing Senate Committee on Banking, Trade and Commerce*, 32d Parl., 1st sess., issue no. 94, June 1, 1982, 94:26.

31 Ibid.

Shortly after the enactment of subsection 112(2.1), the CRA's stated administrative position was that shares acquired in an in-house financing were generally not acquired in the ordinary course of business. The CRA's earliest public statement was made at the 1980 annual conference of the Canadian Tax Foundation, where CRA officials said that they were considering how they should interpret the section but were "satisfied that shares issued on the incorporation of a wholly owned subsidiary would not as a rule be 'in the ordinary course of the business.'"[32]

At the 1984 annual conference of the Canadian Tax Foundation, the CRA was asked what factors would be taken into account in determining that a corporation had not acquired term preferred shares "in the ordinary course of the business carried on" for the purposes of the exception in subsection 112(2.1). The CRA replied by first stating its understanding of the purpose of the exception:

> We understand that the major reason for the exclusion from the application of subsection 112(2.1) for shares "not acquired in the ordinary course of business" of the holder was to minimize the possibility of dividends on "in-house" shares being denied a deduction under subsection 112(1) by virtue of subsection 112(2.1).[33]

The CRA then went on to list the factors that it considered relevant to the determination of whether particular shares were acquired in the ordinary course of a taxpayer's business: (1) the nature of the holder's activities; (2) the number and frequency of such share acquisitions by the holder; (3) whether the funds involved represented the initial capitalization of a new subsidiary or the provision of additional operating capital to a subsidiary, both of which normally indicated permanent capitalization; (4) the terms of the shares acquired and their status as term preferred shares otherwise than by virtue of control of the issuer by SFIs; and (5) whether the shares were acquired as consideration on the sale of a business or part of a business where the holder's business had not previously included such transactions.

In various interpretations issued since 1984, the CRA has cited these factors as relevant in determining whether particular shares were acquired in the ordinary course of business.[34] The CRA has also clearly acknowledged that a distinction should be drawn between investments in "functional subsidiaries" and the acquisition of shares as part of (or in substitution for) commercial lending activities:

> The exception from the term preferred share rules for shares not acquired in the ordinary course of business is intended to permit ordinary tax treatment for dividends (and returns of capital) on shares in, for example, genuine functional subsidiaries as

32 "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Second Tax Conference*, 1980 Conference Report (Toronto: Canadian Tax Foundation, 1981), 591-628, question 23, at 609.

33 "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Sixth Tax Conference*, 1984 Conference Report (Toronto: Canadian Tax Foundation, 1985), 783-847, question 62, at 828.

34 CRA document no. 9203965, March 19, 1992, and CRA document no. 9608455, March 28, 1996.

> opposed to shares representing security on commercial lending in the ordinary course of business.[35]

In an obvious reference to *Société d'Investissement Desjardins*, the CRA stated that

> the Courts have rejected any argument to the effect that all securities acquired by certain types of corporations such as banks or life insurers have been acquired in the ordinary course of business. A factual determination must be made. Factors similar to those used in distinguishing income from capital are relevant in the determination.[36]

At the 1986 annual conference of the Canadian Tax Foundation, the CRA made the following comment, which might be regarded as out of step with some of its other statements:

> Where a specified financial institution invests in term preferred shares of a related corporation, the shares will generally be considered to have been acquired in the ordinary course of business.[37]

In 1991, the CRA issued a technical letter that commented on *Société d'Investissement Desjardins* and hinted at its later position (described below) that the "not in the ordinary course of business" exception should be available only in "exceptional situations":

> Revenue Canada, Taxation agrees fully with the view expressed by the Tax Court of Canada. The exception in subsection 112(2.1) of the Act which permits a specified financial institution to deduct, under subsection 112(1) of the Act, dividends received by it on a term preferred share is intended to encompass only exceptional situations. Similarly, the exception to the application of subsection 258(3) of the Act provided for in subsection 258(4) of the Act [that is, provisions that apply to dividends received from corporations that are not resident in Canada] will only have application in exceptional situations. The use of the phrase ". . . in the ordinary course of business . . ." is designed to distinguish the exceptional situations where subsections 112(2.1) and 258(3) of the Act should not be applied from those where these subsections of the Act should be applied. Accordingly, while the pronouncements cited in your letter are factors that Revenue Canada, Taxation considers in determining what situations may be exceptional, other factors such as the attributes of the term common shares or common units and the business reasons for using a holding company or using equity rather than debt financing may also be relevant factors.
>
> In the hypothetical situation described in your letter, it seems, based on the limited facts provided, that the transaction is structured to avoid the application of subsection 258(3) of the Act. The prime purpose of the transaction is to provide financing to

35 CRA document no. 9608455, March 28, 1996.

36 Ibid.

37 "Revenue Canada Round Table," in *Report of Proceedings of the Thirty-Eighth Tax Conference*, 1986 Conference Report (Toronto: Canadian Tax Foundation, 1987), 51:1-88, question 15, at 51:9.

> Amco, so that Amco can expand its oil and gas operations and this could be done directly by Canco. Whether or not the funds to be advanced to the Barbados' subsidiary would be a genuine capital transaction as opposed to a financing transaction which could be argued would be made in the ordinary course of the Canadian parent's business is a factual question that the Department would look at closely. We would also note that the deductibility of interest on funds borrowed by the Canadian corporation in arrangements such as you described should be considered.[38]

However, the CRA continued to acknowledge that, as the court had held in *Société d'Investissement Desjardins*, generalizations are not appropriate, and the specific facts and circumstances of any particular share acquisition must be taken into account.

More recently, there has been further evidence of a possible significant shift in the CRA's administrative position on the proper scope of the "not in the ordinary course of business" exception. The reasons for this shift are difficult to understand. The CRA's statements in this regard were actually made in connection with the comparable exception in subsection 258(4), applicable to term preferred shares issued by a corporation not resident in Canada. As we have seen, subsection 258(3) deems a dividend received by an SFI on a term preferred share of a non-resident corporation to be interest and not a dividend. Subsection 258(4) provides that subsection 258(3) does not apply to a dividend if the share on which it was paid was not acquired in the ordinary course of the business carried on by the SFI. It is possible that the CRA's position is influenced by its obvious dislike for certain cross-border structures in which Canadian corporations invest in shares of foreign affiliates and earn dividends that are tax-free in Canada. It has attacked such structures by invoking other provisions of the Act, including paragraph 95(6)(b) and GAAR, and in this interpretation it may be signalling that it might also invoke the term preferred share rules as a means of attacking certain international financing structures. However, because the wording of the two provisions is in all material respects identical, it seems clear that the CRA's interpretation of the two provisions should be consistent.

In a 2001 technical interpretation, the CRA took a more expansive, and we believe questionable, view of what constitutes an acquisition of shares "in the ordinary course of" a taxpayer's business.[39] The CRA considered the potential application of subsection 258(3) and the exception in subsection 258(4) to dividends received by a Canadian corporation on shares of a related non-resident corporation. The shares were acquired by the Canadian corporation in what might be described as an isolated acquisition. Nevertheless, the CRA concluded that the shares were acquired by the Canadian corporation as part of the ordinary course of its business.

In the case set out in the technical interpretation, a US financial institution had two wholly owned Canadian subsidiaries—one described as an operating subsidiary and the other (Cansub 2) described as a newly incorporated corporation that received funds on deposit from an arm's-length person for a two-year period. Cansub 2 used

38 *TaxPartner* (Toronto: Carswell) (CD-ROM database), document no. July 1991-296.

39 CRA document no. 2001-0079985, November 13, 2001.

the funds to acquire redeemable, cumulative dividend rate, preferred shares of a related corporation that was a US subsidiary of the US financial corporation. The holder was entitled to require the shares to be redeemed when its obligations in respect of the deposit became due.

On its face, subsection 258(3) applied to deem dividends received by Cansub 2 on the shares of the US subsidiary to be interest because Cansub 2 was an SFI and the shares were term preferred shares. The CRA was asked whether Cansub 2 was entitled to the benefit of the exception contained in subsection 258(4) on the basis that the shares were acquired not in the "ordinary course of its business" but in an isolated transaction. The CRA said that the shares were acquired in the ordinary course of Cansub 2's business. There are three noteworthy points in the technical interpretation.

First, the CRA said that term preferred shares of a related corporation may be acquired in the ordinary course of a taxpayer's business. Second, the CRA seems to have retreated somewhat from the factors-based approach to the determination. The CRA referred to one of the factors that it had previously listed as relevant—that is, whether the shares of the related entity represented permanent capital to the issuer—but noted that this factor was not present. Third, the CRA seems to have adopted the approach previously hinted at—namely, that in the absence of "exceptional circumstances," where an SFI invests in the term preferred shares of a related corporation, the shares will generally be considered to have been acquired in the ordinary course of business. As to what constitutes "exceptional circumstances," the CRA described shares acquired in the course of a reorganization of the acquiring corporation (presumably this was intended as a reference to a reorganization of the corporation whose shares are acquired) that are redeemed quickly or that are acquired on the issue of a wholly owned subsidiary and represent permanent capital of the subsidiary. In substantial part, the CRA based this new administrative position on the following passage from *Société d'Investissement Desjardins*, which discussed the legislative purpose of subsection 112(2.1) (set out above but worth repeating here):

> In fact, this provision was clearly enacted to avoid the improper use by lending institutions of shares similar to loans the dividends on which were tax-free while the interest on the sums loaned had to be included in the income of these corporations. The malice rule that emerges from this provision is accordingly the abuse of this tax-free transaction. However, an exceptional situation that might at a pinch be described as accidental should not suffer from application of the principle in subsection 112(2.1) of the Act.[40]

In support of its position, the CRA also referred to the following passage from *Blok-Andersen v. MNR*, which dealt with the proper interpretation of the phrase "in the course of business" in a context that did not involve the application of the term preferred share rules in the Act:

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40 Supra note 19, at 410.

> The position taken by counsel for the appellant was that the words "in the course of business" necessarily imply a continuing process of sales rather than an isolated sale.
>
> In my opinion such substitution is both permissible and logical and does no violence to the section so as to render it repugnant to the general scheme of the *Income Tax Act* or leading to an absurdity. The phrase "in the course of" contemplates a succession of events in a regular order. It also contemplates a result which follows from an event being set in motion. Such a result will arise in the case of an isolated sale as well as in a continuous number of sales.[41]

The technical interpretation suggests a shift away (and possibly a complete retreat) from the CRA's former administrative position, under which most in-house share acquisitions were accepted as being outside the ordinary course of the acquiror's business, and toward a new position under which only in exceptional circumstances are term preferred shares held in a related corporation acquired otherwise than in the ordinary course of the acquiror's business.[42] If there has indeed been such a change, this new position is seriously flawed, lacks any real jurisprudential or statutory basis, and is inconsistent with the legislative purpose of subsection 112(2.1) (and subsections 258(3) and (4)). In particular, the CRA's position that case law dealing with the phrase "in the course of business" is relevant in determining the proper interpretation of the phrase "in the ordinary course of business" makes no sense and is contrary to Canadian jurisprudence, which distinguishes between the phrases "income from property," "income from a business," and "income from an active business." As is apparent from the passage from *Blok-Andersen* cited by the CRA in its technical interpretation, while the phrase "in the course of" may well include any result that follows from an event being set in motion, this seems an inappropriate basis on which to premise the proper interpretation of the phrase "in the course of a business," much less the phrase actually used in subsection 112(2.1) (and subsection 258(3)), which is the even more precise phrase "in the *ordinary* course of business."

Further, the passage from *Société d'Investissement Desjardins* relied on by the CRA for its position—that, absent exceptional circumstances, any acquisition of term preferred shares by an SFI will be considered to be in the ordinary course of its business—is dubious support for that position. The most significant weakness is that, at best, the passage (which is cryptic and confusing) is obiter. A much more reliable indication of the court's view as to the proper interpretation of the phrase "ordinary course of business" in subsection 112(2.1) may be found in the passages already referred to, where the court examines the purpose of the term preferred share rules and puts the exception in context, specifically noting that the exception for shares not

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41 72 DTC 6309, at 6321 (FCTD).

42 It is noteworthy that the technical interpretation dealt with the acquisition of preferred shares of a foreign sister corporation. In recent years, the CRA has developed a somewhat different basis for asserting that the Canadian investor (Cansub 2 in this scenario) is not entitled to the dividend deduction under subsection 113(1), which is to argue that by virtue of the application of paragraph 95(6)(b) the investee company is not a foreign affiliate of the Canadian investor, even though it meets the technical requirements to qualify as a foreign affiliate.

acquired in the ordinary course of the holder's business was intended to give the court a "certain amount of flexibility" to ensure that situations that did not "fall within the situation that Parliament intended to remedy" were not caught by the rules.

With respect to the scope of the exception in subsection 112(2.1), the Crown in *Société d'Investissement Desjardins* had in fact argued "that in practically all cases a specified financial institution could not claim that the acquisition of term preferred shares did not form part of the ordinary course of the business carried on because of the very nature of the business carried on by these institutions."[43] To a large degree, the Crown based this argument on its reading of commentary in a tax article that dealt with the proper interpretation of the phrase "ordinary course of business" used in subsection 112(2.1). In fact, the Crown's argument that the article supported such a limited interpretation of the scope of the exemption in subsection 112(2.1) was, with respect, somewhat disingenuous.

The Crown's argument in the case was based on the following passage:

> In the case of a purchase of term preferred shares by a financial institution, some assistance may be found in those tax cases that consider whether particular securities transactions carried on by financial institutions are on account of income or capital. The very nature of the business of a financial institution will make it difficult in most cases to contend that a purchase of term common shares or common units was beyond the ordinary course of its business. In the case of a specified financial institution that is not itself engaged in the financing business but is associated with a financial institution, however, there could be considerably more scope to contend that its term preferred share investment was acquired outside the normal course of its business.[44]

A careful review of the passage makes it clear that the writer thought that most SFIs that engaged in actual lending businesses might have a difficult time arguing that term preferred shares were not acquired in the ordinary course of such a business. At the same time, however, the writer made the point that for a corporation that was an SFI only because it was related to another corporation that was a financial institution, "there could be considerably more scope to contend that its term preferred share investment was acquired outside the normal course of its business."

The court in *Société d'Investissement Desjardins* expressly rejected the Crown's argument that the exception in subsection 112(2.1) should be read so narrowly that most term preferred shares acquired by an SFI would be treated as being acquired in the ordinary course of its business and therefore would not be entitled to the benefit of the subsection 112(2.1) exception. Correctly, we believe, the court recognized that adoption of the Crown's argument effectively would emasculate the exception, and that this was an anomalous result that Parliament could not have intended. In this connection, the court, in reference to subsection 112(2.1), stated:

43 Supra note 19, at 407.

44 Dyer, supra note 17, at 25-26.

> In effect, Parliament clearly wanted to make a distinction between specified financial institutions for which the acquisition of term preferred shares was a regular operation and those for which such a transaction was an exception. In fact, if the respondent's [the Crown's] argument is given free rein, the last part of the subsection simply has no force or effect since any acquisition of term preferred shares by a specified financial institution should be subject to the exemption [subsection 112(2.1)] from the deduction [subsection 112(1)] allowed by the said subsection [subsection 112(1)]. In other words, the acquisition of term preferred shares by a specified financial institution primarily involved in the acquisition of shares could only have occurred in the ordinary course of business.[45]

In rejecting the Crown's argument that most term preferred shares acquired by an SFI should be considered acquired in the ordinary course of its business, the court expressly recognized that the ordinary business of an SFI might or might not include the acquisition of term preferred shares. For some, "the acquisition of term preferred shares was a regular operation"; for others, "such a transaction was an exception." Instead, the court focused on a fact-based analysis of the nature of the particular taxpayer's business to determine what the ordinary course of the business was and whether the acquisition of the term preferred shares was part of that ordinary course. Given the foregoing, it is difficult to understand why the CRA believes that *Société d'Investissement Desjardins* is authority for the administrative position set out in the 2001 technical interpretation referred to earlier when its espoused administrative position (or words very close to it) was expressly rejected by the court.

THE PROPER INTERPRETIVE APPROACH

The potentially broad application of subsections 112(2.1) and 258(3) and, in particular, the fact that ordinary common shares can be term preferred shares pursuant to paragraph (b) of the definition where the holder controls the issuer have caused what one commentator has referred to as "innumerable problems in many transactions that are far removed from the after-tax financing evil which the legislation sought to attack."[46] There seems to be no disagreement that from a tax policy perspective, most, if not all, term preferred shares held by an SFI in a corporation that forms part of its corporate group should not be considered to have been acquired in the ordinary course of business.[47]

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45 Supra note 19, at 411.

46 Richard G. Tremblay, "Ordinary Course of Business—Term Preferred Shares" (1991) vol. 3, no. 13 *Canadian Current Tax* C43-48 (commentary on *Société d'Investissements Desjardins* shortly after its release).

47 Guy Fortin and Mélanie Beaulieu, "The Meaning of the Expressions 'In the Ordinary Course of Business' and 'Directly or Indirectly,' " in the 2002 Conference Report, supra note 1, 36:1-60. Nevertheless, it is also agreed that the issue is not one that can be ignored: Downie and Martin, supra note 17.

The proper approach to determining whether the exception in subsection 112(2.1) (or subsection 258(4)) applies to particular shares requires that three questions be answered. First, does the taxpayer actually hold the shares as part of what would be regarded as a business for the purposes of the Act? Second, if so, what is the ordinary course of such business? Third, were the shares acquired in the ordinary course of that business?

The answers will depend on the relevant facts and circumstances of the taxpayer. In *Société d'Investissement Desjardins*, the court recognized that an SFI might have more scope to establish that it did not acquire term preferred shares in the "ordinary course of its business" if, like Canco or Cansub, it was an SFI not because it was a lending or other financing institution, but only because it was related to such an institution. For the most part, this facts-and-circumstances-based approach (as opposed to the approach in which it is presumed that an SFI acquires shares in the ordinary course of its business, subject only to a narrow "exceptional circumstances" exception) is consistent with the CRA's stated administrative position before it issued the 2001 technical interpretation discussed earlier.

Further, and more importantly, we believe that this interpretive approach is consistent with Parliament's legislative purpose in adding the word "ordinary" to the phrase "in the course of business" in subsection 112(2.1)—to narrow the potential application of the subsection to those circumstances where, on the relevant facts, the shares are acquired not simply in the course of a taxpayer's business but in the ordinary (that is, the normal or regular) course of the business. The addition of "ordinary" makes it clear that a taxpayer's isolated or infrequent acquisition of shares in a related corporation that are to be held as a long-term investment should not normally be considered to have occurred in the ordinary course of business.

APPLYING THE PROPER INTERPRETATION TO THE TYPICAL TOWER STRUCTURE

When this interpretive approach is applied to the relevant facts and circumstances of the typical tower structure illustrated in figure 1, the key determinations are (1) whether Partnership and, by extension, Canco and Cansub (or ULC) carry on a business within the meaning of that phrase as it is used in the Act; (2) if so, whether the common shares of ULC, in the case of Partnership, or the common securities of LLC, in the case of ULC, were acquired in the course of that business; and (3) if so, whether those shares were acquired in the ordinary course of that business. For the purposes of the analysis that follows, it is assumed that Canco is a holding corporation that holds, among other things, the shares of Canadian and foreign subsidiaries, and that the sole activity of Cansub is the holding of its general partnership interest in Partnership.

On the basis of the relevant Canadian jurisprudence, there is no question that to the extent that Partnership carries on a business, that business is also carried on by each of its partners, Canco and Cansub. Generally, provincial law defines a partnership as the relation that subsists between persons carrying on a business in common

with a view to profit.[48] Section 2(1) of the Ontario Limited Partnerships Act provides that a limited partnership may, subject to that statute, be formed to carry on any business that a partnership without limited partners may carry on.[49] We have assumed that in the typical tower structure, Partnership's business will be described as the business of the acquisition, holding, financing, management, and administration of companies, partnerships, trusts, and joint ventures and such other objects and purposes as the general partner (Cansub) determines from time to time.

There is reasonable support for the proposition that for the purposes of the Act, the activities of Partnership and, in particular, its activities in regard to the acquisition and holding of the common shares of ULC will not be considered to constitute a business.

The Act identifies potential sources of income as, generally, an office or employment, a business, and property (as well as taxable capital gains). The Act generally groups together the rules that apply to the computation of income from a business or from property, presumably because in many cases there is no reason for identical rules not to apply; this approach avoids the need to determine, in every instance, whether the source of income in question is a business or property. In some cases, however, it is important to determine whether the source is a business or simply the holding of property.

A significant body of case law deals with the distinction between income from a business, on the one hand, and income from property, on the other, for the purposes of the Act. Before we explore the relevant principles, it is of interest to note that subsection 248(1), which contains a number of definitions and interpretation rules that apply for the purposes of the Act, provides that a "business" includes a profession, calling, trade, manufacture, or undertaking of any kind whatever and, except for limited circumstances not relevant to our analysis, includes an adventure or concern in the nature of trade, but does not include an office or employment. Although this might suggest that any "undertaking" that was not an office or employment and that resulted in income would necessarily give rise to income from a business source, this cannot be the case, given the considerable jurisprudence dealing with the distinction between property income and business income.

Generally, the distinction has been based on the amount of activity or "busyness" entailed in the earning of the relevant income and, in the case of a corporation, on a rebuttable presumption that income earned from carrying out the corporation's objects is business income. The overlap between the two types of income was recognized by the Supreme Court in *Canadian Marconi v. The Queen*, where Wilson J observed:

> The distinction between income from a business and income from property is a difficult one to draw but it is one which the Act compels us to make. There are two reasons for the difficulty. First, the terms "business" and "property" are broadly and loosely

48 See, for example, Partnerships Act, RSO 1990, c. P.5, as amended, section 2.

49 RSO 1990, c. L.16, as amended.

> defined in s. 248(1) of the *Income Tax Act*. As a consequence the definitions on a fair reading can be construed in such a way as to overlap. Second, persons or corporations generally engaged in trading-type activity often use property as a means of earning income. On first reflection this sort of income could realistically be considered either business income or property income. The observation of Thurlow, J. (as he then was) in *Wertman v. Minister of National Revenue*, 64 DTC 5158 (Ex. Ct.) at p. 5167, that cases are "readily conceivable where particular income may be accurately described as income from property and just as accurately regarded as income from a business" is frequently apposite. The courts have handled the difficult task of deciding whether a particular receipt is business income or property income by applying certain set criteria or indicia of trading activity and, in the case of a corporate taxpayer, by applying a presumption in favour of the characterization of its income as income from a business.[50]

In *Canadian Marconi*, the issue was the characterization of income from the investment of surplus cash held after the sale of a particular division pending the identification of a new business in which to invest. The court noted the following significant facts:

> Throughout the 1973 to 1976 period, the funds remained invested in short-term interest-bearing securities but considerable energy and effort was expended by CMC in order to obtain a maximum return. About twenty per cent of the working hours of the senior company officer placed in charge of the investments was taken up in the day-to-day management of these investments. Every Friday, this officer carefully reviewed all transactions made during the week and decided on the investment strategy for the following week. At any one time there were as many as twelve employees involved in the management of the investments. The extent of the activity of this staff in managing the investments and their vigilance in earning a maximum return from the funds is evident from the numerous purchases completed each year (201 in 1973, 218 in 1974, 241 in 1975 and 381 in 1976), the variation in the lengths of terms of deposits made and securities purchased according to the trend of market interest rates and the fact that seldom would the staff reinvest the funds realized from a sale in the same instrument. Finally, the funds available for investment and actually invested represented roughly one-half of CMC's total assets during the 1973 to 1976 period and the income earned from the investments constituted a significant percentage of the total income earned by CMC in each of the years in question—21.4% in 1973, 52.7% in 1974, 35.4% in 1975 and 31.2% in 1976.[51]

The court found as follows:

> The presumption which I have discussed above and the day-to-day intervention of the officers and directors of the company in the company's business were enough to characterize the income as business income.[52]

50 86 DTC 6526, at 6528 (SCC).

51 Ibid., at 6527.

52 Ibid., at 6530.

Whether this presumption makes sense, particularly in regard to a corporation governed by modern corporate law with unrestricted objects and powers, has been questioned; however, it still appears to be part of the Canadian jurisprudence, as confirmed in *Canadian Marconi*. Nevertheless, the presumption can be rebutted by clear evidence of a contrary intention established by the corporation's course of conduct. In this connection, reference may be made to *Sutton Lumber and Trading Co. Ltd. v. Minister of National Revenue*[53] and *Burri v. The Queen*.[54] To be considered income from a property source, a receipt must be earned from property in a passive manner without the commitment of significant time, labour, and attention by the taxpayer. In contrast, to be considered income from a business source, a receipt must be earned through a mix of labour and the use of property. In the words of one commentator, "[p]roperty income attains the quality of business income where there is evidence that the profits generated derive from the active exploitation of property in a commercial and businesslike manner."[55]

Or, as the Supreme Court put it in *Canadian Marconi*,

> It is trite law that the characterization of income as income from a business or income from property must be made from an examination of the taxpayer's whole course of conduct viewed in the light of surrounding circumstances: see *Cragg v. Minister of National Revenue*, [1952] Ex. C.R. 40, [52 DTC 1004], *per* Thorson, P. at p. 46. In following this method courts have examined the number of transactions, their volume, their frequency, the turnover of the investments and the nature of the investments themselves.[56]

The *Canadian Marconi* principles were recently applied in *Banner Pharmacaps NRO Ltd. v. The Queen*.[57] The issue was whether a particular corporation was or was not a non-resident-owned investment corporation (NRO). If its principal business was the making of loans, it would not meet one of the requirements of the NRO definition. Its only assets were several promissory notes of a related corporation and the shares of a related corporation. It had not advanced the funds evidenced by the notes, but it had acquired the notes. Although the taxpayer had filed an election to be an NRO, it was now asserting that it had not been entitled to claim NRO status in the relevant years on the basis that its "principal business" was the making of loans. The Tax Court found that to "make loans" requires that the taxpayer advance funds,

53 [1953] 2 SCR 77.

54 85 DTC 5287 (FCTD).

55 Elinore J. Richardson, "Holding Real Estate for the Production of Income," in *Income Tax Aspects of Real Estate Transactions*, 1983 Corporate Management Tax Conference (Toronto: Canadian Tax Foundation, 1983), 1-58, at 5, note 7; and John Durnford, "The Distinction Between Income from Business and Income from Property, and the Concept of Carrying On Business" (1991) vol. 39, no. 5 *Canadian Tax Journal* 1131-1205.

56 Supra note 50, at 6529-30.

57 2003 DTC 245 (TCC); aff'd. 2003 DTC 5642 (FCA).

which it had not done; instead, it had acquired promissory notes. Further, even if it had made loans, it could not be considered to have been in the business of making loans. Citing *Canadian Marconi* as authority for the factors that distinguish income from business from income from property, the Tax Court stated:

> It is difficult to examine the number, volume or frequency of transactions when there are none at all to examine. Apart from acquiring all of the issued shares of Banner Canada which was the sole reason for its incorporation, the Appellant was totally passive in 1996. I have no hesitation in concluding that the Appellant did not engage in any business in 1996. Therefore, it could not have as its principal business "the making of loans" when it did not have any business at all. I reach this conclusion fully cognizant of the broad meaning given to the word "business" in section 248 of the Act.[58]

The Federal Court of Appeal agreed with the trial judge, stating that there was no evidence that Banner ever advanced money to another party on the condition that the money be repaid, and thus no evidence that it made any loans at all, much less that it carried on a moneylending business.[59]

The CRA itself has acknowledged that a corporation can have income from property:

> Where a corporation was incorporated to earn income by carrying on business, there is a general presumption that profits arising from its activities are derived from a business or businesses. However, in some circumstances, a corporation's entire profits can be characterized as income from property, as in the case of a corporation formed for the sole purpose of holding the shares of a second corporation or holding a property to be rented under a long-term lease to a single tenant with limited landlord responsibilities. It is also possible that a corporation could earn both income from property and income from carrying on a business.[60]

If Canco or Cansub were to hold the common shares of ULC directly, that holding would seem much more consistent with the making of an investment to earn income from property (that is, dividends on the shares) than with the conduct of a business. To the extent that there is a presumption that an activity engaged in by a corporation is a business, this seems an instance in which that presumption would probably be rebutted. On the basis of the usual facts and circumstances that might be expected

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58 Ibid., at paragraph 30 (TCC).

59 Interestingly, in several recent rulings granted (see CRA document no. 2006-0171011R3, 2006; CRA document no. 2005-0155361R3, 2006; and CRA document no. 2005-0145911R3, 2005), the CRA ruled that where a special-purpose vehicle, Finco, was established for the sole purpose of borrowing funds and on-lending such funds to a partnership, subsection 15(2.3) of the Act applied to such loans. This entailed an acceptance that Finco was in the business of lending money and that the loans had been made in the ordinary course of that business.

60 *Interpretation Bulletin* IT-420R3, "Non-Residents—Income Earned in Canada," March 30, 1992, paragraph 13.

to be present in the typical tower structure, each of Canco and Cansub intends to hold the common shares—not for the purpose of earning profits from trading in the shares, but as a long-term investment and to earn dividend income. The key issue, therefore, is whether an activity that would not amount to a business if carried on directly by a taxpayer should be elevated to the status of a business merely because it is carried on in a partnership, which by its nature is the relationship that exists between two or more persons carrying on business in common with a view to profit.

The better view is that it should not, and that what is sufficient to amount to carrying on a business for the purposes of the relevant partnership law will not necessarily meet the threshold required for an activity to constitute carrying on a business for the purposes of the Act. The jurisprudence supports this position. For example, in *Fredette v. The Queen*, Archambault J stated:

> The fact that a partnership (in common law) or a commercial partnership (in civil law) must carry on an undertaking (or a business) in order to exist could explain why some believe that such a partnership operates a business (within the narrower sense of the Act, which distinguishes between the notions of business and property) and thus has the right to choose a fiscal period ending after the end of the calendar year. This interpretation would be analogous to that adopted by some who contend that there is a presumption that the activities of a business corporation constitute the operation of a business.
>
> However, it is far from certain that a partnership can always be considered as operating a business within the narrower sense of the Act. For example, the rent earned from a triplex generally constitutes income from property, not a business. Unless one adopts a presumption such as that noted above, there is no logical reason to believe that such an activity would constitute a source of income from a property for an individual and a source of business income for a partnership or business corporation. The nature of income earned by a person should not depend on the status of that person. This is the approach that my colleagues Judge Bowman and Judge Lamarre adopted in *Goldstein v. The Queen*, 96 DTC 1029, and *Marchand v. R.*, [1998] 3 C.T.C. 2340, and I share their point of view.[61]

In the UK case of *Three H Aircraft v. Customs & Excise Comrs.*, the Queen's Bench Division found that the concept of "business" for the purposes of partnership law was not necessarily identical to the concept of "business" for the purposes of the taxing statutes:

> In my judgment, there is no reason why precisely the same meanings should be given to the word in the two Acts. In each act the definition is an inclusive one, not a definitive one. Moreover there is a well accepted doctrine, of application to the 1890 Act [the Partnership Act, 1890], which would be inconsistent with the decisions to which I have already referred about the test to be applied for determining whether an activity is a business within the meaning of that word in the 1972 Act [the Finance Act]. I

61 2001 DTC 621, at 631, note 13 (TCC).

> refer specifically to the doctrine that a single adventure can constitute a partnership: see Lindley on Partnership (14th edn, 1979 p 10, note 1) and *Re Abenheim* (1913) 109 LT 219 there cited, in which Phillimore J rejected a submission that the word "business," where used in ss 1 and 2 of the 1890 Act, does not mean (or include) an isolated adventure. That doctrine, it seems to me, is inconsistent with the test of recognisable continuity to which I have already referred.[62]

It is clear from the jurisprudence that the test to be applied in determining whether a partnership exists for the purposes of the Act is whether a valid partnership exists as a matter of the relevant provincial partnership law. In *Continental Bank Leasing Corporation v. The Queen et al.*,[63] *Backman v. The Queen*,[64] and *Spire Freezers Ltd. et al. v. The Queen*,[65] the Crown put into issue the question of whether or not a valid partnership relationship had been created. The three elements necessary for a relationship to constitute a partnership were described as follows in each of the cases:

> At the time the alleged partnership is formed, the evidence must disclose that the alleged partners were (1) carrying on a business, (2) in common, (3) with a view to profit.[66]

However, it is clear from the reasoning that in determining whether a relationship has been formed to carry on a business, the standards to be applied are those established by the relevant partnership law (and any other relevant legal principles established by the commercial law). Thus, the Supreme Court stated in *Backman*:

> In law, the meaning of "carrying on a business" may differ depending on the context in which it is used. Provincial partnership acts typically define "business" as including "every trade, occupation and profession." The kinds of factors that may be relevant to determining whether there is a business are contained in the existing legal definitions.[67]

The CRA has acknowledged that the income of a partnership is not necessarily income from a business but may also include income from a property.[68] For example, in a technical interpretation issued in 2000, the CRA commented on whether

62 [1982] STC 653, at 659-60 (QB).

63 98 DTC 6505 (SCC).

64 2001 DTC 5149 (SCC).

65 2001 DTC 5158 (SCC).

66 At paragraph 15 of the reasons in *Spire Freezers*, ibid., in turn referring to *Continental Bank*.

67 *Backman*, supra note 64, at paragraph 19.

68 Yvette Morelli, "Structuring Venture Capital Funds" (2003) vol. 51, no. 2 *Canadian Tax Journal* 806-62, at 861-62, quotes to the same effect from an unpublished letter from the Department of Finance, February 22, 2002, dealing with section 115.2, where the department apparently stated that

> partnerships are not subject to a unique test to determine whether they are carrying on a business. The fact that an income-earning activity is carried on by a partnership does not, in and by itself, give rise to an assumption that an activity must be a business or that

interest expense incurred by a non-resident partner on borrowings to fund an equity contribution to a partnership with Canadian activities would be considered deductible in computing the non-resident partner's income from carrying on business in Canada. The CRA stated that it would be necessary to determine to what extent the partnership's income was from a business source rather than from a property source:

> Thus a review of all the facts, including the terms of the particular partnership agreement and any other pertinent information, would likely be required before a determination could be made.
>
> Notwithstanding the above, where a partnership carries on a business in Canada a partner of such a partnership will be considered to be carrying on a business in Canada for the purposes of the Act. Where such a partnership carries on no other income earning activity (i.e., it does not earn income from any other source or type under the Act, such as income from a property) each partner's share of income from that partnership can only be from a source that is from a business for the purposes of the Act (see Technical News No. 3). In such circumstances, where a non-resident partner borrows money that is used by the partnership for the purpose of earning income from its business the interest expense will generally be deductible by the non-resident partner under paragraph 20(1)(c) of the Act (assuming all the other tests in that paragraph are met) and such deduction would be wholly applicable to that particular business source for the purposes of computing the non-resident partner's income referred to in subparagraph 115(1)(a)(ii) of the Act. However, if the non-resident partner incurs interest expense to earn partnership income that is income from a non-business source, such as from property, the interest would not be deductible in computing the non-resident partner's income referred to in subparagraph 115(1)(a)(ii) of the Act. If the partnership has income from both a business source and a non-business source, an allocation of the interest expense between the two sources may be required depending on the facts of the particular situation.[69]

In a technical interpretation released in 2004, the CRA acknowledged that there was a distinction between carrying on business for commercial law purposes and carrying on a business for the purpose of determining whether income of a partnership is from a source that is a business or a source that is a property for income tax purposes:

> It is not clear, on the facts set out above, that the Partnership is carrying on business in Canada. Despite the fact that carrying on business is fundamental to the definition

> the partnership is carrying on a business. Whether any activity carried on by a partnership constitutes a business is, as in the case of any other entity, always a question of fact. . . .
>
> Given the foregoing, it remains our view that no amendments are necessary to ensure that a non-resident limited partner who invests through a partnership with a general partner resident in Canada is not deemed to be carrying on business in Canada, or holding or using the property in the course of carrying on business simply because the investments are made through a partnership.

69 CRA document no. 1999-0011005, April 19, 2000 (and see, to similar effect, CRA document no. 2000-0020335, June 20, 2000).

> of "partnership" for purposes of the various provincial statutes, the level of activity required for purposes of determining whether two or more persons are carrying on business for purposes of the definition of "partnership" in such statutes is not necessarily the same as the level of activity required under the Act in order to distinguish business income from property income. On the other hand, income tax related jurisprudence indicates that the threshold for carrying on business is quite low in the case of corporations and this view would seem to apply to partnerships as well.[70]

The CRA made a similar comment in regard to the position of a limited partner in a limited partnership organized under US law, the "business" of which was investing in non-Canadian securities:

> We recognize that the Canadian Courts have been fairly generous in accepting various arrangements between two or more persons as being formed with a view to carrying on business for profits and thus as partnerships for purposes of provincial partnership law. However, the test for what constitutes "carrying on business" for Canadian partnership law purposes or, possibly, for foreign partnership law purposes, is clearly less stringent than the test under the Act for determining the nature of a potential source of income (i.e., business versus property).[71]

The CRA has not been entirely consistent in its approach, however. In an earlier technical interpretation, the CRA commented as follows with respect to the position of a non-resident tax-exempt organization that was a member of a limited partnership formed for the purpose of investing in shares of various corporations:

> Where the investment activities of the limited partnership constitute carrying on business, the charitable organization's share of business income therefrom would not be subject to paragraph 1 of Article XXI by virtue of paragraph 3 of that Article. Such income would be subject to Article VII of the Convention and Canada's right to tax that income would depend on whether the partnership was considered to have carried on business in Canada through a permanent establishment situated therein.
>
> The Department does not rule out the possibility that a partnership can earn property income. However, in our opinion, where the only activity of the partnership is the investment in shares of various corporations, such activity will likely be considered a business activity.[72]

In the typical tower structure, Partnership either makes a single investment in the shares of ULC or, having capitalized ULC with nominal capital, makes one additional investment in the shares of ULC. It does not hold the shares of any other entity. The only other activities of Partnership consist of receiving dividends on the shares of ULC and issuing and servicing the debt that provides the funding for such share

70 CRA document no. 2003-0039051E5, January 26, 2004.

71 Note accompanying CRA document no. 2003-0039231E5, May 25, 2004.

72 CRA document no. 9219352, October 19, 1992.

investment. Having regard to the limited and passive nature of the activities of Partnership, we believe that the jurisprudence supports the position that in acquiring and holding the ULC common shares, Partnership (and by extension its partners) in most cases is not engaging in an activity that amounts to a business for the purposes of the Act such that those shares should be considered to have been acquired in the course of that business, let alone in the "ordinary course" of that business.

The same reasoning should apply to the acquisition by ULC of the common securities of LLC, without the additional issues that arise from the interposition of a partnership to hold the securities.

"ACQUIRED IN THE ORDINARY COURSE OF THE BUSINESS"

Even if the activities of Partnership in acquiring and holding the common shares of ULC, or of ULC in acquiring and holding the common securities of LLC, would be considered a business for the purposes of the Act, and even if the common shares of ULC or the common securities of LLC were acquired in the course of that business, we believe that the acquisition of the common shares of ULC should not normally be considered to have occurred in the *ordinary* course of that business for the purposes of subsection 112(2.1).

Although the CRA appears to have retreated from the factors-based approach that it initially indicated was the appropriate approach to the "not in the ordinary course" exception, the limited jurisprudence supports the conclusion that the inquiry is a fact-based one, and that there is no presumption, as may be the CRA's current position, that term preferred shares of a related corporation are acquired in the ordinary course of the holder's business except in exceptional circumstances. The jurisprudence supports an interpretive approach that would give the words a sensible and narrow reading, consistent with the acknowledged mischief at which they are aimed, and with the fact that the dividend denial in the circumstances to which subsection 112(2.1) applies is an exception to the normal rule under which intercorporate dividends flow tax-free. In other words, in contrast to the CRA's approach, under which subsection 112(2.1) is viewed as a normal rule, it should be recognized that subsection 112(2.1) itself is an exception to the normal rule, has very punitive consequences where it applies, and should be approached with care.

If the factors-based approach were to be applied to the acquisition of the common shares of ULC by Partnership (or the common securities of LLC by ULC), most, if not all, of the factors would be consistent with the conclusion that the shares (or securities) were not acquired in the ordinary course of a business of Partnership or ULC. In the case of the common shares of ULC, the only factor that raises a concern is the first one—the nature of the taxpayer's business—principally because the shares are held through Partnership, which, as a partnership, is necessarily regarded as carrying on a business for partnership law purposes. If the common shares of ULC were directly held by Canco or Cansub, an assessment of the factors would support the conclusion that the shares were not acquired in the ordinary course of business.

We believe that the ordinary course of a taxpayer's business is the amalgam of day-to-day activities carried out with regularity and a degree of frequency by the management of the taxpayer in conducting the taxpayer's business, which may be contrasted with isolated transactions infrequently engaged in, including significant asset acquisitions or dispositions that are extraordinary events. This view is consistent with the Canadian jurisprudence that has considered the meaning of the phrase "ordinary course of business" found in provisions of the Act dealing with loan reserves available to moneylenders under paragraphs 20(1)(l) and (p) and the inventory allowance in former paragraph 20(1)(gg).[73]

In the typical tower structure illustrated in figure 1, the common shares of ULC (or the common securities of LLC) are acquired as an investment for the purposes of generating a reasonable return in the form of distributions on the common shares or securities. Further, the common shares or securities are acquired almost immediately on the formation of Partnership and ULC by way of an initial subscription by Partnership to ULC or by ULC to LLC. Those shares or securities constitute the most significant asset of Partnership or ULC. To the extent that the operations of Partnership in relation to the common shares of ULC or the common securities of LLC require regular activity, that activity consists primarily of receiving dividends, applying the distribution proceeds by paying dividends, in the case of LLC, or making interest payments on the external debt, in the case of Partnership, and, in each case, reinvesting any excess funds. The minimal activity involved in receiving the dividends and applying the distribution proceeds is carried out by Cansub, the general partner of Partnership, as part of its ongoing responsibility to manage the affairs of Partnership, or by the employees or agents of ULC. On the other hand, the acquisition of the common shares of ULC and the common securities of LLC is an isolated and special transaction, which by its very nature (that is, the fact that the shares or securities are acquired as part of an initial subscription to the issuer) could not have been transacted, in the case of Partnership, by the general partner as part of the day-to-day management of Partnership's business (such as it is) or, in the case of ULC, by its employees or agents. If either Partnership or ULC can be considered to carry on a

73 In *British Columbia Telephone Company v. MNR*, 86 DTC 1286 (TCC), the court, in dealing with paragraph 20(1)(gg), the inventory allowance provision, considered whether certain transactions were carried out in the ordinary course of business. The court held that for a transaction to be in the ordinary course of business, "the transaction must fall into place as part of the undistinguished common flow of business done, that it should form part of the ordinary business carried on, calling for no remark and arising out of no special or particular situation" (ibid., at 1290, quoting *Downs Distributing Co. Pty. Ltd. v. Associated Blue Star Stores Pty. Ltd. (In Liquidation)* (1948), 76 CLR 463, at 477 (HC)). The court referred with approval to a passage from *Re Bradford Roofing Industries* (1966), 84 WN (Pt. 1) 276 (NSW Equity), an Australian case that considered the meaning of the phrase "in the ordinary course of business" in an Australian tax statute. On this point, the court stated (ibid., at 285): "[T]he transaction must be one of the ordinary day-to-day business activities, having no unusual or special features, and being such as a manager of a business might reasonably be expected to be permitted to carry out on his own initiative without making prior reference back or subsequent report to his superior authorities, such as for example, to his board of directors."

business (within the meaning of that term as it is used in the Act)—which, as we have seen, is questionable—the acquisition of the shares or securities, as the case may be, is the acquisition of the very assets that will constitute "the business" and is an extraordinary transaction rather than a transaction that is carried out in the ordinary course of the business.

An analogy is the treatment of inventory sold as part of the sale of an entire business. Subsection 23(1) now provides that where a taxpayer, on or after disposing of or ceasing to carry on a business, sells property included in the inventory of the business, the property so sold is deemed to have been sold in the course of carrying on the business. The addition of this deeming rule was made necessary by the decision of the Supreme Court of Canada in *Frankel Corporation Ltd. v. MNR*,[74] which held that when inventory was sold as part of the sale of the assets of a business, it was not sold *in* that business, but was part of the sale *of* the business. Therefore, any gain was capital.

By similar reasoning, the acquisition of the capital assets with which a taxpayer will carry on a business should be regarded as the acquisition *of* the business, not as an acquisition *in* (the ordinary course of) that business. If Partnership or ULC does carry on a business, it will acquire that business when it acquires the common shares of ULC or the common securities of LLC—the very assets that will generate income in the form of future dividends for Partnership and ULC. The receipt and application of that income in the form of distribution proceeds will be the only real activities of the business of Partnership or ULC that require any ongoing attention. Although assets acquired with the proceeds of reinvestment of the distribution proceeds might be considered acquired in the ordinary course of business, the initial assets, which actually made the business possible, should not be so regarded.

SUMMARY

On the basis of its language, context, and purpose, the shares acquired by a taxpayer as part of a typical tower structure should not be considered to be acquired in the ordinary course of the taxpayer's business. In the typical tower structure illustrated in figure 1, the acquisition of the common shares of ULC by Partnership or of the common securities of LLC by ULC should be treated as an investment in property and not as an acquisition made in the course of a business carried on by the acquiror. Each acquisition is made as an investment to earn dividend income from property rather than income from the conduct of a business.

We recognize that considerable Canadian jurisprudence can be found to support the tax principle that there is a rebuttable presumption that income earned by a corporation such as ULC in the conduct of the corporate objects authorized in its constating documents is income from a business. On the basis of cases like *Sutton* and *Burri*, however, the presumption can be rebutted by evidence of a contrary intention

74 59 DTC 1161 (SCC).

established by the corporation's course of conduct. In the case of the acquisition of the common shares of ULC by Partnership or of the common securities of LLC by ULC, there should be considerable evidence to rebut the presumption. Typically, Partnership, in respect of its common shares of ULC, and ULC, in respect of its common securities of LLC, will be passive investors, in that their expected dealings with the shares or securities will be limited and will not involve the day-to-day supervision or involvement of the management of Partnership (or of Cansub, its sole general partner) or of ULC.

Even if Partnership or ULC is considered to carry on a business, its acquisition of the ULC shares or the LLC securities should not be considered part of the ordinary course of that business, but rather an isolated and special transaction that is not part of a course of conduct that involves repeated dealings of a similar nature.

We are not aware of any circumstances in which the CRA has asserted that the shares of a related corporation acquired by one or more entities in a typical tower structure were acquired in the ordinary course of business, such that the exception to the application of the term preferred share rule in subsection 112(2.1) or the exception to the application of subsection 258(3) in subsection 258(4) would not be available. However, the fact that the issue remains outstanding, and must be addressed, in a tower structure is troubling in itself. A review of the SFI definition and of the appropriateness of the "not acquired in the ordinary course of business" test as the only ground for exclusion from the rule in subsection 112(2.1) is long overdue. As the Supreme Court observed in *Canada Trustco*, taxpayers are entitled to expect a reasonable level of certainty, predictability, and fairness in the interpretation and administration of the tax law so that they may manage their affairs accordingly.[75] The legislative history of the term preferred share rules makes it clear that they were not intended to apply to investments in related corporations within the same corporate group. A less vague test, such as the "substantial interest" test found in other preferred share rules in the Act, would provide the desired certainty and would be entirely consistent with the tax policy underlying the rules.

75 *Canada Trustco*, supra note 10, at paragraphs 12 and 42.

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