Half a loaf is better than none!

Moodys Private Client
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The Federal Court of Appeal's (FCA) recent French language decision in the appeal of *Gervais* considered the use of a sale structure commonly referred to as the "half loaf." In general, this planning technique provides an opportunity to spouses to increase the use of the capital gains deduction (CGD) in cases where only one spouse owns property (and a disposition of which would give rise to an opportunity for use of the CGD). The Tax Court decision in *Gervais* of Jorre J. was largely based on the finding that a transfer of capital property from one spouse to another, that was immediately resold to an unrelated party, was on account of income and not capital. Readers should be forewarned: this case has not yet been officially translated and the writer's grasp of Canada's second official language has become rusty. The facts of the case are as follows.

Taxpayer (G) was a shareholder of a corporation (VCorp). An unrelated purchaser (BW) offered to purchase VCorp in 2002. Prior to the sale, G sold $1 million of his VCorp shares to his spouse (L) on a taxable basis and elected out of subsection 73(1) of the *Income Tax Act* (the *Act*) on the transfer (Purchased Shares). In a second transaction, G gifted $1MM of VCorp shares to L, which occurred on a spousal rollover basis (Gifted Shares) pursuant to the rollover provisions of subsection 73(1) of the *Act*. L then sold the $2 million of VCorp shares to BW. Section 47 of the *Act* operated to average the adjusted cost base (ACB) of these identical properties, with the result that L owned VCorp shares with an ACB equal to $1MM, but a FMV of $2MM. On the sale to BW, $500K of L's capital gain was attributed to G under the attribution rules under subsection 74.2(1) of the *Act*, but $500K remained taxable to her and qualified for the CGD.

The CRA, of course, took umbrage at this course of action and reassessed on the basis that the sale of the Purchased Shares was on account of income (such that the ACB averaging rules did not apply), or in the alternative, the General Anti-Avoidance Rule (GAAR) applied to attribute the entirety of the gain back to G. Jorre J. found that sale of the Gifted Shares was a capital gain to L, but agreed with the Minister that the gain realized on the Purchased Shares (which was zero) was on account of income. Therefore, the entirety of the $1MM capital gain was attributed back to G. Because of this, Jorre J. found that he did not have to examine whether the GAAR applied.

In his judgement, Jorre J. concentrated on distinguishing the Supreme Court of Canada (SCC) decisions in *Irrigation Industries Ltd.* and *Continental Bank* from the facts before him to find that L had embarked on an "adventure or concern in the nature of trade" with respect to the Purchased Shares*.* The SCC had indicated in *Irrigation Industries* that an isolated sale of shares acquired with the intent to resell them for a profit at the earliest possible opportunity would not, without more, give rise to an income gain. Jorre J questioned if the case actually stood for such a broad proposition, and distinguished it from the facts before him. Of concern to practitioners was Jorre J's suggestion that the statement by the SCC in *Irrigation Industries* that shares were generally, by their nature, capital property was outdated in light of the evolution of financial markets in recent years.

Jorre J also considered *Continental Bank.* In a similar "capital transaction," a subsidiary of Continental

Bank had transferred assets to a newly created partnership in exchange for a partnership interest. This interest was subsequently transferred to Continental Bank on a section 88 windup. Despite the fact that Continental Bank sold the partnership interest to a third party only a few days later, the SCC held that the transaction was on account of capital. Jorre J held that the reasoning adopted in *Continental Bank* was not applicable in the *Gervais* case, since the property disposed of had been acquired as part of a taxable transaction rather than a rollover. He also noted that the property disposed in *Continental Bank* had been exchanged by the taxpayer for property it had previously held as capital property. While G had held the VCorp shares he sold to BW as capital property, L had not.

In the FCA's decision of *Gervais*, the court applied the reasoning in the 1995 SCC decision of *Friesen* that in order for there to be an "adventure or concern in the nature of trade" for L on the Purchased Shares, there had to be a reasonable expectation of profit for her. Absent a "profit" for and applying the reasoning in the *Friesen* case, the FCA found that Jorre J. erred in concluding that the transaction gave rise to income. They found his distinction between the *Irrigation Industries* decision and the present case was not justified, and adopted the strong presumption that a sale of shares of a company gives rise to a capital gain at the time of sale of the shares. They also found that the "financial benefit" achieved by the family unit (the reduction of tax on the sale by use of L's CGD), was not a "profit" that would otherwise re-characterize the gain to that of income.

However, the saga is not yet over. After finding the transaction was technically in accordance with the *Act*, the FCA determined that Jorre J. should have analyzed whether the GAAR applied. So the case has been referred back to the Tax Court for a determination if the GAAR applies to the facts of this particular case.

This case is an illustration of the maxim that hard cases sometimes make for bad law. I would think it is reasonable to conclude that Jorre J. found that the half-loaf planning undertaken undermined the attribution rules under the *Act* and sought to achieve a result not consistent with their object and spirit. That he did in a manner that limited and cast doubt on well-established precedents such as *Irrigation Industries* and *Continental Bank*, rather than basing his conclusion on GAAR, which explicitly invites consideration of such factors, is unfortunate. In this case, the FCA clearly got it right by respecting the "capital characterization" cases of *Irrigation Industries* and *Continental Bank*, and determining that the GAAR was a more appropriate tool for examination.

There still may be some legs in this horse yet when it comes to the GAAR. Unlike the convoluted spousal planning in Lipson, where the SCC found that the GAAR applied because of a misuse or abuse of the attribution rules, the "half loaf" relies on the ACB averaging rules in section 47. Attribution actually applies. In the dissenting opinion in *Lipson*, Rothstein J. felt that the specific anti-avoidance provision in subsection 74.5(11) of the *Act* should have taken precedence over the GAAR. In the half-loaf plan, applying subsection 74.5(11) to the facts would prevent any portion of the capital gain realized by L to have been attributed back to G. A serious consideration for the Tax Court in making its "abuse or misuse analysis." Stay tuned…