# Tax Planning in a High Interest Rate Environment

Evan Crocker, CPA
Moodys Tax
Vancouver

Kenneth Keung, CPA, CA, TEP
Moodys Tax
Calgary

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## Introduction

The prescribed interest rates have been low for roughly the past thirteen years, but rates have risen sharply since the third quarter of 2022. At the time of the writing of this paper, the prescribed rate of interest under regulation 4301(a)(i)[1] is 5%. Because of this, anti-avoidance rules that are based on prescribed rates are now potentially much more of an issue. Additionally, the higher prescribed rate and interest yield has various profound impact to tax planning that practitioners should consider. Rather than covering new ground in terms of technical matters, this paper will mostly highlight how the higher interest rate environment raises the importance of or sheds new light to well-known provisions of the Act. The paper will also raise certain policy matters that we hope may be considered by the tax legislators.

## Specific Anti-Avoidance Rules and Other Rules That Become More Taxing As Interest Rate Rises

There are several specific anti-avoidance rules the consequences of which are based on prescribed interest rates, e.g. subsection 74.4(2), section 80.4 and 94.1. There are also some provisions of the Act that become more taxing in a high interest / high yield environment, e.g., accrued interest recognition rules and the AAII grind to the small business deduction. This section of the paper discusses how these rules become more consequential in today's environment and how practitioners should manage them appropriately.

### Subsection 74.4(2) Corporate Attribution

Subsection 74.4(2) is an anti-avoidance rule that targets individuals who transfer or loan property to a corporation with the intention of shifting income to a "designated person". The scope of this provisions starts broadly with an individual having "transferred or lent property, either directly or indirectly, by means of a trust or by any other means whatever, to a corporation", which means that seemingly innocuous transactions could potentially result in the individual being subject to this anti-avoidance provision. However, subsection 74.4(2) might not have been top-of-mind for some practitioners because, despite being called an 'attribution' rule, the consequence of subsection 74.4(2) applying is a deemed interest income inclusion, computed at the prevailing prescribed rate of interest based on the "outstanding amount" which generally is the FMV of the property transferred by the individual to the corporation. As the prescribed rate had historically been low, the financial consequence of being subject to subsection 74.4(2) was not severe. Also, from the authors' experience, there had not been much CRA audit activities around this anti-avoidance provision, further leading to the indifference regarding subsection 74.4(2).

While the recent rise of prescribed interest rate makes the financial consequence of falling into subsection 74.4(2) more adverse than it was previously, another good reason why practitioners should pay more attention to this subsection is because the deemed interest income inclusion could potentially apply in perpetuity and in some cases, the application of this subsection could be incurable.

Generally speaking, subsection 74.4(2) applies for any taxation year of an individual where

- An individual has previously transferred or lent property to a corporation;

[1] All references to section, subsections, etc., are to the *Income Tax Act*, RSC 1985, c.1 (5th Supp.) and its regulations, as amended.

- One of the main purposes of the transfer or loan may reasonably be considered to be to reduce the income of the individual and to benefit directly or indirectly a "designated person" (a designated person is defined in subsection 74.5(5) to include spouse, common-law partner, and non-arm's length minors);
- Throughout the year, the designated person is still a designated person and is a "specified shareholder" of the corporation (the meaning of specified shareholder is narrowed for this purpose to not count shareholding of a non-arm's length person);
- Throughout the year, the individual is a resident of Canada; and
- Throughout the year, the corporation was not a small business corporation.

A frequent example of a transaction that potentially falls within subsection 74.4(2) is an estate freeze, where the freezor individual transferred their existing shareholdings of a corporation to the corporation in exchange for new shares, usually on a tax-deferred basis under either sections 85, 86 or 51. This constitutes a transfer of property by the freezor individual to the corporation. The freezor may argue that none of the main purposes of the estate freeze was to reduce the freezor's future income and to benefit designated persons, but this is hardly a bright line test. Also, while the corporation might be a small business corporation at the time of the freeze, the corporation may fall offside the small business corporation definition in the future, e.g., excess corporate cash build up.

An often-used method to avoid subsection 74.4(2) when implementing an estate freeze is to use a stock dividend to issue the freeze shares equal to the entire FMV of the corporation's net assets to the freezor, thus avoiding a transfer of property by an individual to a corporation. Where there are multiple shareholders, it is very important to be mindful of the subsection 15(1.1) benefit conferral provision whenever a stock dividend is paid. Also, a section 86 or 51 share-for-share exchange of the freezor's common shares into preferred share is sometimes executed subsequent to the stock dividend so that a traditional price adjustment mechanism is in place should the FMV of corporation's net assets be higher than anticipated. While this subsequent share exchange potentially fall into subsection 74.4(2), the consequence of the subsection, if it does apply, is intended to be nominal because the exchanged common shares, and therefore the "outstanding amount" upon which the deemed interest is calculated, are supposed to have a nominal FMV after the stock dividend.

It is possible that a stock dividend freeze may not even be needed in order to avoid subsection 74.4(2) on an estate freeze, as long as there is a proper price adjustment clause and the FMV of the shares are supported by a fair and reasonable valuation. According to the CRA Folio S4-F3-C1, paragraph 1.2 and 1.3, the CRA appears to be suggesting that it would not be applying several anti-avoidance provisions including subsection 74.4(2) where there is a price adjustment clause in place that satisfies the administrative requirements discussed in the Folio, presumably because the CRA would consider the purpose test in subsection 74.4(2) not to be met. However, the CRA's comments in the Folio paragraph 1.2 and 1.3 are not specific to a freeze scenario, so caution should be exercised when relying on these comments.

If an individual is or might be subject to subsection 74.4(2), it is often advisable to pay interest or dividend to the individual in a manner that eliminates the notional interest income inclusion. Generally speaking, the amount of deemed income under subsection 74.4(2) is the excess of the prevailing prescribed interest on the outstanding amount for the year, over interest received by the individual in respect of the transfer or loan, or actual dividend income (deemed dividend under section 84 does not count) received by the individual on shares received from the corporation as consideration for the transfer. For example, if an actual dividend is declared on the shares in an amount that equals or exceeds the prescribed rate, then even though the individual is subject to tax on the dividend received, individual would have actually received cash or property from the corporation (as opposed to being subject to deemed income inclusion with no corresponding corporate value extracted).

Note that due to the definition of “outstanding amount” in subsection 74.4(3) being calculated on the FMV of transferred property at the time of the transfer, certain subsequent transactions could cause subsection 74.4(2) to be incurable, such as where the corporation valuation drops and a refreeze is executed – see discussion by Kakkar, Ghani and Volfovsky.[2]

Another example of accidentally walking into a potentially incurable situation would be where freeze shares are subsequently sold to a Buyco for indebtedness or shares of the Buyco (e.g., on a Bill C-208 transaction where qualified small business corporation shares are sold to a corporation controlled by adult children). The indebtedness or shares of Buyco taken back as consideration is “excluded consideration”, and thus would not reduce the original “outstanding amount” due to the wording in subparagraph 74.4(3)(a)(ii). Since those freeze shares were sold and no longer owned by the individual, dividends can no longer be paid on them to the individual to reduce the deemed interest income inclusion under subsection 74.4(2).

In today’s high prescribed rate environment, practitioners should review historical transactions undertaken by clients to determine if subsection 74.4(2) is an issue, and if so, whether it is possible to pay sufficient dividend or interest to reduce or eliminate the deemed interest amount. When planning a transaction, practitioners should be mindful to avoid the application of subsection 74.4(2) where possible unless the taxpayer is confident of falling outside the purpose test.

Finally, it would appear to the authors that subsection 74.4(2) is an outdated provision. Ever since the broadening of the tax on split income (TOSI) regime of section 120.4 in 2018. The TOSI rules now prevent dividend income from being paid to family members who are inactive in the business of the corporation, so the subsection 74.4(2) regime now appears redundant for the majority of the mischief the provision was meant to target. It would make sense for the Department of Finance to repeal subsection 74.4(2).

## Inclusion of Accrued Interest Income

The Act contains a number of provisions that determine when a taxpayer has to include accrued interest in income. These provisions are sometimes overlooked because the quantum of accrued interest may be insignificant in a low interest rate environment. With interest rates and hence interest income being higher, practitioners should pay more attention to these rules.

Paragraph 12(1)(c) allows the taxpayer to report interest income on either a received or receivable basis depending on the method regularly followed that taxpayer. However, in most cases, paragraph 12(1)(c) is supplanted by subsections 12(3) and (4). Both subsections require recognition of accrued interest income, but they differ in terms of whom the rule applies to and when this forced income recognition is computed.

Subsection 12(3) applies to a corporation, partnership, unit trust or any trust whose beneficiaries include a corporation or partnership. When computing income for for such taxpayers, subsection 12(3)

[2] Manu Kakkar, Alex Ghani, and Boris Volvofsky, "Corporate Attribution: Refreeze May Cause Unsolvable Corporate Attribution Problem" (2018) 18:3 *Tax for the Owner-Manager* 6-7.

requires inclusion into income of the taxation year the amount of interest that accrues to the end of that taxation year, or becomes receivable or is received by the taxpayer before the end of that taxation year (unless the interest was already reported in income for a preceding tax year). This means that, for taxpayers to whom subsection 12(3) applies, accrued interest income needs to be reported even if a debt investment is acquired during a taxation year, irrespective of when entitlement to the interest income legally arises. Subsection 12(3) contains several very narrow exceptions: the subsection does not apply to income bonds and income debentures (these are issued in the insolvency context), net income stabilization accounts (this is an account under the Farm Income Protection Act), and indexed debt obligations (generally speaking these are debts where the amount payable is tied to inflation).[3]

Subsection 12(4) applies to taxpayers whom subsection 12(3) does not apply. In other words, subsection 12(4) applies to individuals and trusts that do not have any corporations or partnerships as beneficiaries. For these taxpayers, subsection 12(4) requires there be included, in computing income, any interest that accrues to the "anniversary day" of an "investment contract", to the extent that interest was not otherwise already included in income for the year or a preceding year. Subsection 12(11) defines these two terms. The beginning of the definition of "investment contract" states that it means any debt obligation, and then provides for a list of exceptions. The most important of these is the exception in paragraph (i) which excludes from investment contract a debt obligation in respect of which the taxpayer has, at least once a year, included the interest accrued on the investment in income throughout the period in which the taxpayer held the debt obligation. Therefore, if the debt obligation already provides for interest to be paid annually or at shorter intervals, then it is not an investment contract and subsection 12(4) would not apply. But otherwise, subsection 12(4) would require accrued interest be reported on each anniversary day, i.e one year after the day immediately preceding the date of issue of the debt obligation contract and every successive one year after that.[4]

Even though a taxpayer may be required to report accrued interest income under either subsections 12(3) or 12(4), if the collection of any portion of such interest is in doubt the taxpayer (including an individual taxpayer) can claim a deduction under paragraph 20(1)(l), or if it ultimately became uncollectible a deduction under paragraph 20(1)(p). Paragraphs 20(1)(l) and (p) are available because the interest amount has been included in the taxpayer's income in computing the taxpayer's income from a business or property.[5]

Another frequently overlooked matter relating to accrued interest on investment contract is T5 filing by the borrower. While the general rule in paragraph 201(1)(b) of the Regulations requires T5 filing upon actual payment of interest, subsection 201(4) of the Regulations contains a special rule for investment contracts. That subsection requires the issuer of a debt obligation, in respect of which subsection 12(4) of the Act applies, to issue T5 in respect of the amount that would, if the calendar year were a taxation year of the debt holder, be included as interest in respect of the debt obligation in computing the debt holder's income for the year. In other words, the T5 would report all interest accrued to each anniversary day.[6] Note that this requirement only applies where the debt obligation is subject to subsection 12(4), and so this requirement to issue T5 for accrued but unpaid interest does not apply to

[3] These terms are all defined in subsection 248(1).
[4] The other exceptions in the definition of "investment contract" are for arrangements where the Act already provides for specialized treatment, e.g., salary deferral arrangement, employee benefit plan, registered plans, etc.
[5] For example, see CRA document #2012-0449671E5.
[6] See CRA document #2014-0519881E5, and CRA T5 Guide T4015.

debt holders who are corporations, partnerships, unit trusts, or any trust of which a corporation or a partnership is a beneficiary.

## Adjusted Aggregate Investment Income (AAII) Grind of the Small Business Deduction (SBD)

Effective for taxation years that begin after 2018, paragraph 125(5.1)(b) reduces the SBD business limit of $500,000 by five times the amount that the preceding year's AAII of the corporation, or of any corporation with which it is associated at any time in the particular tax year, exceeds $50,000. Much has already been written about the computation of the AAII and the mechanics of this SBD reduction, so we will not repeat that here. A high yield and inflationary environment is generally expected to lead to a higher amount of investment income (interest, dividends, rents, taxable capital gains etc.). This in turn will make it easier for investment corporations to reach the $50,000 AAII threshold, hence making this a more prevalent issue for practitioners.

Due to the general rate income pool (GRIP) integration system, a reduced SBD business limit generally should not result in a higher overall tax result on a fully-distributed basis. More corporate income being subject to the general corporate income tax rate as opposed to the SBD tax rate results in a higher GRIP balance, in which provides a greater ability to pay eligible dividends, etc. Also, the AAII income creates non-eligible refundable dividend tax on hand (NERDTOH) that can be refunded by paying sufficient amount of non-eligible taxable dividends.

However, in many cases, it is the corporate cash tax impact, without consideration of the eligible dividend tax advantage, that is relevant to the business owner. This is because many shareholders of a corporation carrying on an active business would rather reinvest the corporate retained earnings than pay them out as dividends. Further, the top marginal tax rate on non-eligible taxable dividend is higher than the NERDTOH refund rate of 38.3% in almost all provinces/territories, making it cash-flow negative to recover NERTDOH where the shareholders are already in the top rate brackets.

Looking at the corporate tax impact of the AAII-grind in isolation (without NERDTOH refund), the marginal tax rate, in Alberta, of earning over $50,000 AAII can be as high as 107%. Here is a breakdown of the math of earning $100 of investment income, such as interest income, assuming the AAII of the associated group is already within the phase-out range of $50,000 to $150,000 and the group has a corporation carrying on an active business that qualifies for the SBD:

- Interest income is aggregate investment income (AII) subject to combined federal and provincial tax rate of 46.7%, so corporate tax of $46.7.
- The interest income is AAII, since $100 of AAII means $500 of active business income being taxed at the combined federal and provincial general corporate tax rate of 23%, instead of the SBD rate of 11%. This means additional corporate tax of 12% x $500 = $60.

For the other major provinces, this marginal rate is even higher given that the spread between their SBD and general corporate rates are larger than Alberta's.

Therefore, where AAII is within the phase-out range of $50,000 to $150,000, there is a significant incentive to reduce AAII where possible. This can be done for example by changing some of the corporate investments to non-income-generating ones. In some cases, business owners have looked to implement arrangements that take investment income out of the corporation's income entirely, such as diverting the corporate funds to corporately-owned exempt life insurance policies, retirement compensation arrangements (RCA) and individual pension plans (IPP). Less drastically, AAII can be managed by ensuring that reasonable expenses have been deducted when reporting the amount of AII on the T2 Schedule 7 of the tax return. AAII is based on AII, and AII is based on "income" from a source that is a property.[7] Income from property, just like income from business, is a profit concept per subsection 9(1). As such, reasonable expenses such as a reasonable portion of the business owner's wages pertaining to their effort in managing the corporation's investment can reduce AII – of course, the quantum of such expenses must also be reasonable to prevent being denied by section 67 (the CRA's administrative policy of not challenging reasonableness of salaries paid to owner-managers does not extend beyond business profits)[8].

In some circumstances, it might be possible to arrange or re-arrange financing so that interest expense reduces AII and AAII, rather than active business income. For example, rather than a corporation borrowing to invest in assets used in its active business, the corporation (or the associated investment corporation) liquidates its investment portfolio and use the proceeds to invest in the business assets. Subsequently, funds can be borrowed to replenish the the investment portfolio. This way, the interest expense should be considered for the purpose of earning income from property, and accordingly reduces AII and AAII. This should be the case even if the active business assets are put up as security or collateral for the borrowing. Note that any planning relating to AAII must consider the anti-avoidance provision contained in subsection 125(5.2).

When the AAII rules were introduced in 2018, it was a low yield environment and back then and a world of high interest and dividend yield seemed to be from a fabled past that shall never return. Now, it is very easy for a CCPC with modest savings to cross into the punitive $50,000 to $150,000 phase-out range. The authors hope that the Department of Finance will consider either raising the $50,000 bottom of the range, or extending the phase-out range like it did with the taxable capital phase-out of the small business limit. Either that, or link that range with the applicable prescribed rate of interest for the relevant period, but the latter would be a much more complicated legislative exercise.

## 80.4 Deemed Interest Income

Closely-held private companies often have shareholder loans in debit position at various times in a year, because shareholders need to access corporate funds for personal expenses or personal investments throughout the year but the salary or dividend remuneration that eliminates these shareholder loan debit balances are done on a sporadic or even annual basis. Since the indebtedness owing by the shareholders are fully repaid before the end of the subsequent taxation year of the lending corporation through this manner, subsection 15(2.6) should prevent subsection 15(2) from applying to deem the loan as income to the borrowing shareholder. However, these periodic repayments do not stop deemed interest income under subsection 80.4(2) from arising.

Generally speaking, subsection 80.4(2) applies at any time a non-corporate person who is a shareholder, or connected to a shareholder, has received a loan from or otherwise incurred a debt to the corporation by virtue of such shareholding. Where the provision applies, the borrower is deemed to have received a taxable benefit equal to a notional amount of interest computed based on the prescribed interest rate applicable for the period during which the debt is outstanding (reduced by actual interest paid by the borrower to the corporation on such debt no later than 30 days after the end of the year). When prescribed rate of interest was low, this was usually an immaterial tax cost, or if section 80.4 benefit was

[7] See definitions of AII and "income" in subsection 129(4).
[8] CRA document #2001-0072825.

not reported at all an immaterial exposure. This is a more significant issue/exposure now that the prescribed rate is 5%.

Fortunately, for corporations that use wages or dividends to fully eliminate shareholder loan debit balances each year, it is generally possible to avoid section 80.4 benefit by proactive management of the timing of such remuneration. This involves ensuring that sufficient wage or dividend payments are made as a credit to the shareholder loan account prior to the shareholder appropriating the corporate funds so that the shareholder loan account does not dip into a debit position during the year. Where the credit to shareholder loan is in the form of a wage, required payroll remittances would usually be due 15th day of the next month – although the wage is not in the form of cash or property, the shareholder employee should generally be considered to have received the amount under the doctrine of constructive receipt on the day it is recorded as a credit to the shareholder loan account. Where the credit is in the form of a dividend, the corporation should contemporaneously make all necessary resolutions and entries in its books and records in order to give proper and legal effect to the dividend. It has been the CRA's longstanding position that dividends, salaries, or bonuses recorded against the shareholder loan account will not be considered "part of a series of loans or other transactions and repayments" for purposes of applying subsection 15(2.6).[9]

If a credit to the shareholder loan is done by way of the shareholder assuming a liability of the corporation, the CRA does not consider this to constitute a "repayment" of a shareholder loan.[10] The authors doubt the correctness of this view, especially where the assumption is supported by contemporaneous legal resolutions and a proper liability assumption agreement is entered into between the corporation and the shareholder (where the consideration is the legal offset of the indebtedness owing by the shareholder). However, even if the CRA is correct in its view in this regard, a shareholder should be able to assume the corporation's liabilities to create a sufficient credit position in the shareholder loan account prior to the shareholder appropriating funds from the corporation. Again, proper resolutions and liability assumption agreement should be executed. Note that the liability assumed by the shareholder should be a liability due to an unrelated third parties, otherwise, subsection 15(2) and 80.4(1) might still apply to the shareholder but on the assumed liability instead.

Where a shareholder borrows funds from the corporation in order to earn income from business or property, e.g., the shareholder borrowed funds to purchase an investment, and section 80.4 applies to deems the shareholder to have received a notional interest benefit, section 80.5 helpfully deems the amount of the section 80.4 benefit to be interest paid by the borrowing shareholder for purpose of paragraph 20(1)(c). In other words, the borrowing shareholder can deduct an amount that completely offsets the section 80.4 benefit if the borrowed money is used to earn income from business or property. Nevertheless, if the borrowing is not repaid within one year after the end of the tax year of the lending corporation as required under subsection 15(2.6), subsection 15(2) will apply to the entire loan amount.

Where subsection 80.4(2) applies and the borrower is a non-resident of Canada, the mechanics in 15(9), 15(1) and paragraph 214(3)(a) triggers Part XIII withholding tax on the interest benefit amount. Finally, note that section 80.4 can also apply to a loan made to an employee – see subsection 80.4(1).

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[9] Paragraph 29 of Archived CRA Bulletin IT-119R4.
[10] CRA document #2013-0482991E5.

## Section 94.1 Offshore Investment Fund Property Rules

The "offshore investment fund property" ("**OIFP**") provisions, contained in section 94.1, collectively, are a specific anti-avoidance provision aimed at reducing any benefit derived by a Canadian investor by investing in offshore funds as opposed to investing in Canadian funds. The OIFP rules were introduced in 1987 to reduce the possible deferral of income tax by investing in offshore funds. This was accomplished by requiring the Canadian resident investor to include in their income, the greater of the actual income received from the OIFP and a notional amount, computed by applying one twelfth of the prescribed rate plus 2 percent multiplied by the tax cost of the investor's interest in the fund at the end of each month. While the prescribed rate was 1 percent, the negative consequences of section 94.1 were quite modest, being 3 percent annually. However, the income inclusion is now 7 percent which is not only a more significant potential tax cost, but it also provides more incentive to the CRA to attempt to apply section 94.1.

The OIFP provisions apply where a taxpayer holds OIFP in a taxation year. For property to be considered OIFP, three conditions, stated in section 94.1, must be met:

1. A taxpayer holds or has an interest in a share of the capital stock of, an interest in, or a debt of, a "non-resident entity"[11] (other than a controlled foreign affiliate) or an interest in or a right or option to acquire such a share, interest, or debt;

2. The property referred to above may reasonably be considered to derive its value, directly or indirectly, primarily from specified portfolio investments which are:

   i. shares of the capital stock of one or more corporations,
   ii. indebtedness or annuities,
   iii. interests in one or more corporations, trusts, partnerships, organizations, funds or entities,
   iv. commodities,
   v. real estate,
   vi. Canadian or foreign resource properties,
   vii. currency of a country other than Canada,
   viii. rights or options to acquire or dispose of any of the foregoing, or
   ix. any combination of the foregoing; and

3. It may reasonably be concluded, having regard to all the circumstances that one of the main reasons for the taxpayer's acquiring, holding or having an interest in the offshore investment fund property was to derive a benefit from portfolio investments in specified assets in such manner that the taxes, if any, on the income, profits and gains from such assets for any particular year are significantly less than the tax that would have been applicable, if the income, profits and gains had been earned directly by the taxpayer.

The first two requirements are usually quite simple to meet as they merely require an investment in a non-resident entity that is not a controlled foreign affiliate, and the investment derives its value from a "portfolio investments". While the term "portfolio investments" is not defined in the Act, it was

[11] Defined in subsection 94.1(2) to mean, *inter alia*, a non-resident corporation.

thoroughly analyzed in *Gerbro Holdings Co v R*[12], ("***Gerbro***") where the court held "*The common thread between the various definitions is that they consider portfolio investments to be investments over which the investor does not exercise significant control, but merely wishes to passively benefit from an appreciation in value.*" Investments in offshore funds in most cases would be considered "portfolio investments" but it should be noted that the shares, debt, or interest in the non-resident entity must primarily derive their value from portfolio investments. As such, when assessing the risk of section 94.1, gaining an understanding of the underlying property of the non-resident entity is recommended.

The final criteria in the application of 94.1 is more nuanced. it is a question of fact whether it is reasonable to conclude that "one of the main reasons" for the investment is to benefit from reduced tax that would have been significantly greater had the taxpayer held the fund investments directly (the "**Purpose Test**"). The leading Canadian jurisprudence with respect to the OIFP provisions is the aforementioned *Gerbro.* The court in *Gerbro* found that the "tax motivated" reasons were ancillary to the main purpose of the offshore investments which were (i) achieving capital preservation, (ii) sufficient investment returns, and (iii) liquidity such that the structure could be dismantled quickly. The facts of the *Gerbro* case that led to the finding that the tax motivations were ancillary to the other purposes included:

- Significant analysis went into the making of each investment;
- The funds' officers/mangers were careful to ensure that the investment guidelines were respected;
- A special business consultant was hired to ensure that optimal funds/investments were selected;
- The funds were highly reputable investment vehicles; and
- There were few comparable funds available in Canada.

The court further found, with respect to the Purpose Test, that a taxpayer's objective must be to achieve a "significant" reduction in/deferral of tax to meet the test. Ostensibly, an investor would achieve a significant deferral of Canadian tax by investing in offshore funds, unless funds distribute their earnings in the year earned, or shortly thereafter.

With respect to the phrase "one of the main reasons" the court in *Gerbro* relied on the following principles:

- A taxpayer's reasons for investing can be disclosed or undisclosed, and the fact that a tax-avoidance reason is undisclosed, as is often the case, does not prevent a court from inferring that such a reason existed[13];
- There can be more than one main reason for investing in a non-resident entity[14];
- The Motive Test is not a *sine qua non* test under which the Court must conclude that tax avoidance was not a main reason for investing if it is convinced that the taxpayer would have invested notwithstanding the absence of any tax benefit[15];

[12] *Gerbro Holdings Co v R*, [2016] 6 C.T.C. 2091 (aff'd 2018 CarswellNat 5999)
[13] *Symes v. R.*[13], [1993] 4 S.C.R. 695 (S.C.C.) at 736
[14] *Groupe Honco inc. c. R.*, 2013 FCA 128, 2014 D.T.C. 5006 (Eng.) (F.C.A.), at paragraph 24, aff'g 2012 TCC 305, 2013 D.T.C. 1032 (Eng.) (T.C.C. [General Procedure])
[15] *Continental Stores Ltd. v. R.*[15] (1978), 79 D.T.C. 5213 (Fed. T.D.) at 5217; *Honeywood Ltd. v. R*., [1981] C.T.C. 38 (T.R.B.); *Jordans Rugs Ltd. v. Minister of National Revenue,* [1969] C.T.C. 445 (Can. Ex. Ct.).

- It is improper to conclude that resulting tax savings automatically lead to the inference that obtaining those tax savings must have been a main reason for investing[16]; and
- Choosing to invest in a non-resident entity when there was the possibility of investing in another vehicle triggering a larger tax liability is not necessarily determinative of a tax benefit main reason[17].

The court's summary finding perhaps best illustrates the standard that Investors should adhere to:

> *"The reasons that Gerbro invested in the Funds were manifold, and can be summarized as follows: 1) To obtain good returns; 2) To reduce the overall volatility of its portfolio; 3) To invest with trustworthy individuals; and 4) To hold liquid investments. These reasons all feed into the overarching bona fide commercial reason for investing, which, according to the evidence, was extremely important for Gerbro. Moreover, the volatility component of the investments was unaffected by the fact that they were made in a low-tax jurisdiction, and this factor was key. Indeed, Gerbro was facing a situation in which it might have to redeem its shares in the Funds at any time (in the event of the death of Ms. Bronfman). In this context, low volatility was an important factor to be considered in the investment decision as it contributed to lowering the risk associated with the investment. That being so, it is not unreasonable to assert that the tax reason that was inferred took a back seat in Gerbro's investment decision and in its continuing decision to hold the investments in the Relevant Period. Obtaining the tax benefit may have been a reason but was not a main reason as it was less important than Gerbro's commercial reason for investing."*

Therefore, to avoid section 94.1, it is paramount that taxpayers have commercial or other non-tax objectives to support that these are the only main reasons for investing in a particular offshore fund and that any tax motivated reason are ancillary to the non-tax main reasons. If the taxpayer would invest in offshore fund regardless of the tax deferral benefit, then the argument becomes compelling that the Purpose Test is not met.

As mentioned above, there had been greater CRA audit activities around section 94.1, and this will likely continue into the future given the increased prescribed rates. Increased vigilance is recommended.

## Amounts Owing by Non-Residents

Section 17 contains provisions that imputes interest income to a Canadian resident corporation that has an outstanding loan to a non-resident, the loan has been outstanding for more than a year, and that has no interest or below regulation 4301(c) prescribed rate interest. Similar to the income inclusion provision in section 94.1, the deemed income is calculated as the prescribed rate (no additional 2% however) and is reduced by income included in the corporation's income in connection with the loan. The deemed income is not applicable if the exception in subsection 17(8) is met. That subsection generally applies if the borrower is a controlled foreign affiliate of the lender entity, and the borrowed funds are used for the purpose of earning income from an active business of the affiliate. Also, if subsection 15(2) has applied to the loan amount, section 17 does not apply because of subsection 17(7).

With an increased prescribed rate, an income inclusion under section 17 is more problematic than before. If any amounts are going to be owed to a Canadian resident corporation for greater than a year, it is prudent, unless the exception in subsection 17(8) is met, to charge at least the prescribed rate of

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[16] *Installations de l'Est Inc. v. Minister of National Revenue*, [1990] 2 C.T.C. 503 (Fed. T.D.), at 509-10; *Saratoga Building Corp. v. Minister of National Revenue*, [1993] 2 C.T.C. 2074 (T.C.C.), at 2086

[17] *Alpine Furniture Co. v. Minister of National Revenue* (1968), 68 D.T.C. 5338 (Can. Ex. Ct.), at 5345

interest (and be updated as necessary) on the indebtedness. Note that even charging the prescribed rate of interest is not sufficient where that rate is less than what persons dealing at arm's length would reasonably have charged. As confirmed by subsection 247(2.1) enacted for tax years beginning after March 18, 2019, section 247 transfer pricing rules take precedence over other provisions of the Act. Therefore, the interest rate charged would need to be at least a rate that meets Canada's transfer pricing requirements, supported by proper contemporaneous transfer pricing documentation. Section 247 does have an analogous exception to the subsection 17(8) contained in subsection 247(7).

The adverse implication of subsection 17(1) also rears its head upon non-payment of the loan. A recent Tax Court of Canada decision, *K & D Logging Ltd. v. The King*[18], provided that where income is included pursuant to subsection 17(1), if the loan is later settled for less than its full amount, then there is no subsection 20(21) deduction for the imputed income. The case is very interesting as it highlights the importance of documentation. The taxpayer argued that the loan was interest bearing, however based on the lack of evidence to support this claim, the judge held that the income inclusion was not accrued interest, rather it was imputed subsection 17(1) income. Further, even if the loan had been interest bearing, the repayment terms of the loan stated that any payment insufficient to cover the full amount owing would be applied as follows: i) fees and expenses, ii) overdue payments and interest thereon, iii) interest, and iv) principal. Therefore, the partial repayment of the loan would have first reduced any interest and thus a subsection 20(21) deduction would not have been available.

Finally, note that where subsection 17(1) applies, Part XIII withholding tax would often also apply due to the imposition of deemed interest benefit under section 80.4(2).

The key takeaway for practitioners is that loans should be properly documented, charge the higher of the prescribed rate of interest or the arm's length interest rate, and potentially have repayment terms that prioritize principal repayments over unpaid interest, although there may be commercial reasons to prioritize interest payment.

# Higher Prescribed Rate Increasing The Cost Of Taking Aggressive Tax Positions

## Computation of CRA Arrears Interest

According to Regulations paragraph 4301(a), every provision of the Act that requires interest at a prescribed rate to be paid to the CRA, the prescribed rate is the subparagraph 4301(a)(i) base prescribed rate (i.e., the rounded average equivalent yield of three-month Government of Canada Treasury Bills) plus 4 per cent. For Q2 2023, this equates to a rate of 9%. To highlight how significant a change this is, the paragraph 4301(a) rate had been 5% for most of the thirteen years from April 2009 to August 2022, with some quarters occasionally rising to 6%.

To illustrate the impact of a 9% arrears interest rate, here is a numerical example of a taxpayer whose 2023 income is subsequently reassessed by the CRA. To simplify the assumptions, this example assumes the prescribed rate of interest will remain unchanged going forward:

- Canco is a CCPC and its tax year end is December 31, 2023 taxation year end. Its taxable income, together with associated corporations, was less than $500,000, so its "balance-due day" as

[18] *K & D Logging Ltd. v. The King*, 2023 CarswellNat 407, 2023 TCC 23, [2023] 3 C.T.C. 2076

defined in subsection 248(1) for its 2023 tax year is March 31, 2024. It timely paid its 2023 tax owing and timely filed its T2 corporate income tax return.

- Shortly before the end of the normal reassessment period in 2027, Canco is reassessed by the CRA for $100,000 of additional Part I tax payable. Canco is not reassessed any penalties.
- Canco goes through the objection and appeals process. On March 31, 2029, Canco was ultimately unsuccessful in its appeal efforts and is now faced with the outstanding tax liability.

Pursuant to subsection 161(1), arrears interest on outstanding Part I income tax liability starts to accrue from the balance-due day for the taxation year. In this case, March 31, 2024. This arrears interest, according to subsection 248(11), is compounded on a daily basis. As a result, the $100,000 tax liability becomes $156,822 after arrears interest as of March 31, 2029 (five years of compounding interest at 9%). In comparison, if the arrears interest rate was 5% for the entire period, like it had been prior to the third quarter of 2022, the $100,000 of tax liability would have become $128,400. This increased of arrears interest from from 5% to 9% has caused the arrears interest to double from $28,400 to $56,822. This arrears interest is not tax deductible as per subparagraph 18(1)(t)(i).

The illustration assumed the CRA has not assessed any gross negligence or other penalties. If there were, subsection 161(11) imposes the arrears interest on the penalty as well. The increased tax payable for the 2023 taxation year also increases the instalment base of the subsequent year, resulting in potential under-instalment penalties and interest for the subsequent year.

Note that if a corporation is subject to arrears interest payable in respect of a tax year, but concurrently over the same period the corporation is accruing refund interest receivable in respect of a different tax year, the corporation can apply to the Minister under section 161.1 to offset the overpayment of tax against the underpayment of tax for interest calculation purposes. This offset is achieved by reallocating the refund amount as if it were a payment against the arrears amount. This result improves fairness because (1) arrears interest under Regulations 4301(a) is 2% higher than the corporate refund interest rate under Regulations 4301(b)(ii), and (2) refund interest is taxable under paragraph 12(1)(c) on overpayment while arrears interest is not deductible per subparagraph 18(1)(t)(i). A request under section 161.1 must be made within the time limits set out in paragraph 161.1(3)(c).

## A Significant Increase to the “Cost” of Taking Aggressive Tax Position

When a business owner is presented with a tax plan or a tax filing position that results in a reduction or deferral of tax payable compared to a more conservative alternative, they should be weighing the benefit of this tax saving or deferral against the likelihood of the CRA successfully challenging said plan or position and the resulting consequences, such as:

- If the CRA reassesses the plan or position, would the reassessed tax payable be the same as the tax that would have been payable under the conservative alternative or would it be worse? For example, claiming the capital gain deduction on a sale to a purchaser corporation, which if the CRA later finds to be not dealing at arm’s length with the seller would lead to the CRA applying section 84.1 where not only the capital gain deduction would be denied but the gain would also be recharacterized as a dividend;
- The arrears interest that applies to the under-reported tax;
- The possibility and amount of penalties, such as the gross negligence penalty under subsection 163(2);
- The professional fees and time needed to deal with the CRA audit and objection process, and potentially the cost of taking the matter to the Courts;

- Reputational risk, particularly for high profile public companies.

For a business owner that, otherwise, would have to incur high interest or financing costs to obtain cash needed to run or expand their business, taking, a technically sound but aggressive, tax plan or tax position, to reduce immediate tax payable might sometimes be a financially logical decision – essentially viewing the CRA as a cheap source of financing even if the taxpayer were to be successfully reassessed by the CRA down the road (taking the reasonable gamble that no gross negligence penalty should apply if a position is technically sound, but only failed upon a GAAR challenge; especially where the particular GAAR issue had never been tested in Court). However, as illustrated in the numerical example above, the higher prescribed interest rate is making this much less the case than before; but the higher interest rate is not the only driver behind this trend towards conservatism in tax planning. The 2023 federal budget proposing to introduce a GAAR penalty equal to 25% of the tax benefit and to extend the normal reassessment period for three additional years to give effect to GAAR reassessments, as well as the proposed mandatory disclosure rules that are in Bill C-47 which passed second reading in the House of Commons on May 2, 2023, all serve to dial back the willingness of taxpayers to risk a CRA reassessment.

## Overpay or Accelerate Tax Payment to Earn Refund Interest from CRA?

Pursuant to paragraph 4301(b) of the Regulations, where the Act requires prescribed interest rate to be applied to an amount payable by the Minister to a taxpayer, the rate shall be the subparagraph 4301(a)(i) base prescribed rate (i.e. the rounded average equivalent yield of three-month Government of Canada Treasury Bills) plus, 0% for corporate taxpayer, and 2% for non-corporate taxpayer. For the second quarter of 2023, this means refund interest rate at 5% for corporate taxpayer and 7% for non-corporate taxpayer. This interest is also compounded daily according to subsection 248(11). On a quick survey of publicly-available investment vehicles in the market place, there are very few that yields a guaranteed 7% yield. Most major banks' GIC products are offering less than 5% interest return. At first glance, the CRA now appears to be one of the best investment vehicles out there especially for non-corporate taxpayer given the 7% rate and the financial backing of the entire federal government, but can a taxpayer simply overpay or accelerate tax payment to profit off this?

Section 164 deals with the overpayment of income tax and its refund by the Minister, and subsection 164(3) provides that the prescribed rate of interest is payable by the Minister on amounts refunded or repaid to a taxpayer or applied to another liability of the taxpayer. However, subsection 164(3) stipulates that interest computation does not commence until the latest of the following dates:

(a) For an individual taxpayer, the day that is 30 days after the individual's balance-due day;
(b) For a corporate taxpayer, the day that is 120 days after the end of its taxation year;
(c) For an individual taxpayer, the day that is 30 days after the filing of the T1 return; for a corporate taxpayer, the day that is 30 days after the filing of the T2 return (unless the T2 return was filed on or before its filing-due date for the year);
(d) In the case of a refund of an overpayment, the day the overpayment arose; and
(e) In the case of a repayment of an amount in controversy, the day where an overpayment equal to the repayment would have arisen if the amount payable for the year were the the amount paid or assessed (which is the lesser) less the amount repaid.

"Balance-due day" is defined in subsection 248(1). For an individual who is alive, the balance-due day is April 30$^{th}$ of the following year, the same day as the tax return filing due date unless the individual (or their spouse) is self-employed. Therefore, if an individual were to deposit a sum of money to their CRA income tax account, in excess of the tax owing for the year, no refund interest would be computed until

May 30th of the subsequent year at the earliest. In most cases, the CRA would already have assessed the individual's T1 return for the previous year and refunded the overpayment before then, so no or nominal refund interest would be earned. For corporate taxpayers, their balance-due day per subsection 248(1) is either two months or three months after the taxation year ended depending on the status of the corporation. However, because corporate taxpayers' refund interest will be begin based on the later of 120 days after the end of its taxation year and its T2 return filing date (assuming it files on or before its filing-due day which is six months after the end of the taxation year), refund interest will apply at most for several month assuming the CRA assesses the T2 return quickly.

What if a taxpayer simply makes a payment to the CRA in respect of a historical year? In that case, refund interest should start accruing right away, since that payment date should then be the 'latest' of the dates in paragraphs (a) to (e) of subsection 164(3). However, the CRA administrative policy since September 2010 had been that the CRA would only hold such deposits (submitted via Form RC159) if there is a risk of a reassessment for that historical year and the amount deposited was reasonable. The CRA stated that they regularly review these deposits and will refund them to the taxpayer if they are not satisfied that there is a risk of reassessment or if the amount deposited exceeded what was reasonable to cover that potential reassessment[19].

In summary, it is seldom possible to earn CRA refund interest for any material length of time by intentionally accelerating or overpaying amounts to the CRA. Most refund interest from CRA would likely be earned when a taxpayer makes an advance deposit relating to and not exceeding a genuinely anticipated reassessment or makes a payment in respect of an actual reassessment, and later became successful in avoiding or reversing such reassessment. Given the punitively high arrears interest rate, more taxpayers are opting to pay the CRA the maximum potential tax liability whenever there is a CRA reassessment or CRA audit adjustment proposal. Doing so, not only minimizes arrears interest if the reassessment is sustained, but if the reassessment is reversed or avoided the payment made would generate refund interest at today's desirable rate under paragraph 4301(b) of the Regulations.

Note, where there is refund interest earned, the interest must be included in the income of the taxpayer pursuant to paragraph 12(1)(c).

## Planning Implications

Higher interest rates have far reaching implications when it comes to tax planning. Below are some of the tax considerations that planners should have top of mind when clients are undertaking various transactions, tax motivated or not.

### Protecting Interest Deductions

As interest rates become more significant, tax advisors should increase their attention to the formalities, as they pertain to interest, of the transactions that are implemented. It becomes more important to protect the deductibility of interest pursuant to paragraphs 20(1)(c) and (d). For instance, in the case of

[19] CRA Fact Sheet: https://www.canada.ca/en/revenue-agency/news/whats-new/fact-sheet-making-managing-advance-deposits.html and CRA Questions and answers: https://www.canada.ca/en/revenue-agency/news/whats-new/questions-answers-advance-deposits.html.

paragraph 20(1)(d), which provides for the deductibility of compound interest (i.e., interest incurred on accrued interest), the compound interest may only be deducted (assuming the underlying interest is deductible pursuant to subsection 20(1)(c)) in the year it is paid. Contrast with paragraph 20(1)(c), which allows interest that is paid or payable to be deducted. However, it should also be noted that non-arm's length interest must eventually be paid to remain deductible. Pursuant to subsection 78(1), an expense owing to a non-arm's length person must be paid by the end to the second taxation year following the taxation year in which the expense arose, unless a joint election under paragraph 78(1)(b) is filed to treat the amount as paid and loaned back.

Absent paragraph 20(1)(c), interest on a capital debt is generally considered to be a capital expenditure and thus disallowed pursuant to paragraph 18(1)(b). It is therefore important, where possible, to ensure that interest paid or payable meets the requirements of paragraph 20(1)(c). Paragraph 20(1)(c) has had much discussion and another review is not the subject of this paper[20]. However, as interest becomes more prominent, proper documentation of legal obligations that sets out a clear lender-borrower relationship between the parties can greatly assist in a defense of the tax authority's questioning of interest deductions. It is also recommended that comfort is attained on the reasonableness of the interest rate charged on related party debts. As noted in the post-amble of paragraph 20(1)(c), interest deduction is limited to a "reasonable amount".

Care must also be taken to ensure there is an income earning purpose and use of the borrowed money. Many readers will be familiar with the *Singleton*[21] case, where a taxpayer received a capital distribution from his firm, used the proceeds to purchase a home in his wife's name, then took out a loan and repaid his capital account in his firm. The court held that there was a direct eligible use of the loan and that the taxpayer was entitled to deduct the interest. Where plans are structured in the attempt to rely on paragraph 20(1)(c), express intentions of the use of the funds for a qualifying purpose and the actual traced use of the funds for that purpose should be documented contemporaneously where possible.

## 164(6) Loss CarryBack Planning and Arrears Interest

A common post-mortem planning tool is the subsection 164(6) election. This subsection allows a graduated rate estate ("GRE") to make an election to deem the amount of capital losses (in excess of capital gains) realized within the GRE's first taxation year to be capital loss in the deceased taxpayer's T1 terminal income tax return instead. Subsection 164(6) is often used when the deceased owns shares in a private corporation: the capital gain realized upon death on the shares bumps up the shares' ACB which can be realized as a capital loss for subsection 164(6) purposes on a redemption of the shares by the estate, within its first taxation year.

Although the subsection 164(6) allows the capital loss to offset the deemed capital gain in the terminal T1 tax return so that the ultimate income tax payable on the deemed capital gain is reduced or eliminated, the effect of this capital loss offset on arrears interest computation is not reflected until a

[20] The authors recommend Balaji Katlai and Bhuvana Rai, "Revisiting Interest Deductibility Rules in the Modern Era," in 2022 Prairie Provinces Tax Conference, (Toronto: Canadian Tax Foundation, 2022), 8: 1-36, as a recent paper from this conference.

[21] *Singleton v. R.*, 2001 CarswellNat 2019, 2001 SCC 61, 2001 D.T.C. 5533 (Eng.), 2001 D.T.C. 5545 (Fr.), 275 N.R. 133, 204 D.L.R. (4th) 564, [2002] 1 C.T.C. 121, 2001 CarswellNat 2020, [2001] 2 S.C.R. 1046, [2001] S.C.J. No. 59, REJB 2001-25874, 2001 CSC 61, [2001] 3 F.C. ix

statutorily determined date. According to the computation of interest rules in paragraph 161(7)(b), the effect of a subsection 164(6) capital loss will not take effect until 30 days after the latest of:

(i) The first day immediately following the first taxation year of the GRE;
(ii) The day on which the GRE's first taxation year T3 return is filed;
(iii) The day on which the amended terminal T1 return reflecting the deemed capital loss pursuant to the subsection 164(6) election is filed; and
(iv) The filing of the written request to elect under subsection 164(6) is filed.

Because the rule refers to 30 days after the "latest of" the four dates, arrears interest will be unavoidable. When a taxpayer passes away during a calendar year, the original and amended terminal T1 return cannot be filed until the CRA releases the year's T1 return in the subsequent year. Also, The CRA's administrative policy is that the GRE's T3 return must be assessed before the reassessment giving effect to a subsection 164(6) election can be processed.[22] Therefore, the only way to avoid arrears interest with respect to 164(6) planning is to fully pay the income tax owing on or before the balance-due day for the original terminal T1 return based on the capital gain amount that is before the application of the deemed 164(6) capital loss, and then wait for the refund after the CRA processes the election and the amended terminal T1 return. In that case, the refund interest should apply in favour of the estate starting from the same "latest" day as set out in paragraph 161(7)(b).[23]

In some cases, it might be difficult for the GRE to come up with sufficient cash to make this tax payment and it might be stuck with arrears interest applying. This might be a nominal issue when prescribed rate is low, but with arrears interest at 9%, this has become an important issue to highlight to clients on subsection 164(6) post-mortem planning. The authors understand that the way that the arrears interest computation works with subsection 164(6) is consistent with the other loss carryback provisions, but hopefully the Department of Finance can consider amending either paragraph 161(7)(b) or the mechanics behind the filing of the 164(6) election and the amendment of the terminal T1 return to alleviate this issue for GREs.

## Loss Consolidation Planning

Loss consolidation and utilization is one of the most common planning objectives for Canadian taxpayers. The lack of consolidated filing in Canada requires taxpayers to undertake various transactions to attempt to achieve a consolidated tax position. Fortunately, there has been an ongoing shift in tax and administration policy that has resulted in the acceptance of certain loss consolidation transactions. With the increase in interest rates perhaps the losses can be consolidated more expeditiously.

Loss consolidation transactions may take many forms, including:

1. Inter-group charges (i.e., management fees)
2. Amalgamations and Wind-ups
3. Transfer of a profitable business to lossco
4. Transfer of appreciated assets to lossco followed by subsequent sale
5. Lossco leasing assets to profitcos
6. Transfer/sale of assets from lossco for interest bearing debt
7. Loss "transfer" planning

[22] CRA document #2020-0852161C6.
[23] CRA document #2022-0929381C6.

Where clients/businesses have an entity earning significant profit and another entity incurring losses or expected to operate in a loss position, loss consolidation planning can be very beneficial.

## Inter-group leases and transfers:

As interest rates climb, leasing rates typically increase in step. A corporation ("Profitco") with operating assets (tangible or intangible) can be transferred on a tax deferred basis, pursuant to subsection 85(1), to a related/affiliated corporation with non-capital losses ("Lossco"). Lossco would subsequently lease the assets, received on the subsection 85(1) transfer, back to Profitco. The rent or lease fees charged by Lossco must be on arm's length or fair market value terms, but the current higher interest rate environment should justify a reasonable leasing rate that is higher than previously possible allowing for quicker utilization of Lossco's non-capital losses. The CRA has stated that this type of planning should not run afoul of the general anti-avoidance rule (the "**GAAR**"), per paragraph 8 of IC88-2.

Commercial realities also need to be considered with respect to the transfer of business assets. For instance, if Lossco is exposed to known or potential creditors, it may be prudent to consider other forms of loss consolidation.

Another relatively straightforward method of loss consolidation is a sale of assets of Lossco to Profitco with Lossco taking back an interest-bearing note. If it is desirable to rely on subsection 85(1) to defer capital gain or to protectively lock in the amount of proceeds, Lossco would also take back some share consideration from Profitco (being mindful of corporate law limitations, i.e., another entity may be required to hold shares of Profitco if Lossco is a subsidiary of Profitco). The interest bearing promissory note generates interest income in Lossco that is sheltered by Lossco's losses, while Profitco benefits from deducting the interest payable to Lossco, provided Profitco acquired the property for the purpose of gaining or producing income from the property or a business pursuant to subparagraph 20(1)(c)(ii). The current higher interest rate environment should help justify a higher interest rate on the promissory note than would have been possible in the past.

## Selecting the correct entity for debt financing

As interest rates rise, greater emphasis should be placed on which entity in the group should be the debtor on a financing arrangement in order to maximize the benefit of the interest deduction. For instance, if a profitable corporation has a subsidiary which has historically incurred losses and requires outside financing it may be best for the parent to receive the loan from the financing institution and use the loan proceeds to subscribe for additional shares or contribute to the capital of the subsidiary. The parent in this situation should receive an interest deduction as the loan proceeds are used, ostensibly, for the purpose of gaining income in the form of dividends from the subsidiary in the future. The CRA has indicated that this type of structuring is acceptable from a GAAR perspective, per paragraph 19 of IC88-2.

## Other interest focused loss transfer plans

Loss transfer planning can take various forms and typically can only be utilized within related and/or affiliated groups given the various loss trading restrictions (most notably subsection 111(5)) and general policy against loss trading (see *OSFC Holdings Ltd. V. Canada*, 2001 FCA 260, at paragraph 98). The general idea is similar to the discussion above, to create an interest deduction in Profitco and an interest inclusion in Lossco.

Where Profitco is a subsidiary of Lossco, Profitco could redeem a portion of its shares and issue an interest-bearing promissory note to Lossco. The interest should be deductible to Profitco as it is a similar transaction to the "filling the hole" concept introduced in *Trans-Prairie Pipelines v MNR*[24]. Note however that the interest would only be deductible to the extent that Profitco has sufficient contributed capital and accumulated profits. A promissory note issued as consideration is not "borrowed money", so Profitco would not be entitled to an interest deduction pursuant to subparagraph 20(1)(c)(i). However, in *Penn Ventilator*[25] the court found that a note issued on the redemption replaced the paid-up capital and retained earnings that were used in operating the business, which constituted an acquisition of property for the purpose of gaining or producing income from a business or property and thus allowed the interest to be deducted pursuant to subparagraph 20(1)(c)(ii)

"Debt-share loops" are another set of transactions where losses can be consolidated. These transactions typically use a "daylight loan" from a financial institution to cycle funds in such a manner that results in Lossco earning interest income and Profitco being able to deduct the interest. Where Profitco is the parent of Lossco, Profitco could take out a daylight loan to fund a subscription for shares of Lossco. Lossco would use the subscription proceeds to make a loan to Profitco at a commercial rate of interest, Profitco would then use the loan proceeds to repay the daylight loan. The result is Lossco earning interest income and Profitco being able to deduct the interest expense.

Where Lossco is the parent corporation of Profitco, similar transactions can be undertaken to generate the desired results. Assuming that a subsidiary holding shares of its parent is not permitted in the relevant jurisdictions the following transactions could be undertaken[26]:

1. Lossco forms a new subsidiary corporation ("Newco")
2. Lossco takes out a daylight loan
3. Lossco makes an interest-bearing loan to Profitco at a commercial rate of interest
4. Profitco subscribes for preferred shares of Newco (note the preferred shares should yield a dividend at a rate that exceeds the interest rate on the loan to provide support for interest deductibility, care should be taken to ensure that Profitco and Newco are connected)
5. Newco makes a non-interest bearing loan to Lossco
6. Lossco repays the daylight loan

The annual operation of the "debt-share loop" is as important as the initial set-up. As Newco's only asset is a non-interest bearing promissory note it would be possible to argue that it has no ability to fund its dividend payment requirements which jeopardizes Profitco's deductibility of the interest (i.e., the shares weren't acquired for the purpose of producing income). Therefore, on an annual basis, Lossco should make capital contributions (for no additional shares and no increase in stated capital[27]) to Newco who uses the contributions to fund its dividend payment obligation to Profitco (which should be deductible

[24] 1970 CarswellNat 280, [1970] C.T.C. 537, 70 D.T.C. 6351
[25] *Penn Ventilator Canada Ltd v R,* [2002] 2 C.T.C. 2636 (TCC)
[26] CRA has issued many favourable tax rulings with respect to debt-share loops. See 2018-0787361R3, 2016-0673141R3, and 2020-0871841R3, among others.
[27] Many advance tax ruling requests contain this caveat, presumably to satisfy corporate law restrictions of dividend payments and/or to ensure no tax attributes are created.

pursuant to subsection 112(1)[28]). Profitco then uses its dividend payment to fund the interest payment to Lossco.

The CRA has provided that in this context subsection 55(2) should not apply to recharacterize the dividends as capital gains where any ACB that is created(e.g. on the preferred share subscription or the capital contributions) is eliminated on the unwinding of the structure (i.e. through the redemption ofthe preferred shares and wind-up of Newco). This is because the dividends do not meet the purpose test in subsection 55(2.1), which requires one of the purposes of the payment or receipt of the dividend to be to effect a significant reduction in the FMV of any share or significant increase in the cost of property of the dividend recipient immediately after the dividend. In this context, the purpose of the dividends is simply to consolidate losses within a corporate group.

These transactions yield the sought after result of Profitco incurring deductible interest expense and Lossco earning interest income which should be offset by its non-capital losses.

The "debt-share loop" transactions have been scrutinized by the CRA who have indicated that these types of transactions within related/affiliated groups are generally acceptable, however the transactions must be legally effective, the interest must be paid for the purpose of earning income (i.e., very important that the interest is deductible pursuant to paragraph 20(1)(c)) which, in the CRA's view, requires that there be a positive spread on the dividend yield compared to the interest expense[29], and that the amount of the daylight loan must not exceed the amount that Lossco could borrow for use in its business on its credit (from Paragraph 5 of the IC88-2 supplement 1, which also implies that these facts would result in the GAAR not being applied)[30].

The final requirement of the debt share loops, i.e. the amount of the loan must be an amount that Lossco could borrow on its own, is particularly interesting in the high interest rate environment. As interest rates rise, it would be expected that the debt capacity of corporations would decrease. Therefore, it is possible that the ability to expedite the use of losses through use of higher interest rates in debt-share loops may be mitigated by the lower debt capacity.

## High interest rates and the Canadian tax base

As interest rates rise, there is increased opportunity for international corporate groups to reduce group income subject to tax in Canada through interest charges (note the loss consolidation transactions discussed above typically are not available in cross-border situations). This section reviews the some of the limitation in the Act with respect to interest and protecting the Canadian tax base.

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[28] Note that subsection 55(2) is also a concern with the dividend payments as Newco likely will not have sufficient safe income. The CRA has provided many rulings where it is stated that subsection 55(2) will not apply, presumably this is due to an assertion that any ACB created from the capital contributions or preferred share subscription will disappear upon unwinding the structure. As such the purpose of the dividend should not be significantly decrease the amount of a gain that would otherwise be realized on the shares or to increase the cost of property of the dividend recipient (subsection 55(2.1)).
[29] Income Tax Folio S3-F6-C1, Interest Deductibility at para 1.73.
[30] For a more in-depth discussion of debt-share loops, see: Joshua Morry, "Interest Deductibility and Interest Inclusion," in 2021 YP Focus Virtual Conference (Toronto: Canadian Tax Foundation, 2021), 5: 1-67.

## Thin Capitalization

Thin capitalization used to be the first provision that came to mind with respect to cross-border financing. This honour now belongs to the proposed excessive interest and financing expense limitation ("**EIFEL**") regime which will be discussed below. Prior to EIFEL, subsection 18(4) to (8) were the primary defense to base erosion and profit shifting. Introduced in 1972, the thin capitalization rules currently deny a portion of interest deductions of a corporation with interest paid or payable to specified non-residents where the Canadian corporate taxpayer's debt-to-equity ratio exceeds 1.5:1. The portion of the interest denied, is denied permanently and is deemed to be a dividend pursuant to subparagraph 214(16)(a)(i) and thus subject to 25% withholding tax pursuant to 212(2) (unless reduced by a treaty).

As interest rates increase, the impact of the thin capitalization rules increases and thus increases the potential withholding tax that must be paid to Canada and results in increased income subject to Canadian tax.

Advisors and taxpayers are advised to ensure their thin capitalization calculations are monitored more closely in the high interest rate environment and, subject to EIFEL, to maximize the specified non-resident debt financing of a Canadian corporation to the permitted 1.5:1 ratio to reduce Canadian taxation (assuming the parent is in a lower tax jurisdiction). The rate of interest cannot exceed an arm's length rate, and generally should be supported by transfer pricing documentation.

## EIFEL

The proposed EIFEL regime, announced in the 2021 budget on April 19, 2021 with initial draft legislation released on February 4, 2022, and revised legislation released on November 3, 2022, is primarily contained in subsections 18.2 and 18.21 is expected to be enacted and applicable to taxation years beginning on or after October 1, 2023 and are limited to corporations and trusts. Generally, EIFEL will limit interest and financing expenses to 30% (40% for taxation years beginning on or after October 1, 2023, and before January 1, 2024) of "tax EBITDA". The EIFEL rules are intended to address BEPS Action 4: *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*. The rules are still in draft and therefore subject to change; however this paper will discuss the legislation as currently drafted and how the increased interest rates impact the EIFEL rules.

Subsection 18.2(2) contains the primary provision of the EIFEL rules and it states that a corporation or trust that is not an "excluded entity" (defined in subsection 18.2(1)) may not deduct greater than 30% of its "tax EBITDA". The calculation of "tax EBITDA" is quite detailed and beyond the scope of this paper[31]. Qualifying taxpayers may choose to use the "group ratio" method, which may provide for a better result than the default 30% ratio, but the group ratio method is only available where the group prepares audited consolidated financial statements. In the authors' experience, most private businesses will not meet this requirement due to the prohibitive cost and expense of a financial statement audit. Interest denied under the EIFEL rules may be carried forward (as a new tax pool known as "restricted interest and financing expenses") and deducted when excess capacity is available.

[31] For detailed discussion of the EIFEL rules refer to Eivan Sulaiman and Janette Pantry, "A Primer on the Excessive Interest and Financing Expenses Limitation," in 2022 British Columbia Tax Conference, (Toronto: Canadian Tax Foundation, 2022), 5: 1-64.

One of the most significant impacts of the higher interest rates is the impact to the "*de minimis*" exception in paragraph (b) of the definition of excluded entity in subsection 18.2(1). Generally, corporations are exempt from the EIFEL rules if net interest and finance expenses of the taxpayer and other eligible group entities [defined in subsection 18.2(1) as generally a Canadian resident corporation or trust that is related or affiliated (excluding de facto control defined in subsection 251.1(3), a trust which the taxpayer is a discretionary beneficiary, or a discretionary beneficiary if the taxpayer is a trust] are less than $1,000,000, excluding interest and financing revenues of any financial institution that is a group entity. With the increase in interest rates this $1,000,000 dollar threshold can be crossed with much lower levels of debt. For example, a $33,000,000 loan would result in $1,000,000 of interest expense at a 3% interest rate, whereas ~$14,000,000 at 7% would result in the same $1,000,000 interest expense. Therefore, the EIFEL rules will apply to more taxpayers due to the increased interest rates.

A corporate group having interest and financing expenses in excess of $1,000,000 does not automatically mean that the EIFEL regime becomes applicable. The other excluded entity exceptions should also be considered: the "small CCPC exception" and the "domestic exception" which are paragraphs (a) and (c) of subsection 18.2(1) respectively.

The small CCPC exception applies to a corporation that was throughout the particular year a CCPC in respect of which the amount determined for C in paragraph 125(5.1)(a) for the year is less than $50,000,000 (i.e., taxable capital employed in Canada is less than $50,000,000).

The domestic exception generally requires all of the below:

i. All or substantially all of the business, undertakings and activities of the taxpayer and each eligible group entity to be carried on in Canada,
ii. The greater of (a) all balance sheet share amounts (using Canadian GAAP) of all foreign affiliates of the taxpayer and eligible group entities or (b) the total fair market values of all property of all foreign affiliates of the taxpayer and eligible group entities being less than $5,000,000,
iii. No person or partnership, at any time in the particular year, is a non-resident "specified shareholder" or "specified beneficiary" (as defined in subsection 18(5), generally holding more than 25% votes or value) of the taxpayer or any eligible group entity, and
iv. All or substantially all of the interest and financing expenses of the taxpayer and any eligible group entity are paid or payable to persons or partnerships who are not tax-indifferent investors (defined in subsection 248(1), generally tax-exempts, non-residents, and discretionary trusts) that do not deal at arm's length with the taxpayer or any eligible group entity.

As interest rates rise, the impact of the EIFEL rules become more prominent, not only from the perspective of the $1,000,000 exemption, but also the fact that increases in interest expenses make it much more likely that that the interest and financing expenses of a taxpayer exceed the 30% of "tax EBITDA" capacity threshold. In some cases, a taxpayer might be able to make slight adjustments to their business or structure to stay within the 'domestic exception' so as to prevent the EIFEL rules from applying. Otherwise, it may be worthwhile to consider restructuring the financing of Canadian corporations to reduce or eliminate any interest denied by the EIFEL rules.

Is it possible to structure financing transactions in such a manner as to reduce the amount of interest or financing expenses incurred? For example, a loan structured with a reduced interest rate to finance the purchase of a particular property, but the debtor grants a royalty, akin to an oil and gas royalty, where the lender is entitled to x% of the gross revenue or profit of the debtor. The analysis would need to consider the classification of the "royalty" payments. The *Sherway*[32] decision would indicate that the "participating payments" would likely be deductible pursuant to paragraph 20(1)(e) (or even paragraph 20(1)(c) if it can be classified as interest), which is included in the ambit of the EIFEL rules. Additionally, any participating payments should be analyzed to determine whether the payments could be considered "participating debt interest" as defined in 212(3) and subject to Part XIII withholding tax by paragraph 212(1)(b). Similarly, a loan issued at a discount in lieu of paying interest should result in the payment or a portion thereof being deductible pursuant to paragraph 20(1)(f), which is also caught by the EIFEL rules. It is recommended that caution be exercised when attempting to plan around the EIFEL rules and the specific anti-avoidance rule in subsection 18.2(13) and the GAAR should be kept in mind whenever avoidance transactions are undertaken.

To prepare for the enactment of EIFEL, practitioners should now be doing modeling for capital intensive clients to identify whether and to what extent they have EIFEL exposure.

## Hybrid Mismatch Arrangements

Another item that Canadian taxpayers must keep in mind are the proposed "Hybrid Mismatch Arrangement" rules[33] (new sections 12.7, 18.4, and subsection 113(5)). Draft legislation was released on April 29, 2022 and is aimed at multinational corporations that structure arrangements to leverage differences in income tax regimes. Essentially, where a payment is made by a taxpayer that is deductible in determining income in that taxpayer's jurisdiction but is not included in income the recipient's jurisdiction the hybrid mismatch rules will apply to include the payment in income, or deny the deduction, as appropriate. Where a Canadian taxpayer pays interest that is deductible to a non-resident, the hybrid mismatch rules may deny the deduction. Furthermore, where the hybrid mismatch rules deny an interest deduction by a Canadian taxpayer, proposed subsection 214(18) will deem the denied interest to be a dividend that is subject to Part XIII withholding tax.

## Intercompany Loans and Value

Practitioners should also be cognizant of the impact of increasing interest rates on various inter-company transactions interactions. For instance, there is concern that a non-interest bearing loan to a non-arm's length person can result in deemed interest income pursuant to subsections 12(3) or (4)[34]. The underlying premise is that the debtor is acquiring funds at a discount and that paragraph 69(1)(a) would operate to reduce the cost base of the loan to the lender to be below the amount loaned. This is an intuitive position as the time value of money would suggest that the fair market value of the receivable is less than the amount advanced. Given the deemed cost of the loan being lower than amount payable on maturity, paragraph 7000(2)(a) of the Regulations could deem interest to accrue under subsection 12(9). However, the CRA indicates that a demand loan does not suffer from this issue, presumably because the lender can demand payment the instant after the advance, and thus could recoup the amount in full immediately. In practice it is rare for related party loans to not contain a

[32] *Sherway Centre Ltd. v. R.*, 1998 CarswellNat 67, (sub nom. R. v. Sherway Centre Ltd.) 98 D.T.C. 6121, (sub nom. Minister of National Revenue v. Sherway Centre Ltd.) 223 N.R. 93, (sub nom. Canada v. Sherway Centre Ltd.) [1998] 3 F.C. 36, [1998] 2 C.T.C. 343
[33] Although the legislation is subject to change the authors recommend reading Nik Diksic, "Canada's New Hybrid Mismatch Rules" (2022) 1:1 International Tax Highlights 10-13 for a primer on the hybrid mismatch rules..
[34] See CRA doc: 2014-0532651E5

demand clause, but now that interest rates are increasing, this is something that practitioner should be more vigilant about when dealing with non-interest bearing related party loans.

One issue that is difficult to reconcile is that the debt having cost less than its face amount would presumably result in the lender realizing a gain upon repayment, which would be in addition to the deemed interest income that is purported to apply. Despite the fact that the time value of money suggests that a loan under such circumstances would have value less than its face amount, these implications arising from paragraph 69(1)(a) appear overly punitive.

## Amending Debt Agreements

As interest rates increase there is inherently incentive to amend debt agreements to potentially change the interest rate or change other terms of the debt. The primary concern with making adjustments to existing debt agreements is the potential for the debt to be settled and a new debt issued in its place. Amending terms of a debt contract should be approached with caution. According to *General Electric* [35] the fundamental terms of promissory notes are:

1. The identity of the debtor;
2. The principal amount of the debt;
3. The amount of interest under the note; and
4. The maturity date of the note.

This case also states that changes to the terms of a promissory note must be significant enough to materially alter the terms of the obligation for the obligation to have been replaced by a new obligation. In the case of *General Electric*, three of the four fundamental terms were altered. While the *General Electric* case and other cases[36] dealing with the issue of updating debt obligations do not provide any bright-line tests that can be universally relied upon, they do provide a useful framework to analyze whether there is a disposition of a debt obligation and an issuance of a new obligation.

The CRA's position is "*… a rescission of a debt obligation will be implied when the parties have effected such an alteration of its terms as to substitute a new obligation in its place, which is entirely inconsistent with the old, or, if not entirely inconsistent with it, inconsistent with it to an extent that goes to the very root of it.*"[37]

This view should be consistent with the *General Electric* case as the CRA goes on to say that the *General Electric* case is the current standard of case law.

As interest rates rise, leveraged corporations may have more difficulty funding their interest commitments, which could call into question the value of the debt to the creditor. If the terms of the

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[35] *General Electric Capital Equipment Finance Inc. v. R.*, 2001 CarswellNat 2915, 2001 FCA 392, 2002 D.T.C. 6734, [2002] 1 C.T.C. 217, 20 B.L.R. (3d) 53, 284 N.R. 287, 216 F.T.R. 322 (note), 2001 CAF 392

[36] CRA refers to the following cases in CRA Views doc: 2005-0156081I7. *Morris v. Baron and Co.* case in the House of Lords ((1918) AC 1), *Weibe et al v. The Queen,* [1987] 1 C.T.C. 145 87 D.T.C. 5068, *Amirault v. MNR,* [1990] 1 C.T.C. 2432 90 D.T.C. 1330, *National Trust Co. v. Mead,* [1990] 2 S.C. R. 410], and *Quincaillerie Laberge Inc. v. The Queen,* [1995] 2 C.T.C. 2975D [1995] 2 C.T.C. 2975, 95 D.T.C. 47 and 155.

[37] Income Tax Technical News No. 14, dated December 9, 1998 and referred to again in CRA Views doc: 2005-0156081I7.

debt obligation are altered in such a manner that results in a disposition of the debt then there may be debt forgiveness consequences. Protecting a corporation from the consequences of debt forgiveness should be top of mind when re-structuring debts. Thankfully, in the even the amendment of a debt obligation results in the original debt being discharged and a new debt being issued, provided the face amount of the debt is not changed then there should be no forgiven amount as a result of paragraph 80(2)(h). There is no requirement that the new debt have value equal to the face amount of the original debt (which is in contrast to debt for share exchanges pursuant to paragraphs 80(2)(g)). Where possible, if the terms of a debt are to be altered, ensuring the face value of the debt remains the same should alleviate the risk of adverse consequences as a result of the debt forgiveness provisions.

Also, debts not denominated in Canadian currency might cause foreign exchange gains to arise on a novation of a debt.

## Specified Class of Shares - Association

The association rules in section 256, most commonly thought of in terms of sharing of the small business deduction limit, are also impacted by the increase in interest rates. Cross shareholdings that are a “specified class” of shares do not, by itself, cause two corporations to be associated.

Subsection 256(1.1) contains the definition of “specified class” which includes, *inter alia*, a reference to the prescribed interest rate at the time the shares are issued. Where transactions, particularly in the owner-manager space, result in related persons holding shares in the same corporation whilst also controlling a separate corporation it is advised that the shares to one of the persons are specified shares, which mean including a dividend rate that is equal to or less than the prescribed rate of interest at the time the shares are issued which should result in the corporations not being associated. The prescribed rate of interest is contained in regulation 4301 and is currently 5%.

Specified class of shares are also featured prominently in the amendments that are proposed to section 84.1 as proposed in the 2023 Federal Budget as shares allowed to be retained by the vendor after the disposition time (subject to certain limitations depending on whether the “immediate” or “gradual” business transfer option is selected).

## Protecting Historical Prescribed Rate Loan Structures

After the TOSI regime was introduced in 2018, prescribed rate loans became one of few remaining tools to income split with family members in lower tax brackets. Combined with the historically low prescribed rate at that time, prescribed rate loan structures became extremely popular. Such strategies have lost much of their luster given the higher prescribed rate today, but for the same reason, it is more important than ever to properly maintain existing prescribed rate loan structures.

A prescribed rate loan refers to a loan made between individuals or trusts that bears interest that is equal to or greater than the Regulation 4301(c) prescribed rate in effect at the time the loan was made. Such a loan avoids income attribution under section 74.1 and subsection 56(4.1), due to subsections 74.5(1) or (2) and 56(4.2) respectively. This ability to ‘lock in’ the interest rate for the term of the loan (which can be indefinite) was the reason why this planning was popular when the prescribed rate was low. However, in order for a prescribed rate loan to be and to remain valid, the full amount of interest must be paid no later than 30 days after each year the loan is outstanding (i.e., no later than January

30th of each year, assuming the lender is an individual or a non-GRE trust). To satisfy this, cash or property must be transferred to the lender to fully satisfy the interest amount on or before that date. CRA has confirmed recently that issuing a promissory note for the interest amount, even if it is issued as absolute payment, will not satisfy this payment requirement[38].

Missing the 30-day after year-end payment requirement for any year will invalidate the protection under subsections 74.5(1) or (2) and subsection 56(4.2) for the year in question as well as for all future years. Therefore, practitioners should clearly communicate the 30-day interest payment requirement to their clients who have prescribed rate loan structures in place, and ideally retain documentation of their clients satisfying this requirement for every year the loan remain outstanding.

## Economic and Policy Discussion

"*One of the most pervasive aspects of inflation is its eroding effect on the real value of people's savings.*" John N. Turner, 1974 Budget Speech.

The current economic environment is significantly different than it has been in the recent history. Inflation which is typically targeted to be about 2% is now in the vicinity of 6%. The typical response to increasing inflation is to increase interest rates to increase the cost of borrowing which is meant to deter consumption and thus reduce the rate of inflation. From an economic perspective it is straight from the playbook. However, what may not always be considered is the impact of inflation and interest rates on the savings of Canadian taxpayers, particularly with tax being included in the calculation. As inflation increases, the larger returns taxpayers need to derive from their investment portfolios to maintain the same purchasing power.

Using a simple example and individual who is subject to a 50% tax rate on interest income. In order for the taxpayer to maintain the same purchasing power the interest rate return on their portfolio needs to be twice the rate of inflation:

| | Low Inflation | | High Inflation | |
|---|---|---|---|---|
| Portfolio Base | | 100.00 | | 100.00 |
| Inflation | 2.00% | (2.00) | 6.00% | (6.00) |
| Interest | 4.00% | 4.00 | 12.00% | 12.00 |
| Tax | 50.00% | (2.00) | 50.00% | (6.00) |
| Net | | 100.00 | | 100.00 |

This is an admittedly simplistic calculation; however, the underlying premise should cause some concern as the Canadian taxpayers have seen a large increase in inflation, however interest rates have not increased at double the pace of inflation which can result in the erosion of the purchasing power of the Canadian taxpayer.

This very issue led to the implementation of former section 110.1 in 1974 which was a $1,000 deduction from interest or dividend income which was implemented to assist in protecting the savings of the average Canadian. Section 110.1 was eventually repealed in 1988 as a part of tax reform. The "Supplementary Information Relating to Tax Reform Measures" implied that the repeal of the

[38] CRA document #2018-0761551C6

investment income deduction was in response to the increase in basic personal tax credits, however it was also estimated that the repeal of former section 110.1 was projected to result in the second largest revenue gain to the government from the tax reform[39]. It was also suggested that the repeal of former section 110.1 would result in individuals paying down debt with previously invested cash.

Should there be a re-introduction of an investment income deduction to assist in protecting the retirement savings of Canadians? It is an attractive idea; since it reflects the tax policy goal of neutrality; taxpayers should not be taxed unless there is an economic benefit realized or gained which there is not when the investment returns are merely reflect inflationary adjustments. It should be noted that Canada actually already have a form of inflationary adjustment tax exemption: the much-cherished principal residence exemption.

Perhaps an investment credit (akin to the Canada employment amount), the "Canada Inflationary Return amount", would be a good solution. It could even be income tested, if the desire is to only assist Canadians below a certain income level, but theoretically higher income individuals are more adversely impacted by inflation eroding the purchasing power of their assets. Protecting the savings of Canadians during high inflationary periods should be considered by the Department of Finance, and an investment income credit available to Canadian who earn investment income would be a simple and effective method to reduce the impact of inflation on Canadians.

Aside from the above, earlier sections of the paper have also suggest for the Department of Finance's consideration:

- Repealing subsection 74.4(2) since the rationale for this subsection appears redundant after the expansion of the TOSI rules.
- Increasing the $50,000 bottom of the AAII phase-out range for small business limit, or expanding the $50,000 to $150,000 phase-out range, to take into account a higher yield investment environment.
- Carving out no or low interest related party loans from the application of paragraph 69(1)(a) given the overly-punitive consequences.
- Either amending paragraph 161(7)(b) or the mechanics of the 164(6) election and terminal T1 amendment, so that a GRE wanting to avoid arrears interest does not have to pay the full amount owing on the capital gain reported on the deceased's terminal return even though the gain will be subsequently offset by the subsection 164(6) loss.

*Kenneth Keung*
Moodys Private Client Law LLP / Moodys Tax, Calgary

*Evan Crocker*
Moodys Private Client Law LLP / Moodys Tax, Vancouver

[39] Canadian Tax Reports Number 800, July 9, 1987.