Income Splitting Among Family Members: The Attribution Rules

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Abstract/Resume

This thesis is a study of certain means available to taxpayers who wish to split their income with other members of their family and thereby reduce their taxes. There are essentially four sections to the study: (a) a description of the Canadian system of taxation of the family and the reasons why the Income Tax Act treats each individual as a separate unit for income tax purposes as opposed to recognizing the family unit itself as the basis for taxation; (b) an analysis of the tax consequences of loans and transfers of property between spouses; (c) an analysis of the tax consequences of loans and transfers of property to children under the age of 18 years; and (d) an analysis of the concept of indirect payments. The principal conclusion of the study is that the means available to split income among family members are limited, especially in view of the recent amendments to the Income Tax Act to gradually eliminate the "family loan" method of splitting income.

Cette thèse est une étude de certains moyens disponibles aux contribuables qui veulent fractionner leurs revenus avec d'autres membres de leur famille, et par conséquent, réduire leurs impôts. Cette étude se divise en quatre sections: (a) une description du système Canadien de la taxation de la famille et des raisons pour lesquelles notre Loi de l'impôt sur le revenu traite chaque individu comme un élément séparé pour les fins de l'impôt au lieu de reconnaitre la famille elle-même comme base pour la taxation; (b) une analyse des conséquences fiscales des prêts et transferts des biens entre les époux; (c) une analyse des conséquences

fiscales des prêts et transferts des biens aux enfants de moins de 18 ans; et (d) une analyse du concept des paiements indirects. La conclusion principale de cette étude est que les moyens disponibles pour le fractionnement du revenu entre les membres de la famille sont limités, surtout si on tient compte des derniers amendements a la Loi de l'impôt sur le revenu pour éliminer graduellement la méthode du "prêt familial" comme moyen de fractionner le revenu.

Table of Contents

	Page
Introduction	
I. History of the Attribution Rules.....	7
A. Loans Used to Avoid the Attribution Rules.....	8
II. Purpose and Function of the Attribution Rules.....	14
III. Subsection 74.1(1): Loans and Transfers to a Spouse	17
A. General.....	18
B. Definition of Spouse.....	18
IV. Loan or Transfer of Property.....	19
A. Statutory Definition of Property.....	19
B. Statutory Classification of Property.....	22
(i) Real Property.....	22
(ii) Capital Property.....	23
(iii) Depreciable Property.....	23
(iv) Eligible Capital Property.....	24
C. Judicial Interpretation of "Transfer".....	25
(i) Sale.....	26
(ii) Sale or Transfer for Fair Market Value Consideration.....	28
D. Loans.....	33
(i) General.....	33
(ii) Exemption for Loans Made on a Commercial Basis.....	34
(iii) Back-to-Back Loans and Transfers.....	37
(iv) Loan Guarantees.....	39
(v) Repayment of Loans.....	42

Page

(vi) Artificial Transactions..... 44

E. Loans or Transfers to a Trust..... 47

(i) Attribution of Ordinary Income..... 47

(ii) No General Attribution of Trust Income..... 49

(iii) Allocation of Sources of Income..... 50

(iv) Comment..... 53

F. Loans or Transfers to Corporations..... 54

(i) General..... 54

(ii) Terminology..... 57

(a) Excluded Consideration..... 57

(b) Designated Ben it..... 57

(c) Monthly Designated Benefit..... 58

(iii) Computation of the Attributed Amount..... 59

(iv) Comment..... 59

(v) Exclusion of the Attributed Amount from the Recipient's Income..... 62

(vi) Exception for Small Business Corporation... 64

(vii) Timing..... 65

(viii) Limits to the Corporate Attribution Rules 66

(ix) Anti-avoidance Rules..... 67

G. Repayment of Loans Outstanding on May 22, 1985 67

H. Indirect Transfers..... 70

(i) Judicial Interpretation of "Indirect"..... 70

(ii) Requirement of Ownership..... 75

I. The Requirement of Vesting..... 81

(i) Comment..... 86

	Page
V. Antenuptial Gifts and Agreements.....	90
A. General.....	90
B. Gifts made prior to Marriage.....	92
C. Post-Nuptial Gifts.....	93
D. Wedding Gifts.....	95
E. Superficial Losses.....	97
F. Antenuptial Gifts in the Province of Quebec.....	99
(i) Transfer by Future Wife to Future Husband: Community of Property.....	100
(ii) Transfer by Future Husband to Future Wife: Community of Property.....	102
VI. Substituted Property.....	103
VII. Losses.....	104
VIII. Residence.....	105
A. Transfers Effected outside Canada.....	105
B. Severance of Residence.....	109
IX. Transfer by Operation of Law.....	110
X. Only Income from Property is Subject to Attribution.	112
A. Business Income vs. Property Income: The Basic Tests.....	115
B. Definition of Business.....	116
(i) Transfer of Rental Real Property.....	118
(ii) Transfer of Personal Property.....	120
XI. Attribution of Capital Gains: Spouses.....	126
A. Purpose and Effect of Section 74.2.....	126
(i) Transfers Covered.....	128
(ii) Transfer by Operation of Law.....	128
B. Inter Vivos Spousal Transfer of Property.....	129

	Page
C. Application of Subsection 74.2(1).....	130
D. Period during which Capital Gains Atribution Applies.....	133
E. Identical Properties.....	133
F. Recapture of Capital Cost Allowance.....	134
G. Lifetime Capital Gains Exemption.....	135
H. Capital Losses.....	136
I. Capital Gains vs. Business Income: The Basic Tests.....	138
(i) Judicial Tests.....	138
(ii) Intention of Taxpayer.....	139
(iii) Change of Intention.....	141
(iv) Doctrine of Secondary Intention.....	142
(v) Length of Ownership.....	144
(vi) Number and Frequency of Transactions.....	146
(vii) Relation to Ordinary Business.....	148
(viii) Subject-Matter of Transaction.....	149
(ix) Whether the Taxpayer Acts as a Dealer Would	150
XII. Principal Residence.....	151
A. General.....	151
B. Definition of Principal Residence.....	151
(i) Nature of Property.....	152
(ii) Nature of Ownership.....	152
(iii) Ordinarily Inhabited.....	153
(iv) Designation.....	155
(v) Surrounding Land.....	155
C. Status of Dwelling as Capital Property.....	156

	Page
D. Determination of Gain	156
E. Change in Use	157
(i) Deemed Disposition	157
(ii) Subsection 45(2) Election	158
F. Transfer of Principal Residence to a Spouse	160
(i) Principal Residence and the Attribution Rules	161
G. Joint Ownership of Principal Residence	163
XIII. Registered Retirement Savings Plans	164
A. General	164
B. Maturity of Plan	165
C. Retirement Income	166
D. Spousal Registered Retirement Savings Plan	167
(i) No Attribution on Payments to a Spousal Registered Retirement Savings Plan	168
XIV. Preservation of Assets	170
XV. Marriage Break-Ups	171
A. Income Attribution	171
B. Capital Gains Attribution	171
C. Loans or Transfers to a Corporation	172
D. Tax Planning for Marriage Break-Ups	173
(i) Property Transfers	173
(ii) Principal Residence	174
XVI. Non-Tax Considerations	176
XVII. Loans and Transfers to Minors Children	177
A. General	177
B. Relationship of Individual and Minor Child	178
C. Period during which Income Attribution Applies	179

	Page
D. Capital Gains	180
E. Loans to Minor Children	183
(i) Capacity of Minor to Contract	184
F. Deferred Interest Securities	188
G. Gifts and Sales to Adult Children	189
H. Investments on Behalf of Minors in Capital Gains Securities	191
I. Non-Tax Considerations	194
XVII. Tax Liability on Property Transferred not at Arm's Length	195
A. General	195
B. Purpose	195
C. Application	197
(i) Joint Liability for Tax on Income or Gain Attributed to Transferor	197
(ii) Joint Liability for Transferor's Tax in Year of Transfer	198
(iii) Procedure for Assessing the Transferee	201
D. Discharge of Joint Liability	202
E. Exception	202
XIX. Burden of Proof and the Attribution Rules	203
A. General	203
B. Attribution and the Burden of Proof	206
XX. Attribution and Family Law	209
A. Marital Regimes in the Province of Quebec	209
(i) Formation of the Marital Regime	209
(ii) Existence of the Marital Regime	215
B. Family Law Reform in the Common Law Provinces	221

	Page
(i) General	221
(ii) Characteristics of Marital Property Reform Legislation	222
(iii) Property Rights and Attribution:	224
(a) Is there a Transfer of Property for the Purposes of the Attribution Rules?	224
(iv) Family Law Reform and Community of Property	227
(v) Domestic Contracts	228
(vi) Judicial Interpretation of the Family Law Reform Act	229
XXI. Indirect Payments	232
A. General	232
B. Indirect Benefits	232
(i) General	232
(ii) Purpose of Subsection 56(2)	234
(iii) Requirements for Taxation under Subsection 56(2)	235
(iv) Policy of the Department	245
C. Cases Involving Income Splitting Share Capital Structures	246
D. Comment	266
E. Planning Possibilities	271
(i) Dividend Reserve Account	272
F. Transfer of Income Rights	273
(i) General	274
(ii) Exception	275
(iii) Sale	276
(iv) Capital vs. Income	277
(v) Property Income vs. Business Income	279

Page

G. Conferral of Benefits..... 279

(i) Purpose of Subsection 245(2)..... 280

(ii) Requirements of Subsection 245(2)..... 280

(iii) Conferral of a Benefit..... 280

(iv) Classification of the Payment..... 281

Conclusion..... 293

Appendix A: Loans or Transfers to a Trust..... 298

Appendix B: Loans or Transfers to a Non-Small Business Corporation..... 301

Appendix C: Burden of Proof..... 305

Bibliography..... 434

Table of Cases

	Page
Adams v. MNR, [1960] 24 Tax ABC 154 (TAB).....	410
Anderson v. MNR, [1947] CTC 223 (Ex. Ct.).....	383
Anderson Logging Co. v. The King, [1917-27] CTC 196 (SCC)	203
Applebaum v. MNR, [1971] Tax ABC 550 (TAB)	427
Associates Corp. of N. America v. The Queen, [1980] CTC 80 (FCTD).....	346
Ass'n of Data Processing Service v. Camp, [1970] 397 U.S. 150 (U.S. S. Ct.).....	432
Atlantic Sugar Refineries v. MNR, [1949] CTC 196 (SCC).	148
Avnet v. Avnet, [1953] 124 NYS (2d Series) 517 (NY Municipal Ct.).....	96
Baginski v. MNR, [1978] CTC 2679 (TRB).....	352
Barbeau v. The Queen, [1981] CTC 496 (FCTD).....	412
Bayridge Estates Ltd. v. MNR, [1959] CTC 158 (Ex. Ct.).	362
Becker v. The Queen, [1983] CTC 11 (FCA).....	361
Bedford v. MNR, [1969] 29 Tax ABC 397 (TAB).....	347
Bell Telephone Co. v. MNR, [1944] CTC 207 (Ex. Ct.)....	397
Blumenthal v. MNR, [1950] 2 Tax ABC 354 (TAB).....	316
Bossin v. The Queen, [1976] CTC 358 (FCTD).....	354
Bradley v. Min. of Finance, [1974] 5 WWR 347 (BCCA)....	377
Brampton Brick Co. Ltd. v. MNR, [1963] CTC 57 (Ex. Ct.)	431
Brazeau and Brazeau v. MNR, [1984] CTC 2955 (TCC).....	201
Brewster v. The Queen, [1976] CTC 107 (FCTD).....	307
B.C. Electric Rly. Co. Ltd. v. The King, [1946] CTC 224. (J.C.P.C.).....	345
Brooks v. MNR, [1977] CTC 2048 (TRB).....	377
Bruce v. Warwick, [1815] 6 Taunt. 118.....	283
Burka v. Comm'r, [1950] 179 F.2d 483 (4th Cir.).....	310
Burland v. Earle, [1902] A.C. 83 (J.C.P.C.).....	414
Burri v. The Queen, [1985] 2 CTC 43 (FCTD).....	364
CIR v. Clarkson-Webb, [1933] 1 K.B. 507.....	178
CIR v. Korean Syndicate Ltd., [1921] 12 T.C. 181 (C.A.)	353
CIR v. Livingston, [1926] 11 T.C. 538 (HL).....	364
CIR v. Reinhold, [1953] 34 T.C. 389 (C.A.).....	150
California Copper Syndicate v. Harris, [1904] 5 T.C. 159 (SCE).....	138
Campbell v. MNR, [1952] CTC 334 (SCC).....	395
Campbell v. MNR, [1963] 32 Tax ABC 203 (TAB).....	26
Canadian Marconi Co. Ltd. v. The Queen, [1984] CTC 319 (FCA).....	124
Card v. CSD, [1940] NZLR 637 (NZCA).....	11
Carrigan v. MNR, [1981] CTC 2916 (TRB).....	391
Caspari v. MNR, [1983] CTC 2001 (TRB).....	412
Champ v. The Queen, [1983] 1 CTC (FCTD).....	255
Clements v. London and N. Western Rly. Co., [1894] 2 Q.B. 482 (C.A.).....	386
Cohen v. MNR, [1957] CTC 251 (Ex. Ct.).....	355

	Page
Cohen v. The Queen, [1980] CTC 318 (FCA)	401
Collins v. MNR, [1976] CTC 2048 (TRB)	377
Connell v. MNR, [1946] CTC 306 (Ex. Ct.)	93
Conway Estate v. MNR, [1965] CTC 283 (Ex. Ct.)	429
Copp v. MNR, [1954] 11 Tax ABC 147 (TAB)	412
Cox v. MNR, [1985] 1 CTC 2324 (TCC)	370
Coutts and Co. v. Browne-Lecky, [1947] 1 K.B. 104	387
Craig v. MNR, [1973] CTC 2119 (TRB)	391
Cross Country Development Co. v. MNR, [1981] CTC 2558 (TRB)	353
D'auteuil Lumber Co. Ltd. v. MNR, [1970] CTC 122 (Ex. Ct.)	379
Del Grande v. MNR, [1951] 3 Tax ABC 371 (TAB)	206
Demers v. MNR, [1950] 2 Tax ABC 387 (TAB)	351
DeVall v. Wainwright Gas Co. Ltd., [1932] WWR 281 (Alta. C.A.)	414
Dezura v. MNR, [1947] CTC 375 (Ex. Ct.)	395
Dickerson v. MNR, [1967] Tax ABC 977 (TAB)	391
Dickson v. The Queen, [1977] CTC 64 (FCA)	363
Dobell v. MNR, [1950] CTC 379 (Ex. Ct.)	340
Dobieco Ltd. v. MNR, [1965] CTC 507 (SCC)	431
Dubois v. MNR, [1982] CTC 2585 (TRB)	394
Dunkelman v. MNR, [1959] CTC 380 (Ex. Ct.)	83
Duplessis v. MNR, [1971] Tax ABC 247 (TAB)	106
Eagles v. Rose, [1945] 26 T.C. 427 (High Ct.)	433
Earl of Tyrone v. Marquis of Waterford, [1860] 1 D.F. and J. 613	319
Edwards v. Carter, [1893] A.C. 360 (HL)	386
Egan v. MNR, [1980] CTC 2882 (TRB)	374
Engel v. Engel, [1980] 30 O.R. (2d) 152 (Ont. HCJ)	408
Ennist v. MNR, [1985] 2 CTC 2398 (TCC)	371
Erichsen v. Last, [1881] 4 T.C. 422 (C.A.)	116
Evans v. MNR, [1960] CTC 69 (SCC)	277
Fairhall v. Butler, [1928] SCR 369 (SCC)	415
Falk v. Falk, [1947] 103 NYS (2d Series) 1036 (NY Supreme Ct.)	342
Farand v. MNR, [1983] CTC 2275 (TRB)	415
Fasken Estate v. MNR, [1948] CTC 265 (Ex. Ct.)	20
Feinstein v. The Queen, [1979] CTC 329 (FCTD)	412
First Charter Fin. Corp. v. Musclow, [1974] 49 D.L.R. (3d) 188 (BCSC)	185
Fisher v. MNR, [1979] CTC 2771 (TRB)	395
Fletcher v. MNR, [1977] CTC 2256 (TRB)	346
Fogel v. MNR, [1959] CTC 227 (Ex. Ct.)	362
Foley v. Canada Permanent Loan and Savings Co., [1884] 4 O.R. 38 (Ont. C.A.)	386
Fraser v. MNR, [1964] CTC 372 (Ex. Ct.)	142
Fraser Companies Ltd. v. The Queen, [1981] CTC 61 (FCTD)	235

Page

Fribance v. Fribance, [1957] 1 All E.R. 357 (C.A.)..... 196
Fyke v. MNR, [1964] CTC 54 (Ex. Ct.)..... 395

Gabco Ltd. v. MNR, [1968] CTC 313 (Ex. Ct.)..... 416
Gairdner Securities v. MNR, [1954] CTC 24 (SCC)..... 148
Garland Mfrg. Co. v. Northumberland Paper Co., [1899] 31 O.R. 40 (Ont. C.A.)..... 337
Gartside v. IRC, [1968] A.C. 558 (HL)..... 338
Gathercole v. Smith, [1881] 17 Ch. D. 3 (C.A.)..... 347
German v. MNR, [1957] CTC 291 (Ex. Ct.)..... 27
Ginsberg v. MNR, [1953] 9 Tax ABC 321 (TAB)..... 352
Glaspie v. MNR, [1963] 33 Tax ABC 274 (TAB)..... 352
Goldblatt v. MNR, [1964] CTC 185 (Ex. Ct.)..... 409
Goldman v. MNR, [1951] CTC 241 (Ex. Ct.)..... 304
Goodman v. MNR, [1951] 3 Tax ABC 280 (TAB)..... 112
Gov't of India v. Taylor, [1955] A.C. 491 (HL)..... 345
Groulx v. MNR, [1967] CTC 422 (SCC)..... 398
Guthrie v. Walrond, [1883] 22 Ch. D. 573 (Chan. Ct.)... 319

Haber v. The Queen, [1982] CTC 405 (FCTD)..... 369
Hargrove v. MNR, [1978] CTC 2212 (TRB)..... 376
Haythornthwaite and Sons Ltd. v. Kelly, [1927] 11 T.C. 659 (C.A.)..... 433
Hazeldean Farm Co. v. MNR, [1966] CTC 607 (Ex. Ct.).... 362
Helvering v. Clifford, [1940] 309 U.S. 331 (U.S. S. Ct.) 314
Helvering v. Taylor, [1935] 293 U.S. 507 (U.S. S. Ct.). 310
Hichens v. Hichens, [1945] 1 All E.R. 451 (C.A.)..... 341
Hillsdale Shopping Centre Ltd. v. MNR, [1981] CTC 322 (FCA)..... 365
Hinspergers Harness and Tent Co. Ltd. v. Koropeski, [1956] O.W.N. 167 (Ont. C.A.)..... 386
Hiwako Invts. Ltd. v. The Queen, [1978] CTC 378 (FCA).. 143
Holden v. MNR, [1931] CTC 116 (Ex. Ct.)..... 397
Hollinger v. MNR, [1972] CTC 592 (FCTD)..... 117
Hollo v. MNR, [1978] CTC 2617 (TRB)..... 371
Horkins v. MNR, [1976] CTC 52 (FCTD)..... 377
Horvath v. The Queen, [1980] CTC 467 (FCTD)..... 365
Hotel Cartier Inc. v. MNR, [1978] CTC 3029 (TRB)..... 417
Houghton v. MNR, [1956] 15 Tax ABC 246 (TAB)..... 94
Hughes v. The Queen, [1984] CTC 101 (FCTD)..... 362
Hunter-Douglas v. The Queen, [1979] CTC 424 (FCTD)..... 346

IRC v. Fraser, [1942] 24 T.C. 498 (SCS)..... 364
Ilgenfritz v. Ilgenfritz, [1952] 49 Mo. App. 127 (Mo. Ct. App.)..... 342
In re Earnshaw-Wall, [1894] 3 Ch. 156 (Chan. Ct.)..... 319
In re Prater, [1888] 37 Ch. D. 481 (C.A.)..... 320
Industrial Addition Ass'n v. CIR, [1945] 323 U.S. 310 (U.S. S. Ct.)..... 432

	Page
Inland Resources Ltd. v. MNR, [1964] CTC 393 (Ex. Ct.).	431
Irrigation Industries Ltd. v. MNR, [1962] CTC 215 (SCC)	140
J.A. Leroux Inc. v. MNR, [1979] CTC 3051 (TRB).....	353
J.P. Harrison Ltd. v. Griffiths, [1960] 40 T.C. 281 (C.A.).....	312
James v. CIR, [1973] 2 NZLR 19 (NZSC).....	11
James v. MNR, [1985] 2 CTC 2001 (TCC).....	370
Johnston v. MNR, [1948] CTC 195 (SCC).....	204
Jones v. Skinner, [1836] 5 L.J.N.S. 87.....	20
Joseph Simard Ltd. v. MNR, [1964] CTC 289 (Ex. Ct.)....	192
Kennedy v. MNR, [1952] CTC 59 (Ex. Ct.).....	364
Kingsdale Securities Ltd. v. MNR, [1975] CTC 10 (FCA)..	429
Kit-Win Holdings (1973) Ltd. v. The Queen, [1981] CTC 43 (FCTD).....	363
Lackie v. The Queen, [1979] CTC 389 (FCA).....	114
Lamarche v. MNR, [1983] CTC 2260 (TRB).....	392
Lapointe v. MNR, [1973] CTC 2001 (TRB).....	287
Laporte v. MNR, [1984] CTC 2260 (TCC).....	40:
Leaside Realty Co. v. MNR, [1986] 1 CTC 2024 (TCC).....	145
Leatherdale v. Leatherdale, [1982] 2 SCR 743 (SCC).....	231
Leduc v. MNR, [1967] Tax ABC 771 (TAB).....	403
Levine v. MNR, [1973] CTC 219 (FCTD).....	432
Luck v. MNR, [1980] CTC 2614 (TRB).....	336
McClurg v. The Queen, [1986] 1 CTC 355 (FCTD).....	259
McConachie v. MNR, (August, 1981) (TRB).....	252
McDonough v. MNR, [1949] CTC 213 (Ex. Ct.).....	365
McGain v. CIR, [1966] 116 CLR 172 (HCA).....	11
McLaughlin v. MNR, [1952] CTC 104 (Ex. Ct.).....	27
McLean v. MNR, [1962] CTC 93 (Ex. Ct.).....	395
McPhee v. MNR, [1980] CTC 2042 (TRB).....	318
MacIsaac v. MNR, [1974] CTC 576 (FCA).....	395
Madsen v. MNR, [1981] CTC 2131 (TRB).....	370
Mandel v. The Queen, [1976] CTC 545 (FCTD).....	351
Manson v. MNR, [1952] 7 Tax ABC 298 (TAB).....	352
Marsland v. MNR, [1970] Tax ABC 49 (TAB).....	292
Martens v. MNR, [1964] 35 Tax ABC 9 (TAB).....	345
Martin v. MNR, [1948] CTC 189 (Ex. Ct.).....	116
May v. The Queen, [1982] CTC 66 (FCTD).....	369
May and Hecht v. MNR, [1980] CTC 2457 (TRB).....	371
Maziade v. MNR, [1951] 5 Tax ABC 184 (TAB).....	206
Meade v. MNR, [1964] 34 Tax ABC 155 (TAB).....	24
Medicine Hat Greenhouses Ltd. v. The Queen, [1981] CTC 141 (Alta. C.A.).....	431
Mele v. MNR, [1985] 1 CTC 257 (FCTD).....	412
Michael v. MNR, [1985] 2 CTC 2122 (TCC).....	370

	Page
Miller v. Miller, [1982] 39 O.R. (2d) 75 (Ont. C.A.)...	404
Miller v. MNR, [1962] CTC 199 (FCTD).....	234
Millstock Co. Ltd. v. MNR, [1943] CTC 155 (SCC).....	397
Minden v. MNR, [1963] CTC 364 (Ex. Ct.).....	316
MNR v. Bessemer Trust Co., [1973] CTC 186 (FCA).....	358
MNR v. Bisson, [1972] CTC 446 (FCTD).....	410
MNR v. Bronfman, [1965] CTC 378 (Ex. Ct.).....	410
MNR v. Consolidated Mogul Mines, [1966] CTC 16 (Ex. Ct.)	429
MNR v. Dufresne, [1967] CTC 153 (Ex. Ct.).....	282
MNR v. MacInnes, [1954] CTC 50 (Ex. Ct.).....	103
MNR v. Pillsbury Holdings Ltd., [1964] CTC 294 (Ex. Ct.)	305
MNR v. Simpson's Ltd., [1953] CTC 203 (Ex. Ct.).....	304
MNR v. Spencer, [1961] CTC 109 (Ex. Ct.).....	355
MNR v. Taylor, [1956] CTC 189 (Ex. Ct.).....	147
MNR v. The Davidson Cooperative, [1956] CTC 26 (Ex. Ct.)	395
MNR v. Thibeault, [1964] CTC 232 (Ex. Ct.).....	431
MNR v. Wardean Drilling Ltd., [1969] CTC 265 (Ex. Ct.).	322
Miron and Freres Ltd. v. MNR, [1955] SCR 679 (SCC).....	395
Molson v. MNR, [1938] SCR 213 (SCC).....	92
Moluch v. MNR, [1966] CTC 712 (Ex. Ct.).....	361
Montfort Lakes Estates Inc. v. The Queen, [1980] CTC 27 (FCTD).....	365
Montreal Trust Co. v. MNR, [1962] CTC 418 (Ex. Ct.)....	365
Moose Jaw Flying Club v. MNR, [1955] SCR 679 (SCC).....	397
Morin v. The Queen, [1975] CTC 106 (FCTD).....	410
Morrison v. MNR, [1917-27] CTC 343 (Ex. Ct.).....	146
Mulder Bros. Sand and Gravel Ltd. v. MNR, [1967] Tax ABC 761 (TAB).....	416
Murdock v. Murdock, [1975] 1 SCR 423 (SCC).....	222
Murphy v. The Queen, [1980] CTC 386 (FCTD).....	76
Naiberg v. MNR, [1966] Tax ABC 492 (TAB).....	336
Nelson v. The Queen, [1974] CTC 360 (FCA).....	412
Newgrosh v. Newgrosh, [1950] L.T. Jo. 108 (Chan. Ct.)..	96
Nightingale v. Nightingale, [1978] ACWS 451 (Ont. HCJ).	407
Nikolic v. Nikolic, [1980] 29 O.R. (2d) 66 (Ont. HCJ)..	408
Noak v. MNR, [1954] CTC 6 (SCC).....	364
Norman v. Golder, [1944] 26 T.C. 293 (C.A.).....	433
No. 13 v. MNR, [1951] 3 Tax ABC 397 (TAB).....	364
No. 136 v. MNR, [1953] 9 Tax ABC 366 (TAB).....	352
No. 161 v. MNR, [1954] 10 Tax ABC 277 (TAB).....	283
No. 481 v. MNR, [1957] 18 Tax ABC 294 (TAB).....	20
No. 605 v. MNR, [1959] 21 Tax ABC 317 (TAB).....	233
No. 673 v. MNR, [1959] 23 Tax ABC 240 (TAB).....	18
No. 676 v. MNR, [1960] 25 Tax ABC 95 (TAB).....	348
O'Brien v. MNR, [1957] 18 Tax ABC 189 (TAB).....	328
O'Connor v. MNR, [1943] CTC 255 (Ex. Ct.).....	397
Oelbaum v. MNR, [1968] CTC 244 (Ex. Ct.).....	10
Osler, Hammond and Nanton v. MNR, [1963] CTC 164 (SCC).	365

	Page
Oceanspan Carriers Ltd. v. The Queen, [1986] 1 CTC 114 (FCTD).....	345
Parsons v. Fox, [1979] 179 Ga. 605 (Ga. Ca.).....	325
Partington v. Attorney-General, [1869] L.R. 4 (HL).....	306
Pashovitz v. MNR, [1961] CTC 288 (Ex. Ct.).....	431
Payette v. MNR, [1978] CTC 3113 (TRB).....	391
Peachey Ltd. v. The Queen, [1979] CTC 51 (FCA).....	141
Peery Estate v. MNR, [1952] 6 Tax ABC 311 (TAB).....	352
Perrault v. The Queen, [1978] CTC 395 (FCA).....	410
Phillips v. Greater Ottawa Development Corp., [1916] 33 D.L.R. 259 (Ont. S. Ct.).....	386
Pichosky v. MNR, [1964] CTC 149 (Ex. Ct.).....	49
Pickford v. Quirke, [1927] 13 T.C. 251 (C.A.).....	146
Pitt Estate v. MNR, [1959] 22 Tax ABC 57 (TAB).....	412
Pope v. MNR, [1960] 25 Tax ABC 22 (TAB).....	348
Potts' Executors v. IRC, [1951] 1 All E.R. 76 (HL).....	71
Power v. The Queen, [1975] CTC 580 (FCTD).....	362
Purcell v. MNR, [1961] CTC 199 (Ex. Ct.).....	277
Racine v. MNR, [1965] CTC 150 (Ex. Ct.).....	142
Rafael v. MNR, [1978] CTC 2398 (TRB).....	329
Rainy Lake Hotel Co. Ltd. v. MNR, [1961] 26 Tax ABC 293 (TAB).....	358
Rapistan Canada Ltd. v. MNR, [1974] CTC 495 (FCA); appeal dismissed: [1976] CTC 296 (SCC).....	21
Rathwell v. Rathwell, [1978] 2 WWR 101 (SCC).....	221
Ravasi v. MNR, [1979] CTC 2808 (TRB).....	352
Re Baden's Trust Deed, [1971] A.C. 424 (HL).....	338
Re Canada Tea Co. Ltd., [1959] OWN 378 (Ont. HCJ).....	414
Re Cummins and Cummins, [1971] 1 All E.R. 782 (C.A.)...	222
Re Kozub and Timko, [1984] 45 O.R. (2d) 558 (Ont. C.A.)	406
Re Ralli's Settlement, [1965] Ch. D. 286 (C.A.).....	433
Re Sovereign Bank of Canada, [1916] 35 O.L.R. 448 (Ont. C.A.).....	386
Re Taylor and Taylor, [1971] 1 O.R. 715 (Ont. C.A.)....	222
Reese v. MNR, [1955] 13 Tax ABC 379 (TAB).....	111
Regal Heights Ltd. v. MNR, [1960] CTC 384 (SCC).....	142
Reicher v. The Queen, [1975] CTC 659 (FCA).....	361
Reininger v. MNR, [1958] 20 Tax ABC (TAB).....	412
R v. Arnos, [1980] CTC 12 (FCA).....	358
R v. Campbell, [1980] CTC 319 (SCC).....	398
R v. Canada Southern Railway, [1986] 1 CTC 236 (FCA)...	354
R v. Canadian-American Loan Invt. Co. Ltd., [1974] CTC 101 (FCTD).....	363
R v. Greenington Group Ltd., [1979] CTC 31 (FCTD).....	365
R v. LePain, [1978] CTC 711 (FCTD).....	411
R v. Littler, [1978] CTC 235 (FCA).....	192
R v. McKay, [1975] CTC 279 (Ex. Ct.).....	396
R v. Marsh and McLennan Ltd., [1983] CTC 231 (FCA).....	122

	Page
R v. Rash, [1923] 53 O.L.R. 245 (Ont. C.A.)	386
R v. Rockmore Investments, [1976] CTC 291 (FCA)	350
R v. St. John Shipbuilding and Dry Dock Co., [1980] CTC 352 (FCA)	321
R v. Yates, [1983] CTC 105 (FCTD)	370
Richter v. MNR, [1977] CTC 2261 (TRB)	377
Roberts and Bagwell v. The Queen, [1957] SCR 28 (SCC)	390
Robertson v. MNR, [1964] CTC 113 (SCC)	354
Robins v. MNR, [1963] CTC 47 (Ex. Ct.)	113
Robinson v. MNR, [1985] 1 CTC 2054 (TCC)	278
Rockwell v. CIR, [1975] 512 F.2d 882 (9th Cir.)	431
Rode v. MNR, [1977] CTC 2365 (TRB)	371
Rode v. MNR, [1985] 1 CTC 2324 (TCC)	370
Rubinstein v. MNR, [1962] 22 Tax ABC 348 (TAB)	352
Ruderman v. U.S., [1966] 355 F.2d 995 (2d Cir.)	432
Rutledge v. IRC, [1929] 14 T.C. 490 (SCS)	364
Russell v. Scott, [1948] A.C. 422 (HL)	433
S and S Properties Ltd. v. The Queen, [1978] CTC 412 (FCTD)	365
Sachs v. The Queen, [1980] CTC 358 (FCA)	48
St. Aubyn v. Attorney-General, [1952] A.C. 53 (HL)	83
Salomon v. Salomon, [1897] A.C. 22 (HL)	420
Sampson v. Sampson, [1960] 1 All E.R. 653 (C.A.)	96
Sanscoucy v. MNR, [1980] CTC 2312 (TRB)	326
Sazio v. MNR, [1968] CTC 579 (Ex. Ct.)	412
Schapira v. MNR, [1966] 40 Tax ABC 223 (TAB)	318
Schlamp v. The Queen, [1982] CTC 304 (FCTD)	305
Scott v. Scott, [1943] 1 All ER (Ch. D.)	413
Sebilleau v. MNR, [1950] 2 Tax ABC 245 (TAB)	351
Secretary of State in Council for India v. Scoble, [1903] A.C. 299 (J.C.P.C.)	397
Sherman v. MNR, [1973] CTC 192 (FCTD)	362
Silverstein v. Silverstein, [1978] 2 O.R. (2d) 185 (Ont. HCJ)	230
Simson-Maxwell Ltd. v. MNR, [1962] 29 Tax ABC 169 (TAB)	424
Skelton v. MNR, [1956] 14 Tax ABC 413 (TAB)	348
Smith v. MNR, [1963] CTC 484 (Ex. Ct.)	145
Smith v. MNR, [1965] CTC 257 (SCC)	243
Snook v. London and West Riding Investments, [1967] All E.R. 518 (C.A.)	255
Sokil v. MNR, [1968] Tax ABC 337 (TAB)	318
South Shore Estates v. The Queen, [1981] CTC 252 (FCTD)	365
Sovereign Life Assurance v. Dodd, [1892] 2 Q.B. 573 (C.A.)	414
Spence Building Ltd. v. MNR, [1977] CTC 2104 (TRB)	353
Spooner v. MNR, [1928-34] CTC 178 (SCC)	419
Stalker v. U.S., [1965] 209 F. Supp. 30 (Mich. D. Ct.)	321
Stratton v. MNR, [1966] CTC 637 (Ex. Ct.)	344
Stubart Investments Ltd. v. The Queen, [1984] CTC 294 (SCC)	337

	Page
Subsidiaries Holding Co. Ltd. v. MNR, [1956] CTC 240 (Ex. Ct.)	393
Sura v. MNR, [1962] 62 DTC 1007 (SCC)	101
Talon Exploration Ltd. MNR, [1964] CTC 468 (Ex. Ct.)	429
Taylor v. Davies, [1917] 41 OLR 403 (Ont. S. Ct.)	404
Thalheimer v. MNR, [1983] CTC 2498 (TCC)	208
Thomson v. MNR, [1946] CTC 51 (SCC)	368
Thornsteinson v. MNR, [1980] CTC 2415 (TRB)	208
Titeley v. MNR, [1977] CTC 2045 (TRB)	245
Tobias v. The Queen, [1978] CTC 113 (FCTD)	308
Torduff Ltd. v. MNR, [1972] CTC 295 (FCTD)	365
Toronto Marlboro Hockey Club v. Tonelli, [1975] 67 D.L.R. (3d) 214 (Ont. HCJ)	386
Trinca v. MNR, [1951] 3 Tax ABC 354 (TAB)	316
Trueman v. Trueman, [1971] 2 WWR 688 (Alta. C.A.)	222
Usarco Ltd. v. The Queen, [1980] CTC 308 (FCTD)	421
Valitalo and Murillo v. MNR, [1979] CTC 2320 (TRB)	78
Vancouver Pile Driving and Constructing Co. Ltd. v. MNR [1963] CTC 10 (Ex. Ct.)	422
Van Der Voort v. MNR, [1958] 21 Tax ABC 28 (TAB)	352
Victory Hotels Ltd. v. MNR, [1962] CTC 614 (Ex. Ct.)	379
Viking Food Products Ltd. v. MNR, [1967] CTC 101 (FCTD)	423
Von Westphalen v. MNR, [1964] 35 Tax ABC 29 (TAB)	352
Waddell v. MNR, [1983] CTC 2205 (TRB)	412
Walsh and Micay v. MNR, [1965] CTC 478 (Ex. Ct.)	118
Warnford Court (Can.) Ltd. v. MNR, [1964] CTC 175 (Ex. Ct.)	145
Watson v. MNR, [1985] 1 CTC 2270 (TCC)	370
Watts v. MNR, [1961] 27 Tax ABC 432 (TAB)	412
Wauthier v. Wilson, [1912] 28 TLR 239 (C.A.)	185
Weintraub v. The Queen, [1975] CTC 112 (FCTD)	350
Welton v. MNR, [1978] CTC 3153 (TRB)	371
Wertman v. MNR, [1964] CTC 252 (Ex. Ct.)	40
Western Electric Co. Inc. v. MNR, [1971] CTC 96 (Ex. Ct.)	21
Whittall v. MNR, [1967] CTC 394 (SCC)	354
Wilder v. MNR, [1949] CTC 302 (Ex. Ct.)	397
Wilderton Shopping Centre Inc. v. MNR, [1972] CTC 319 (FCTD)	365
Williscroft v. MNR, [1952] 7 Tax ABC 118 (TAB)	364
Wood v. MNR, [1969] CTC 57 (SCC)	355
Woods v. MNR, [1978] CTC 2802 (TRB)	372
Yardley Plastics Ltd. v. MNR, [1966] CTC 215 (Ex. Ct.)	422

Introduction

A persistent problem in the theory of income taxation is whether natural persons should be taxed as isolated individuals, or as social beings whose family ties to other taxpayers affect their taxpaying capacity.[1] From its inception, the federal income tax law has required every taxpayer to file a personal return, embracing his or her own income but excluding the income of the taxpayer's spouse, children and other relatives.[2] In this respect the Canadian tax system has never recognized the social fact that "taxpaying ability is determined by total family income regardless of the distribution of such income among the members of the family," but rather has espoused the contrary theory that "the family as a unit has no combined taxpaying ability *per se*; its taxpaying ability is composed of the separate taxpaying ability of its individual members, and the taxpaying ability of each of these is determined by the amount of income of which he or she is the owner without reference to the income of the other members of the family."[3]

Since income is taxed at progressive marginal rates[4] in the hands of individuals, the *Income Tax Act*[5] (hereinafter referred to as the "*Act*") has long encouraged taxpayers, particularly those in the higher income bracket, to attempt to divert their income, prior to or after receipt, to other members of their family who pay lower taxes or none at all.[6] This method of diverting income to other family members is commonly referred to as "income splitting" -*i.e.* the arranging of income within a family unit in such a way that the income which would otherwise have been taxed in the hands of the principal income earner in the family unit is

taxed in the hands of other members of that family unit.[7]

Income splitting as a tax planning strategy can take many forms and variations, some of which may involve a significant degree of complexity.[8] Without setting out the detailed mathematical calculations which confirm the tax savings which may result from income splitting,[9] a list of the more popular forms of organization adopted for the purpose of income splitting illustrate how broad this area of tax law is:

(a) Inter-family loans and transfers of property;

(b) Management or service companies;

(c) Inter-vivos trusts;

(d) Partnerships;

(e) Indirect payments;

(f) Spousal registered retirement savings plans; and

(g) Employment of a spouse.

This essay will concern itself with the tax treatment of inter-family loans and transfers of property, as well as indirect payments to family members, and will examine the anti-avoidance rules contained in the Act and used by the Minister to prevent and recombine split income. The responses of the law to attempts at splitting income are, of course, influenced by the need for revenue and by Revenue Canada's capacity to audit returns and enforce the rules, but the impact of such rules on the public and on Parliament also depend on a much more influential context - society's assumptions about the role of the marriage and the family.

The philosophy of consolidation of family income was proposed

by the Canadian Royal Commission on Taxation (Carter Commission) in its 1966 report. The Commission's legislative proposals in this area were not enacted, but the Commission's statement in favour of consolidating family income is a clear and succinct exposition of the social premises that underlie this position:

> We conclude that the present [Canadian tax] system is lacking in essential fairness between families in similar circumstances and that attempts to prevent abuses of the system have produced serious anomalies and rigidities. Most of these results are inherent in the concept that each individual is a separate taxable entity. Taxation of the individual in almost total disregard for his inevitably close financial and economic ties with the other members of the basic social unit of which he is ordinarily a member, the family, is in our view a striking instance of the lack of a comprehensive and rational pattern in the present tax system. In keeping with our general theme that the scope of our tax concepts should be broadened and made more consistent in order to achieve equity, we recommend that the family be treated as a tax unit and taxed on a rate schedule applicable to family units. Individuals who are not members of a family unit would continue to be treated as separate tax units and would be taxed on a schedule applicable to individuals...
>
> We believe firmly that the family is today, as it has been for many centuries, the basic unit in society. Although few marriages are entered into for purely financial reasons, as a marriage is contracted it is the continued income and financial position of the family which is ordinarily of primary concern, not the income and financial position of the individual members. Thus, the married couple itself adopts the economic concept of the family as the income unit from the outset. In western society the wife's direct financial contribution to the family income through employment is frequently substantial. It is probably even more true that the newly formed family acts as a financial unit in making its expenditures. Family income is normally budgeted between current and capital outlays, and major decisions involving the latter are usually made jointly by the spouses...
>
> Where the family grows by the addition of children, further important financial and economic decisions are made in the family as a unit. Questions of the extent of education, time of entrance into the labour force and, frequently, choices of a career are

> decided on a family basis, although of course there are many exceptions to this statement. In some circumstances the income of the child is added to the family income, and, even where this is not done directly, the fact that a child has income of his own will have some bearing on the main family expenditure decisions. Certainly when the child becomes self-supporting he is normally expected to relieve the family of further expenditure on his behalf. Thus, the income position of children has an important bearing on the family income, although frequently in an indirect way.[10]

This rationale implies that the tax on a family with a given amount of consolidated income should be the same regardless of the proportion of each spouse's contribution to their total income, and it also suggests, although less clearly, that the ratio of parent-child contributions should also be irrelevant. A corollary of this emphasis on the family's consolidated income is that legal ownership of property and income within the family should be disregarded in judging its taxpaying capacity. For many years, a major theme in the taxation of income from property transferred within the family has been that bedchamber transactions are suspect because the allocation of legal rights within the family is a trivial matter.[11]

As indicated in the above excerpt, the Carter Commission advocated consolidation of the income of children as well as the income of spouses. In a society whose children are expected to work and to contribute their earnings to the family pool without expressing any opinion with respect to how the funds are used, the case for consolidation is perhaps stronger. But even in a society that accords more financial independence to children, their earnings may well affect the behaviour of the parents; as the child's income grows, the parents are relieved of pressure to support the children currently and even to pass on an inheritance

to them. The larger the aggregate pool of resources, it is argued, the greater the group's capacity to pay taxes.[12]

In its proposals for tax reform in 1969,[13] however, the government rejected the concept of the family tax unit, arguing that such a tax unit would impose a "tax on marriage" because a husband and wife who each had an income together would pay more tax than two people who had the same income and were not married.[14] Because this was considered unfair and undesireable, the government was not prepared to change to a system of separate rate schedules at that time. It thus, in effect, opted for the existing system, which emphasizes the separateness of family members as the primary reality for tax purposes, and which then reflects family relationships through special deductions and rules.

The writer also feels that, although the Carter Commission report was written only twenty years ago, certain structural changes in Canadian society in particular, and in North American society in general, appear to have rendered its foregoing propositions somewhat out of date. The most significant change, in this regard, has been the increasing number of married women who have entered the work force as businesswomen and professionals pursuing lucrative carreers. For many of these women, a large number of whom have achieved financial independence from their husbands, the notion of filing a joint return is an idea whose time has clearly passed. They feel that joint taxation would unduly discriminate against them, and their sentiments were expressed in the following paragraph, taken from the 1975-76

Interdepartmental Committee on the Taxation of Women, whose mandate was to review the Carter Commission's recommendations:

> ... During the 1950's and 60's when most wives worked in the home, [joint returns] would perhaps have been a better tax system than individual returns. In the 1970's, however, when the government is making such efforts to improve the status of women by recognizing them as individuals outside the family unit, [joint returns] would seem a retrograde step...[15]

The essay itself may be said to be sub-divided into twenty sections. These sections are as follows:

(1) a brief history of the attribution rules;

(2) the purpose and function of the attribution rules;

(3) the meaning of "property" within the context of the Act;

(4) judicial interpretation of the concept of "transfer;"

(5) rules concerning loans of property;

(6) loans and transfers to a trust;

(7) loans and transfers to a corporation;

(8) indirect transfers of property;

(9) the notion of "vesting" of property;

(10) marriage gifts;

(11) transfers by operation of law;

(12) the distinction between income from property and income from business;

(13) the attribution of capital gains between spouses;

(14) the concept of a principal residence;

(15) tax consequences of marriage break-ups;

(16) loans and transfers to minors;

(17) joint liability of the transferor and transferee for taxes owed by the transferor;

(18) burden of proof and the attribution rules;

(19) attribution and family law; and

(20) indirect payments and benefits.

I. History of the Attribution Rules

The present attribution rules are derived from one of the original anti-avoidance provisions of the 1917 Income War Tax Act which read as follows:

> 4(4) A person who, after the first day of August, 1917, has reduced his income by the transfer or assignment of any real or personal, moveable or immovable property, to such person's wife or husband, as the case may be, or to any member of the family of such person, shall, nevertheless, be liable to be taxed as if such transfer had not been made, unless the Minister is satisfied that such transfer or assignment was not made for the purpose of evading the taxes imposed under this Act or any part thereof.[16]

This rule, while simple by today's standards although somewhat inequitable in its application (since it could be applied not only to spouses and minor children but to any member of the taxpayer's family), blocked the obvious route that the first generation of taxpayers may have followed to reduce their taxable income and thereby "evade" taxation.

The general wording of the attribution sections[17] remained relatively stable until significant changes were introduced in the 1948 Act which were deemed necessary in order to close certain loopholes and clarify certain areas of the law. As a result of such changes, the law then read as follows:

> 21(1) Where a person has, on or after the first day of August, 1917, transferred property, either directly or indirectly, by means of a trust or by any means whatsoever, to his spouse, or to a person who has since become his spouse, the income for a taxation year from the property or from the property substituted therefor shall be deemed to be income of the transferor and not of the transferee.[18]

In effect, the 1948 amendments meant that the attribution sections would thereafter apply to:

(a) "indirect" transfers of property made by means of a trust or by any other means whatsoever;

(b) prenuptial transfers of property; and

(c) property substituted for the original property transferred.

Subsequent amendments and refinements to the attribution rules resulted in the immediate predecessor to the current legislation. Former subsection 74(1) provided that:

> 74(1) Where a person has, on or after August 1, 1917, transferred property either directly or indirectly by means of a trust or by any other means whatsoever to his spouse, or to a person who has since become his spouse, any income or loss, as the case may be, for a taxation year from the property or from property substituted therefor shall, during the lifetime of the transferor while he is resident in Canada and the transferee is his spouse, be deemed to be the income or loss, as the case may be, of the transferor and not of the transferee.[19]

The changes contained in former subsection 74(1) were, one might say, equitable improvements over the previous rules. Thus, losses incurred by the transferee in respect of transferred and/or substituted property would also be attributed to the transferor; and attribution would apparently cease to be effective upon either the transferor ceasing to be a Canadian resident or dying, or upon a dissolution of the parties' marriage. In addition, under former subsection 74(2) (the present subsection 74.2(1)) capital gains realized by the transferee in respect of the transferred property became subject to attribution and, in 1975 and thereafter, capital losses also became subject to the attribution rules.

A. Loans Used to Avoid the Attribution Rules

Notwithstanding that the word "transfer," for the purposes of

the attribution sections, was defined very broadly to include any situation where the transferor divested himself of property and vested it in the transferee,[20] the courts made it clear, and the Department (with certain qualifications and a great degree of reluctance) accepted this judicial interpretation,[21] that a loan of money (irrespective of whether or not it carried an interest charge) made from a taxpayer to his spouse and/or to a minor child did not constitute a "transfer of property" within the meaning of these provisions.

In the case of Dunkelman v. MNR,[22] the taxpayer loaned a sum of money to trustees in order to purchase a building owned by a third party. The declaration of trust provided that all rental income from the building which remained after the payment of the mortgage and other expenses would be held in trust for the taxpayer's three minor children. The Minister assessed he taxpayer in respect of the rental income from the property, contending that he had transferred money to minors by means of a trust, and that the building was substituted property so as to bring the entire transaction within the former subsection 22(1).[23] Thurlow J. (as he then was) refused to accept the Minister's contention that a loan constituted a "transfer." The learned judge felt that since, by definition, a borrower of money was obligated to subsequently repay an identical sum to the lender, there coulld not be said to be any transfer of property from the latter to the former. In effect, Thurlow J. was influenced by the temporary nature of any change in the holding of property involved in a loan.[24]

The decision in Dunkelman was expressly followed in the case

of Oelbaum v. MNR.[25] Here the taxpayer loaned a total of $150,000 to his wife by way of personal cheques and took back three non-interest bearing demand promissory notes for $50,000 each. The notes remained unpaid at the time the case came to trial. The Minister assessed the taxpayer on all the income which the wife received from her investment of the loaned money on the ground that the loans were not bona fide and therefore such investment was substituted property for the transferred money. The Minister also attempted to distinguish the Dunkelman case on the basis that that case only applied where the transaction in question was very "businesslike" (i.e. there was a mortgage granted as security for the loan), whereas in the instant case there was no written record of the loan except for promissory notes.

In vacating the assessment, Jackett P. accepted the husband's oral evidence that the promissory notes constituted a loan to his wife and not a gift. On this basis, he followed the Dunkelman case and held that the loan was not a transfer of property. He also stated that, for the purposes of the attribution provisions, it was immaterial whether or not a loan was "businesslike" so long as it was bona fide and was not a sham.[26]

It is interesting to note that, while the judicial position (as reflected in the Dunkelman and Oelbaum cases) was that a loan of money did not constitute a transfer of property, under the Quebec Civil Code it seems that a loan of money has always constituted a transfer of property.

Under article 1762 of the Civil Code, there are essentially two kinds of loans which may be transacted: (a) a "loan for use,"

which is the loan of a thing which may be used without being destroyed; and (b) a "loan for consumption," which is the loan of a thing which is consumed by the use made of it. Articles 1763 and 1764 of the Civil Code provide that a "loan for use" is gratuitous; the thing lent is to be returned by the borrower to the lender, who continues to own it. With respect to a "loan for consumption," this is defined in article 1777 of the Civil Code as "a contract by which the lender gives the borrower a certain quantity of the thing which are consumed by the use made of them, under the obligation by the latter to return a like quantity of the same kind and quality." By virtue of article 1779 of the Civil Code, a loan of money is considered to be a loan for consumption. It seems clear that, by virtue of article 1778, which provides, inter alia, that in a loan for consumption the borrower becomes owner of the thing lent, a loan of money is considered to be a transfer of property since, for the purposes of the Civil Code, there is a transfer of ownership in such a case.

It also appears that, in other Commonwealth jurisdictions, a loan of money is generally considered to constitute a transfer of property. In James v. CIR,[27] a New Zealand case, it was held that a loan of money (in this case to a trustee in trust for the taxpayer's wife and children) constituted a "transfer of assets" within the context of the existing succession duties legislation. The court agreed with the dissenting views of Fair and Smith JJ. in Card v. CSD[28] (also a New Zealand case) where the justices were of the opinion that an interest-free loan of money from a father to his son constituted a transfer of property.

In Australia, the High Court held, in the case of McGain v.

CIR,[29] that a sum of money loaned by the taxpayer to a company controlled by him constituted a "disposition of property" under the relevant gift tax legislation as it existed at that time.

In the United Kingdom, the general rule is that a loan will constitute a transfer ("disposition of property") if the lender's estate is diminished in consequence of the loan.[30] Such will be the case, generally speaking, where the lender does not charge any interest on the loan or charges a rate less than that prescribed by the Finance Act. However, consistent with the notion that transfers of property between spouses are generaly considered to be tax-exempt,[31] subsection 115(1) of the Finance Act provides that a "disposition" does not include a loan made by one spouse to the other.[32]

In Canada, as a result of the decisions in Dunkelman and Oelbaum, taxpayers were able to avoid the application of the attribution rules where funds were loaned to other members of their family. Typically, the high-income taxpayer in the family would be able to shift investment income to a lower-income spouse or minor child (the latter usually by means of a trust) by making an interest-free (or low-interest) loan to such persons. Because a loan was not considered to be a "transfer of property," any income earned from investing the proceeds of the loan, or from property substituted therefor, would be taxed in the hands of the spouse and/or minor child at a lower tax rate. Since income derived from property acquired with the proceeds of the loan would usually remain in the taxpayer's immediate family, the taxpayer could reduce his tax bill and continue to retain effective control over

the loaned funds and income derived therefrom.

There were other ways in which taxpayers could use the loan exception to their advantage. For example, suppose that, in 1982, a husband loaned $50,000, without interest, to his wife, for her to invest the money on her own behalf. Subsequently, in 1984, he made a gift of $50,000 in cash which she used to repay the loan. Since a loan was not regarded as a transfer of property under the law at that time, the husband was not taxable in 1982 and 1983 in respect of the income and capital gains which the wife realized from the investment of the borrowed funds. The gift of money in 1984 was, however, a transfer of property which was clearly subject to the attribution rules but no income was derived from this money because it simply went to repay the loan. Consequently, although there were no decided cases on this point, it seemed clear that under the prior law there could be no attribution of income as a result of the husband's cancellation of the loan to his wife in this manner.[33]

Perhaps because of the relative ease and simplicity with which income could be split through the use of the family loan, this method of income splitting (and its concomitant avoidance of the attribution rules) became very widespread. In fact, the family loan became such a popular method of splitting income that many trust companies and stock brokerage firms began to sell pre-packaged income-splitting trusts with the interest-free loan utilized as an unsophisticated but cost-effective method of reducing taxes.[34]

While there was no question that the family-loan method of income splitting was a legitimate form of tax planning available

to reduce taxes on investment income, it is submitted that many Canadians felt (as in the case of, say, tax shelters generally suitable for only high-income individuals) that it was unfair and unjust for high-income taxpayers to make such extensive use of such a loophole and accordingly reduce their tax burden. It is also the writer's opinion that the Department of National Revenue felt a strong sense of frustration at seeing many taxpayers simply circumvent the law (i.e. the attribution provisions) and defeat its ostensible purpose by means of the family loan.

More than twenty-five years after the decision in the Dunkelman case, the Department's frustration manifested itself in the repeal, inter alia, of the attribution rules contained in former subsections 74(1) and 75(1),[35] and in the introduction of a new set of complex rules (analyzed below) designed to block the family loan and to limit the use of trusts and corporations for income splitting purposes.[36]

II. Purpose and Function of the Attribution Rules

The principal provisions of the Act designed to frustrate income splitting (commonly referred to as the "attribution rules") are contained in section 74.1 through subsection 74.5(11) inclusively. These provisions are directed at specific transfers and loans of property by which a transferor or lender (hereinafter referred to as an "individual") might otherwise succeed in diverting taxable income from his hands into those of the recipient. Broadly speaking, the transfers and loans affected are those made to or for the benefit of a spouse or minor child (whether directly, indirectly, by means of a trust, or through the

medium of a corporation) and those which confer equitable interests under a trust in which the settlor retains a reversionary interest, a power of appointment or a power to veto any further disposition of the trust property.[37]

In general terms, the attribution rules attribute back to the individual certain types of income earned from the loaned or transferred property. Thus, income or losses,[38] as the case may be, taxable capital gains and allowable capital losses,[39] net gains from dispositions of listed personal property[40] realized from property loaned or transferred between spouses, and dividends imputed to an individual with respect to loans or transfers made to a non-small business corporation of which the individual's spouse and/or a minor child are shareholders,[41] are attributed back to the individual. The attribution rules operate between spouses only where the individual is alive, resident in Canada, married to the recipient of the loaned or transferred property and not legally separated.[42] The rules also apply to a person who subsequently becomes a spouse of the individual.

As a consequence of the new rules adopted to prevent income splitting through loans,[43] Parliament also introduced a myriad of additional provisions which basically consist of:

(a) exemptions for loans made on a commercial basis[44] and transfers made where the transferor receives consideration which is not less than the fair market value of the property transferred;[45]

(b) specific rules to determine the amount attributed to the individual where property is loaned or transferred to: (i) a trust of which the individual's spouse and/or a minor child are

beneficiaries;[46] or (ii) a non-small business corporation of which the individual's spouse and/or a minor child are shareholders;[47] and

(c) anti-avoidance rules with respect to back-to-back loans and transfers,[48] loan guarantees,[49] repayments of loans,[50] and artificial transactions.[51]

With respect to minor children, income from loaned or transferred property is attributed back to the individual up to but not including the year in which the child attains 18 years of age,[52] and for attribution to apply there does not have to be any special relationship between the individual and the minor child - i.e. the individual may be any person including a parent, relative or stranger. However, taxable capital gains and allowable capital losses from property loaned or transferred to a minor (with the exception of certain farm property)[53] are not attributed to the individual.

In addition to the rules contained in section 74.1 et. s., a taxpayer may, as the controlling shareholder of a small business corporation, be subject to attribution on the basis of the indirect payments rule in subsection 56(2). In this case, the share capital of the company will usually consist of several classes of common shares, each with discretionary dividend entitlement that is not dependent on dividends paid on any other class of common shares. The taxpayer will own one class of shares while his family members will own shares of a different class. The issue here is whether, when dividends are paid on the class of shares owned by members of the taxpayer's family (but not on the

class of shares owned by the taxpayer himself) a proportionate share of such dividends should also be included in the taxpayer's income by virtue of subsection 56(2).

A taxpayer may also attempt to transfer property (in a non-arm's length transaction) by transferring the right to income from certain property, in which case the income will be attributed back to him by virtue of subsection 56(4), unless he also transfers the property itself.

Also, where a taxpayer, as the controlling shareholder of a corporation, confers a benefit on another individual by, for example, arranging for the other individual to acquire a majority share position in the corporation at the expense of a reduction in his own shareholding, the effective result, pursuant to subsection 245(2), may be a transfer of shares from the controlling shareholder to the other individual.

III. Subsection 74.1(1): Loans and Transfers to a Spouse

A. General

Subsection 74.1(1) provides that:

> (1) Where an individual has transferred or loaned property, either directly or indirectly, by means of a trust or by any other means whatever, to or for the benefit of a person who is his spouse or who has since become his spouse, any income or loss, as the case may be, of that person for a taxation year from the property or from property substituted therefor, that relates to the period in the year throughout which the individual is resident in Canada and that person is his spouse, shall be deemed to be income or a loss, as the case may be, of the individual for the year and not of that person.

The purpose of subsection 74.1(1) is to prevent avoidance of tax by the loan or transfer of property by a taxpayer to his spouse. If property has been loaned or transferred by an

individual to his spouse whether before or after marriage and where the individual was resident in Canada, then the income from that property or from property substituted therefor, will be taxed not in the hands of the recipient by whom it is received (whether directly, or as a beneficiary of a trust, or as a shareholder of a non-small business corporation) but in the hands of the individual for as long as he resides in Canada and the recipient is his spouse. Similarly, any loss arising in the 1975 and subsequent taxation years from the loaned or transferred property or property substituted therefor, will be deemed to be the loss of the individual and not of his spouse. The same rules apply with respect to taxable capital gains and, for 1975 and subsequent taxation years, allowable capital losses arising from the disposition of such property but only in the case of a transfer made after 1971.[54] However, the rules contained in subsections 74.1(1) and 74.2(1) are subject to the exceptions set forth in subsection 74.5(3) where the parties separate pursuant to a decree, order or judgment of a competent tribunal or a written separation agreement.

B. Definition of Spouse

While the word "spouse" is used in numerous sections of the Act,[55] it is nowhere defined. In dealing with the availability of the marriage status deduction, the Tax Review Board has interpreted the word "spouse" strictly to refer to a marital arrangement which is recognized under Canadian law, and which does not include a common-law spouse.[56] In No. 673 v. MNR[57] the taxpayer lived with a woman who had taken his name and whom he openly acknowledged and represented as being his wife. The pair,

however, were never legally married. The issue was whether or not the taxpayer could claim the statutory marital exemption under the former subparagraph 26(1)(a)(i) in respect of "a married person who supported his spouse." The Board held that the taxpayer was not entitled to the marital exemption since such exemption only applied to legally married persons, which was not the true nature of the parties' relationship.[58]

It should be noted, however, that while the jurisprudential position is that the term "spouse" refers only to a legally married spouse and does not include a "common-law" spouse, "common-law" spouses are recognized as qualified transferees in limited circumstances under the Act.[59] To qualify they must fall within the prescribed provisions of the law of a province and must belong to a prescribed class of persons referred to within the prescribed provisions.[60] Therefore, for example, only those persons who are recognized by provincial law to possess property rights arising from a "common-law" relationship are recognized for income tax purposes under subsection 73(1).[61] In other words, provincial law determines eligibility and the Act describes the tax consequences to eligible persons.[62]

It should also be noted that while the decisions of the Board have confined the meaning of "spouse" to a legally married person, recent amendments to the Act have extended the meaning of "spouse," as well as "former spouse," to include a party to a void or voidable marriage.[63]

IV. Loan or Transfer of Property

A. Statutory Definition of Property

Subsection 248(1) defines "property" as follows:

> 'property' means property of any kind whatever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes
> (a) a right of any kind whatever, a share or a chose in action,
> (b) unless a contrary intention is evident, money,
> (c) a timber resource property, and
> (d) the work in progress of a business that is a profession.[64]

This definition makes it obvious that the concept of property for tax purposes is very broad. In Fasken Estate v. MNR,[65] Thorson P. pointed out that the English courts have recognized the wide extent of the concept[66] and he quoted with approval an extract from the opinion of Langdale M.R. in Jones v. Skinner where the Lord Justice, in dealing with the construction of a will, said:

> It is well-known that word 'property' is the most comprehensive of all terms which can be used, inasmuch as it is indicative and descriptive of every possible interest which the party can have.[67]

The learned President went on to decide that the word "property" included a contingent right to receive income from a trust.[68]

As broad as the definition of property appears to be, there are certain instances in which Canadian courts have not extended the concept. In No. 481 v. MNR[69] the contract of sale between the parties provided that the non-resident vendor undertook not to sell a certain product in Canada for a period of ten years or compete in Canada with the taxpayer with respect to the manufacture of such product. The issue was whether or not such a covenant of non-competition constituted "property" of a specified class available for capital cost allowance. It was held that such a covenant did not constitute "property" since it had no character of ownership which, it was felt, was the condition sine qua non of

the meaning of the word "property."[70] In Rapistan Canada Ltd. v. MNR[71] a non-resident U.S. company granted and assigned to the taxpayer company certain manufacturing technology and know-how for exclusive use in Canada for a ten-year period. The taxpayer sought to deduct capital cost allowance under Class 14 with respect to such technology and know-how. The Federal Court of Appeal, per Jackett C.J., held that knowledge or an idea, unless protected by a monopoly such as a patent or registration of an industrial design, did not constitute property.

The implication which flows from both of the above cases is that in order for something to constitute property, not only must it be possessed but it must be capable of being possessed to the exclusion of others.[72] This interpretation, however, has not met with unanimous judicial acceptance. In Western Electric Co. Inc. v. MNR[73] the taxpayer aquired the right to use certain confidential technical information in return for a fee based on its sales. Such information was non-transferable and was not patented. Dumoulin J., while expressly stating that he did not assimilate commercial trade secrets to patented information, was of the opinion that such confidential information constituted "property" for the purposes of non-resident witholding tax imposed by paragraph 212(d). The learned judge appeared to be impressed by the large sum of money ($6 million) which the taxpayer paid for the information in question, reasoning that such a large expenditure would not have been made unless the taxpayer obtained a flawless degree of exclusivity in respect thereof.[74]

The obvious question posed by these conflicting viewpoints is

whether, for something to constitute "property," it must be possessed to the absolute exclusion of others, or whether it can take the form of an interest which is less than complete ownership. It does not seem arguable that mere abstract ideas or individual skills can be classified as property, unless such ideas or skills are patented or registered as statutory monopolies. However, if a taxpayer acquires confidential information or trade secrets pursuant to a contract under which he gives valuable consideration in exchange for such information, he thereby acquires a legal contractual right to receive and possess such information (irrespective of whether or not such information is patented) and since "property" includes "a right of any kind whatever or ... a chose in action" it seems that trade secrets and manufacturing technology aquired in this manner would constitute "property" within the meaning of subsection 248(1).[75]

B. Statutory Classification of Property

The Act classifies property into a number of different categories, with the tax treatment of certain of the categories subject to differing rules. These categories are as follows:

(i) Real Property

The phrase "real property" is not specifically defined in the Act, although it is enumerated as one of the types of property included in the general definition of property. The meaning to be accorded to the phrase, therefore, is its ordinary meaning at common law.[76]

Although at common law a leasehold interest is not real property,[77] subsection 248(4) provides that, for the purposes of the Act, an interest in real property includes a leasehold

interest therein. Subsection 248(4) also provides that an interest in real property does not include an interest as security only, claimed by virtue of a mortgage, hypothec, agreement for sale or similar obligation.[78]

(ii) Capital Property

Subsection 248(1) defines capital property to be the meaning assigned by section 54. Paragraph 54(b) defines capital property as follows:

> 'capital property' of a taxpayer means
> (i) any depreciable property of the taxpayer, and
> (ii) any property (other than depreciable property), any gain or loss from the disposition of which would, if the property were disposed of, be a capital gain or a capital loss, as the case may be, of the taxpayer.

This definition indicates that the category of capital property contains two sub-categories. The meaning of the term "depreciable property" is discussed immediately below. Once a taxpayer has been entitled to make a claim for capital cost allowance, the property will remain a depreciable capital property unless there has been a change in use of the property under subsection 13(7).[79] Whether a property falls into the second sub-category of capital property depends on how the gain or loss on the disposition thereof is treated.[80]

(iii) Depreciable Property

Subsection 248(1) provides that the term "depreciable property" is to have the meaning assigned to that term in subsection 13(21). Paragraph 13(21)(b) provides that:

> 'depreciable property' of a taxpayer as of any time in a taxation year means property aquired by the taxpayer in respect of which he has been allowed, or, if he owned the property at the end of the year, would be entitled to, a deduction under regulations made under paragraph

> 20(1)(a) in computing income for that year or a previous taxation year;[81]

As the definition states, depreciable property includes only property that has been "acquired by the taxpayer." The words quoted do not limit the category to property which the taxpayer owns, although he must have an interest in the property in question.

The proper test as to when depreciable property has been acquired by a taxpayer for the purposes of paragraph 13(21)(b) relates to the title to the property in question or to the normal incidents of title, either actual or constructive, such as possession, use and risk. Thus, for example, a taxpayer would not be considered to have acquired depreciable property if he had merely agreed (under a binding contract) to purchase the property from the vendor; to fall under the regulations for the deduction of capital cost allowance, the taxpayer must have a right in the property itself rather than rights in a contract relating to the property which is the subject matter of the contract.[82]

(iv) Eligible Capital Property

Eligible capital property is defined in paragraph 54(d) as follows:

> 'eligible capital property' of a taxpayer means any property, 1/2 of any amount payable to the taxpayer as consideration for the disposition of property which would, if he disposed of the property, be an eligible capital amount in respect of a business within the meaning given that expression in subsection 14(1);

Eligible capital expenditures of a taxpayer are defined in paragraph 14(5)(b) to be expenditures made on account of capital for the purpose of gaining or producing income from a business other than expenditures that are otherwise deductible, are for

tangible property, are for intangible depreciable property or are made for the purpose of producing exempt income. One-half of these expenditures fall into the taxpayer's "cumulative eligible capital" in respect of the business.

Subparagraph 39(1)(a)(i) provides that a capital gain cannot be realized on the disposition of eligible capital property and this property, therefore, does not fall within the definition of capital property. Although gains on the sale of eligible capital property are treated similarly to capital property in that the inclusion in income on the disposition of eligible capital property is computed on the basis of one-half of the gains, there are significant differences in timing due to the pooled account concept.[83]

C. Judicial Interpretation of "Transfer"

There is no statutory definition of "transfer" for the purposes of the Act. The word has been subject to judicial consideration on several occasions, however. The most frequently quoted and extensive of the judicial interpretations is found in the judgement of Thorson P. in Fasken Estate v. MNR:

> The word `transfer' is not a term of art and has not a technical meaning. It is not necessary to a transfer of property from a husband to a wife that it should be made in any particular form or that it should be made directly. All that is required is that the husband should so deal with the property so as to divest himself of it and vest it in his wife, that is to say, pass the property from him to her. The means by which he accomplishes this result, whether direct or circuitous, may properly be called a transfer.[84]

It has been said of this and similar judicial statements that the word "transfer" has been given its "normal, everyday meaning" and has not been viewed as being used in any special sense.[85] This

may be true to the extent that an outright gift, either directly or indirectly to a spouse,[86] or through the medium of a trust,[87] falls within its scope. Nevertheless, it seems arguable that the definition formulated by Thorson P. has narrowed the implications of "transfer" in at least one sense - namely, that the use of the words "divest" and "vest" strongly implies the passing of some legal right or interest between the parties to a transfer. Strictly construed, this terminology suggests that a mere change in the physical possession of property does not constitute a transfer within the meaning of the attribution sections.[88]

(i) Sale

Viewed in isolation, there appears to be no doubt that a bona fide sale by a taxpayer - for example, a sale of shares in the capital stock of a company or of land - should be considered a "transfer" - this is, after all, one of the most common uses of the word. In every sale there is an eventual divesting of title, possession and ownership and subsequent vesting in another individual.

The prevailing judicial opinion seems to be that a sale does constitute a transfer of property in the context of subsections 74.1(1) and 74.1(2). In Campbell v. MNR[89] the taxpayer purported to sell some shares of a private corporation to his wife on the security of a promissory note given by the wife as consideration for the sale. It was the parties' stated intention that the debt was to be repaid out of forthcoming dividends paid to the wife by the same corporation. Although he doubted the existence of any sale in substance, the Assistant Chairman clearly accepted that

even if there were a sale at common law, the "transfer" requirement of what is now subsection 74.1(1) would be satisfied. Similarly, in German v. MNR,[90] the taxpayer arranged for his wife to receive $5,000 of the sale price of his house as consideration for her relinquishing her dower rights therein.[91] It was held that the income earned by the wife from her investment of the said $5,000 was properly attributable to the husband. Thurlow J. (as he then was) felt that the factor of consideration provided by the transferee did not alter the fact that a transfer had taken place:

> Regardless of whether or not anything capable of constituting consideration was given by the wife for the property or rights so transferred [subsection 74.1(1)] would apply to render the appellant taxable on such income.[92]

While the trend of judicial authority has indicated that a sale should be classified as a "transfer," the fact remains, however, that in no case has the matter been fully considered. In both Campbell and German there was some doubt as to whether adequate consideration had been given for the transferred property and in fact, in Campbell, it was suggested that there was no sale at all. However, it is not surprising that the above decisions were reached since in both cases the transactions in question were clearly designed to avoid the impact of the attribution provisions, and while attribution will operate irrespective of whether or not there is an intention to avoid taxation,[93] clear evidence of such a motive will strongly influence the determination of the court.

The only other authority which supports the finding of a transfer is the decision in McLaughlin v. MNR[94] where, as in Campbell, a husband sold certain shares of a private company

(owned by him) at par value to his wife who gave a demand promissory note in return as payment. Subsequent to this transaction, the wife exchanged the shares of her husband's company for the shares of a company owned by a third party, and when she received dividends in respect of the latter, such dividends were attributed to her husband. It was held that the dividends paid to the wife were properly attributed to her husband on the ground that such dividends were income from substituted property.[95]

While the attribution rules were held to apply in McLaughlin, yet the court made no positive statement on the issue; on the contrary, it expressly noted that since the taxpayer had admitted that the sale of the shares to his wife constituted a transfer, it was relieved of the necessity of determining whether or not a sale of property from a husband to his wife came within the context of former subsection 32(2).[96] It would appear, however, that the question is beyond reconsideration since there seems to be an unqualified acceptance that a sale of property from one spouse to another constitutes a "transfer" within the context of the attribution sections.[97]

(ii) Sale or Transfer for Fair Market Value Consideration

It should be noted that while, strictly speaking, a sale of property would still appear to constitute a transfer for the purposes of the attribution sections, by virtue of subsection 74.5(1) such a transfer will no longer attract attribution if, at the time of the sale, the fair market value of the transferred property does not exceed the fair market value of property

received as consideration therefor by the vendor.

Subsection 74.5(1) provides that:

> (1) Notwithstanding any other provision of this Act, subsections 74.1(1) and (2) and section 74.2 do not apply to any income, gain or loss derived in a particular taxation year from transferred property or from property substituted therefor if
>
> (a) at the time of the transfer the fair market value of the transferred property did not exceed the fair market value of the property received by the transferor as consideration for the transferred property;
>
> (b) where the consideration received by the transferor included indebtedness,
>
> (i) interest was charged on the indebtedness at a rate equal to or greater than the lesser of
>
> (A) the rate prescribed for the purpose of subsection 161(1) that was in effect at the time the indebtedness was incurred, and
>
> (B) the rate that would, having regard to all the circumstances, have been agreed upon, at the time the indebtedness was incurred, between parties dealing with each other at arm's length,
>
> (ii) the amount of interest that was payable in respect of the particular year in respect of the indebtedness was paid not later than 30 days after the end of the particular year, and
>
> (iii) the amount of interest that was payable in respect of each taxation year preceding the particular year in respect of the indebtedness was paid not later than 30 days after the end of each such taxation year; and
>
> (c) where the property was transferred to or for the benefit of the transferor's spouse, the transferor elected in his return of income under this Part for the taxation year in which the property was transferred not to have the provisions of subsection 73(1) apply.[98]

In addition to the requirement that fair market value consideration be received by the transferor, subsection 74.5(1) requires that, in the case of property transferred to a spouse or to an inter vivos spouse trust, the exemption from attribution will be available only where the transferor elects under subsection 73(1) not to have the automatic rollover rules apply.[99] The apparent reason for this requirement is that since the

transfer is otherwise treated as an arm's length transaction (in the sense that the attribution rules will not apply), and since, in an arm's length sale a vendor will be required to pay capital gains tax (if applicable), it would not be consistent with the arm's length treatment for the vendor or transferor not to realize accrued capital gains upon the sale or transfer of property to his spouse. To the extent, however, that any gain realized on the transfer is sheltered by an individual's capital gains exemption,[100] this additional requirement will not result in any immediate tax consequences.

Where all or part of the consideration received by the transferor includes indebtedness, the exemption under subsection 74.5(1) is available on a year-to-year basis so long as interest is charged on the indebtedness at a rate not less than either the prescribed rate of interest[101] or the rate that would have been agreed upon between arm's length parties transacting under similar circumstances at the time the indebtedness was incurred.[102] In such a case, the exemption from attribution is available in a year only if the interest payable on the indebtedness in respect of that year and each preceding year has in fact been paid not later than 30 days after the end of each such year.[103]

The enactment of subsection 74.5(1) has clearly overruled the dicta of Thurlow J. in German v. MNR[104] to the effect that valuable consideration moving from the transferee does not prevent the application of the attribution rules.[105] This enactment, in fact, seems to provide very real possibilities for income splitting that did not exist under the previous rules.

For example, assume that a husband gives his wife a set of jewellry as a gift. The adjusted cost base of such jewellry is $10,000. Some time thereafter, the wife sells the same jewellry, for cash, to her husband for its current fair market value of $15,000. The wife then invests the $15,000 in interest or dividend-bearing securities. If the wife elects under paragraph 74.5(1)(c) to have the jewellry transferred to her husband at its fair market value (i.e. $15,000), none of the interest or dividends received by her will be attributed to her husband. However, subsection 74.2(1) will apply to attribute the taxable capital gain of $2,500 realized by the wife on the sale of the jewellry to her husband since no consideration was given in respect of the original gift by the husband. If, on the other hand, the wife had sold her jewellry to a third party for $15,000, the cash received would constitute substituted property, and any income derived from such property would be attributed to the husband.[106]

Another example, which has greater income splitting potential, involves the transfer of the family's principal residence between the spouses. For instance, assume that at the time that a taxpayer purchased his principal residence (entirely with his own funds), he took title to a portion of the residence in the name of his spouse. At some later date, the taxpayer could purchase, at its current fair market value, his wife's percentage ownership in the principal residence. The wife would then elect under subsection 73(1) not to have the inter vivos spousal rollover apply in respect of such percentage ownership. Where the wife is able to designate the home as her principal residence,[107]

there would be no taxable capital gain realized on the transfer,[108] and therefore no amount in respect of the gain would be attributed to the husband. Any future income or capital gains derived from the cash consideration, or property substituted therefore, would be taxed in the wife's hands only and would not be subject to attribution.[109]

It is submitted that the insertion of subsection 74.5(1) is a welcome and necessary change which removes the anomaly whereby a spouse who was paid full value for property was still subject to income and capital gains attribution. Since the purpose of the attribution rules is to prevent income splitting in the family unit, it is clearly necessary to catch, apart from loans, gifts and other dispositions of property for inadequate consideration. If these transactions were excluded, the attribution rules would be relatively ineffective. But the same objections would not seem to apply to a sale or transfer for full consideration because if the parties had theoretically conducted such transaction at arm's length in the open market, the same result would presumably have been reached; that is, the vendor would receive, and the purchaser would pay, fair market value for the property sold or transferred.

Of course, as the foregoing examples illustrate, subsection 74.5(1) introduces the possibility of "circulating" property within a family unit so as to minimize total tax liability. To this extent, then, the provisions of subsection 74.5(1) may conflict with the rationale of the attribution sections. Some degree of income splitting may be achieved. Nevertheless, it is felt that any tax savings which flow from the sale or transfer of

property for adequate consideration do not appear to be particularly ominous, and in the writer's opinion it is difficult to justify attribution in such circumstances.

D. Loans

(i) General

As noted above, the federal budget of May 23, 1985, proposed significant new measures to restrict high marginal rate taxpayers from avoiding tax by using the classical income-splitting technique - the interest-free loan - to shift investment income to their lower-income spouses or minor children. But the actual legislation which followed[110] proved to be a much tougher and wider-ranging assault than the budget foreshadowed. In fact, as will be seen below, it would not be any exaggeration to say that the new rules have attacked income splitting with a vengeance.

Generally speaking, there will be attribution of income or loss where an individual "has transferred or loaned property,[111] either directly or indirectly, by means of a trust or by any other means whatever, to or for the benefit of the individual's spouse or a minor child" (referred to collectively as "loans to or for a spouse or minor").[112] There are similar rules for the attribution of taxable capital gains and allowable capital losses realized with respect to loaned property.[113] Where an individual loans property to a trust in which his spouse and/or a minor are income beneficiaries, specific rules will determine the amount of their income or capital gains from the trust that is attributed to the individual for a taxation year.[114] If a taxable capital gain or an allowable capital loss is attributed to an individual, the nature of the gain or loss will retain its character for the purposes of

computing the individual's capital gains exemption.[115] These rules apply to loans outstanding on May 22, 1985, that are not repaid before January 1, 1988, and to loans and transfers of property made after May 22, 1985.[116]

(ii) Exemption for Loans Made on a Commercial Basis

Subsection 74.5(2) provides that where an individual makes a loan to or for a spouse, a minor child, or a trust in which such a person has a beneficial interest, such loan will be exempt from attribution if it bears a commercial rate of interest. The subsection states that:

> (2) Notwithstanding any other provision of this Act, subsections 74.1(1) and (2) and section 74.2 do not apply to any income, gain or loss derived in a particular taxation year from loaned property or from property substituted therefor if
>
> (a) interest was charged on the loan at a rate equal to or greater than the lesser of
> (i) the rate prescribed for the purpose of subsection 161(1) that was in effect at the time the loan was made, and
> (ii) the rate that would, having regard to all the circumstances, have been agreed upon, at the time the loan was made, between parties dealing with each other at arm's length;
>
> (b) the amount of interest that was payable in respect of the particular year in respect of the loan was paid not later than 30 days after the end of the particular year; and
>
> (c) the amount of interest that was payable in respect of each taxation year preceding the particular year in respect of the loan was paid not later than 30 days after the end of each such taxation year.

A loan is considered to bear a commercial rate of interest if the interest charged on the loan is at a rate not less than either the prescribed rate of interest or the rate that would have been agreed upon by arm's length parties at the time the loan was

made.[117] This exemption will apply if the interest payable on the loan is paid not later than 30 days after the end of each taxation year. If, in any taxation year, the interest is not paid within this prescribed time, the attribution rules will commence to apply in that year. A subsequent payment on account of late interest will not restore the loan to its previous exempt status.[118]

To qualify for the exemption, the loan must bear a commercial rate of interest at the time it is concluded. If this requirement is not satisfied at the outset, the attribution rules will apply even if the loan agreement is subsequently amended to provide for interest at a commercial rate. The attribution rules will also continue to apply if the original loan is repaid with a new loan that bears a commercial rate of interest.[119]

It is clear that, if a borrowing spouse or trust must pay a stipulated rate of interest on their loans, the scope for effective income splitting is thereby reduced to the amount of income or capital gains in excess of the prescribed rate that the spouse or trust can earn on the money borrowed. The obvious result is that in the straightforward case of a direct loan to a spouse or minor to split investment income, the attribution rules will be effective in significantly reducing income splitting.

Where the lender charges interest on a loan (whether at the prescribed rate or at a rate less than the prescribed rate) an interesting situation may arise where the borrower is unable to repay the loan due to prodigality or improvident investing. In such a case it may be that two losses will be realized for tax purposes in the same family unit. With respect to the lender, once the debt owing to him is established to have become a bad debt,

paragraph 50(1)(a) deems him to have disposed of it at the end of the year and to have reacquired it immediately thereafter at a cost equal to nil. The resulting loss may be claimed as a capital loss.[120] With respect to the borrower, he or she will have a loss on the investments and it would appear that subsection 80(1) would not apply since the debt at this point would not have been settled for less than its principal amount.[121]

The writer feels that, notwithstanding the statutory curtailment of income splitting by means of the inter-family loan, a low-inflation economy offers some potential for income splitting. The reason is as follows. With a low rate of inflation (and assuming the value of the Canadian dollar stabilizes in the foreign exchange markets), the Bank of Canada has more scope to lower the bank rate, which in turn will result in a lower statutory prescribed rate. With lower interest rates generally, stock market and bond prices should go significantly higher.[122] The result is that the capital gains to be realized in respect of such investments may far exceed the amount of interest required to be paid in order to exempt the loan from attribution. This reasoning assumes, of course, that the borrowing spouse has sufficient tolerance for risk to invest in stocks and bonds, which are inherently risky investments but which may offer significant capital gains potential.

A low-interest rate economy may also make real estate investments attractive since mortgage interest rates will generally be lower, resulting in a higher net rate of return on invested capital. The real estate market is more complex, however,

than passive investments such as stocks and bonds, and the spouse seeking to invest in this area should obtain expert advice. With respect to fixed-income investments such as term deposits or guaranteed investment certificates, such investments will generally not be attractive since their yield will normally be the same as or less than the prescribed rate.

(iii) Back-to-Back Loans and Transfers

Subsection 74.5(6) provides rules to ensure that the application of the attribution rules cannot be avoided through the use of third party intermediaries by an individual to effect a loan or transfer of property to or for the benefit of a "specified person."[123] The subsection states that:

> (6) Where an individual has loaned or transferred property
>
> (a) to another person and that property, or property substituted therefor, is loaned or transferred by any person (in this subsection referred to as a "third party") to or for the benefit of a specified person with respect to the individual, or
>
> (b) to another person on condition that property be loaned or transferred by any person (in this subsection referred to as a "third party") to or for the benefit of a specified person with respect to the individual,
>
> the following rules apply:
>
> (c) for the purposes of sections 74.1, 74.2 and 74.4, the property loaned or transferred by the third party shall be deemed to have been loaned or transferred, as the case may be, by the individual to or for the benefit of the specified person; and
>
> (d) for the purposes of subsection (1), the consideration received by the third party for the transfer of the property shall be deemed to have been received by the individual.

Subsection 74.5(6) applies where an individual loans or transfers property to another person and that property or property

substituted therefor is ultimately loaned or transferred, either by that person or any other person, to or for the benefit of the specified person. The subsection also applies where the individual loans or transfers property to another person on condition that any property be loaned or transferred by that other person to the specified person. In these types of situations, the effect of the subsection is that the property loaned or transferred by the third party is deemed to have been loaned or transferred by the individual to or for the benefit of the specified person. For example, assume that A and B agree between them to transfer to the other person's spouse 100 shares of equal fair market value that they presently own. As a result, A's wife would receive 100 shares of X Co. from B, and B's wife would receive 100 shares of Y Co. from A. This crisscross transfer would constitute a back-to-back transfer and, accordingly, future dividends received by A's wife from X Co. would be attributed to A, and future dividends received from Y Co. by B's wife would be attributed to B. In the same manner, capital gains and losses realized on the disposition of either set of shares would be attributed to the husbands accordingly.[124]

Paragraph 74.5(6)(d) provides that, for the purposes of the exemption from the attribution rules provided under subsection 74.5(1) in respect of transfers for fair market value consideration, any consideration received by the third party from a specified person in a back-to-back transfer is deemed to have been received by the individual. Therefore, where the consideration received is equal to (or greater than) the fair market value of the transferred property, the back-to-back

transfer will be exempt from any attribution. Similarly, a back-to-back loan will also be exempt from attribution where the loan made by the third party bears a commercial rate of interest and the interest is paid. This is possible because the exemption in respect of commercial loans provided under subsection 74.5(2) refers to interest paid by the specified person on the loan, and not to whom the interest is paid.[125]

(iv) Loan Guarantees

Subsection 74.5(7) provides rules to ensure that the attribution sections cannot be avoided where an individual is obligated, either absolutely or contingently, to guarantee the repayment of all or part of the principal and/or interest payable on a loan made by a third party to or for the benefit of a person who is a specified person in respect of the individual. The subsection provides that:

> (7) Where an individual is obligated, either absolutely or contingently, to effect any undertaking including any guarantee, covenant or agreement given to ensure the repayment, in whole or in part, of a loan made by any person (in this subsection referred to as the "third party") to or for the benefit of a specified person with respect to the individual or the payment, in whole or in part, of any interest payable in respect of the loan, the following rules apply:
>
> (a) for the purposes of sections 74.1, 74.2 and 74.4, the property loaned by the third party shall be deemed to have been loaned by the individual to or for the benefit of the specified person; and
>
> (b) for the purposes of paragraphs (2)(b) and (c), the amount of interest that is paid in respect of the loan shall be deemed not to include any amount paid by the individual to the third party as interest on the loan.

Where such a guarantee is given, the individual will be deemed to have made the loan to the specified person and any

income from the property loaned or from property substituted therefor, will be attributed to the individual. This provision will not apply, however, where the loan otherwise qualifies as an exempt loan (that is, where a commercial rate of interest is paid by the specified person)[126] and, for the purposes of determining whether the loan is exempt from attribution, any interest paid by the individual (i.e. the guarantor) is immaterial.

The provisions of subsection 74.5(7) appear to overrule one aspect of the decision in Wertman v. MNR[127] where it was held, inter alia, that attribution did not apply to investment income (in this case, rental income) earned with the assistance of a spousal loan guarantee. Here the initial investment in the purchase of land ($122,500) was taken in the names of both spouses jointly, although the purchase price was paid entirely by the husband from his own funds. In the subsequent transaction, the spouses borrowed $270,000 in their joint names, with the husband guaranteeing his wife's one-half portion of the loan. Such money was used to purchase a building which was constructed on the land. Thurlow J. ruled that the rental income applicable to the $122,500 investment in the land should be attributed to the husband since his taking of title in the name of his wife constituted an indirect transfer of property to her. However, he also held that former subsection 21(1)[128] did not apply with respect to such part of the rental income as was derived from the money borrowed by the wife which was guaranteed by her husband (i.e. one-half of $270,000). That is, with respect to the entire amount of income derived from the property, the proportion attributable to the husband was 257,000/392,000, with the balance taxable in his

wife's hands.[129]

According to the Wertman case, there was no transfer of property in the situation where one spouse derived income from property acquired with the proceeds of a loan guaranteed by the other spouse. This result, however, as noted above, has been nullified by the enactment of subsection 74.5(7), and it indicates the extent to which Parliament was willing to go in order to erode the use of the family loan as a means of income splitting. Although, in this case, no property might ever leave the hands of the guarantor spouse since he may never, in fact, be called upon to fulfill his obligations under the guarantee (so long as the other spouse repays the loan), nevertheless he will be subject to attribution in respect of income derived from property acquired with the proceeds of the guaranteed loan.[130]

There are, however, certain situations wherein a taxpayer may be able to avoid and/or use subsection 74.5(7) to his or his spouse's advantage. For example, suppose a husband wished to make an investment (E.g. in real estate) using funds borrowed from a bank, and he expects to incur a loss on the investment during the first few years, but thereafter the investment will be profitable. If the loan is not guaranteed by the wife during the years in which the losses are incurred, these losses will be treated as the husband's for tax purposes. However, if after a few years of losses, the wife guarantees the bank loan, then once net profits are realized on the investment, these profits will be attributed to the wife, so long as interest is paid not more than 30 days after the year end. It would seem difficult for the Minister to

invoke the anti-attribution provisions of subsection 74.5(11) since the profits will be attributed to the low-income spouse.[131]

The exemption from attribution in respect of a small business corporation[132] may also work to a spouse's benefit. For example, assume that the spouse of an individual acquired shares of a corporation engaged in active business. If the individual guarantees a bank loan made directly to the spouse, the attribution rules would apply with respect to any dividends or capital gains realized in respect of the shares acquired unless the spouse paid interest annually on the loan at a commercial rate. However, if instead the spouse formed a holding company to acquire the shares of the small business corporation and the individual guaranteed the loan of the holding company, the attribution rules would not apply, regardless of the terms of the loan, since the holding company would fall within the definition of a small business corporation under subsection 248(1) and paragraphs 186(4)(a) or (b), depending upon the nature of the holding company's investment in the small business corporation.[133]

(v) Repayment of Loans

Subsection 74.1(3) provides that where an individual loans or transfers property to or for the benefit of a spouse or minor child and such property is used to repay an already existing loan which has been used to acquire other property, any income from the other property, or property substituted therefor, will be attributed to the individual. The subsection reads as follows:

> (3) For the purposes of subsections (1) and (2), where, at any time, an individual has loaned or transferred property (in this subsection referred to as the "loaned or transferred property") either directly or indirectly, by means of a trust or by any means whatever, to or for

> the benefit of a person, and the loaned or transferred property or property substituted therefor is used
>
> (a) to repay, in whole or in part, borrowed money with which other property was acquired, or
>
> (b) to reduce an amount payable for other property,
>
> there shall be included in computing the income from the loaned or transferred property, or from property substituted therefor, that is so used, that proportion of the income or loss, as the case may be, derived after that time from the other property or from property substituted therefor that the fair market value at that time of the loaned or transferred property, or property substituted therefor, that is so used is of the cost to that person of the other property at the time of its acquisition, but for greater certainty nothing in this subsection shall affect the application of subsections (1) and (2) to any income or loss derived from the other property or from property substituted therefor.

The provisions of subsection 74.1(3) appear to work in the following way. For example, assume that an individual's wife borrowed $10,000 from a bank on June 1, 1985, in order to purchase $10,000 of common shares. In December, 1985, she sold the shares for $15,000 and invested the proceeds in a term deposit. Subsequently, in January, 1985, the individual repaid hs wife's bank loan of $10,000. Under the terms of subsection 74.1(3), the individual will be deemed to have made a $10,000 loan to his wife in respect of which $15,000 of substituted property has been acquired. The result is that all the interest income received by the wife in respect of the term deposit of $15,000 will be attributed to the individual commencing in January, 1986, and thereafter.[134]

It is interesting to note that the provisions of subsection 74.1(3) do not prevent the attribution rules from also applying to the original loan. That is, where a loan bearing a commercial rate of interest that is made by an individual is used to refinance a

post-May 22, 1985 interest-free loan made by the individual to his wife, any income from property acquired with the original loan will continue to be attributed to the individual so long as his wife owns the property or property substituted therefor.[135]

If an individual makes two interest-free loans to his wife, with the second loan being used to repay the first, it seems that income from the property acquired with the original loan may be attributed twice to the individual -i.e. the first time as a consequence of the attribution rules on the original loan, and the second time by virtue of subsection 74.1(3).[136] However, since both amounts which are attributed to the individual are from the same source, subsection 4(4) would presumably apply to exclude one amount from the individual's income.

The same result would not, however, obtain where the two loans were made by different individuals to a minor child. For example, where a father makes an interest-free loan to a trust for a minor child so that the trust can repay a loan previously made to it by the child's grandfather, where the grandfather's loan was subject to the attribution rules, the income earned on the property acquired with the original loan will be taxed twice; that is, once in the grandfather's hands and once in the father's hands.[137]

The wording of subsection 74.1(3) - that is, its reference only to income from property acquired with the original loan - implies that the subsection will not apply to attribute capital gains realized by a spouse in respect of such property.[138]

(vi) Artificial Transactions

Under former subsection 74(1), it was possible for spouses to

split income by carrying out what were termed "reverse attribution" plans. For example, the lower-income spouse (assuming it was the wife) could set up a shell company (i.e. a company with little or no assets) with her own money and then transfer or sell the shares to her husband for nominal consideration. The husband could then use the company for investment purposes, but any dividends which were paid to him by the company on the shares which were transferred to him by his wife would be attributed to the wife for tax purposes. Similarly, the wife could make a gift of cash (from her own funds) to her husband to be used by him to subscribe for additional shares in the corporation. Any dividends received by the husband in respect of these additional shares would be taxed in the wife's hands and not in the husband's hands.[139] Yet another strategy involved the wife purchasing common shares of, say, a public company, using funds obtained by a bank loan. These shares would be sold to her husband for cash consideration equal to their fair market value and the wife would then use the cash to repay her bank loan. Any dividends received or capital gains realized in respect of the shares would be attributed back to the wife.[140]

By virtue of subsection 74.5(11), it seems that spouses will no longer be able to utilize "reverse attribution" plans in order to split income between them. The subsection states that:

> (11) Notwithstanding any other provision of this Act, sections 74.1 to 74.4 do not apply to a transfer or loan of property where it may reasonably be concluded that one of the main reasons for the transfer or loan, as the case may be, was to reduce the amount of tax that would, but for this provision, be payable under this Part on the income and gains derived from the property or from property substituted therefor.

The result of the application of subsection 74.5(11) is that a taxpayer will not be able to engage in a transaction (i.e. loan or transfer of property) or a series of transactions where the principal purpose is to have the attribution rules apply to attribute income of the taxpayer to another person who would pay less tax on that income than the taxpayer would. Thus, reverse attribution plans, where the main objective was to use the attribution rules to have investment income and/or capital gains taxed in the hands of the wife (being the lower-income spouse), will be considered to be artificial transactions and consequently ineffective for tax purposes.

The provisions of subsection 74.5(11), however, do not appear to nullify an inter-spousal transfer of property whereby non-deductible interest may be converted into deductible interest. For example, a wife may borrow funds from the bank to acquire shares with accrued gains that her husband owns. The transfer of shares may be effected on a tax-free basis[141] with the cash proceeds used by the husband to repay a debt previously incurred to acquire a personal-use property such as a principal residence. The provisions of subsection 74.1(1) would apply to attribute future dividends on the shares (net of any interest expense) to the husband. As a result, this transfer has effectively converted non-deductible interest to deductible interest without triggering a capital gain in the husband's hands.[142] In these circumstances, the artificial transactions rule in subsection 74.5(11) should not apply since the dividends will be attributed to the higher-income spouse -i.e. the husband.

E. Loans or Transfers to a Trust

(i) Attribution of Ordinary Income

Under the provisions of former subsections 74(1) and 75(1), there could be no attribution of income unless the income-producing property, or property for which it was substituted, had been transferred by an individual directly or indirectly "by means of a trust or by any other means" to a spouse or minor child. In consequence, there was a possible implication that it was not sufficient for the Minister merely to show that a spouse or minor had received income from a trust to which the taxpayer had transferred property; arguably, it was necessary to show that the taxpayer had transferred to the beneficiary a proprietary interest that produced income.

This argument was supported to some extent by the analysis of Thorson P. in Fasken Estate v. MNR[143] where the transaction was essentially a novation of a debt owed originally by a corporation to trustees who held it in trust for the taxpayer. As a result of the novation, the taxpayer's wife became entitled to receive part of the interest payable on the debt. It was held that the wife's right to receive the interest was property from which income was derived and that such property had been transferred by the taxpayer to his wife. In the view of some commentators,[144] the reasoning in this decision supported an inference that a beneficiary who had no right to demand payments of income under a trust would have no income-producing property and, in consequence, that such a beneficiary could not be considered to have received income from property that had been transferred to the beneficiary by the settlor or other contributor of property to trust.[145]

On the basis of such reasoning, it was argued that there could be no attribution where a beneficiary with a contingent[146] or defeasible[147] capital interest received income by virtue of an exercise by trustees of a discretionary power to distribute income; that the contingent or defeasible interest was property but did not produce income and, despite the wide statutory definition of "property" in subsection 248(1),[148] it was thought that the mere possibilty of receiving income by virtue of the exercise of the trustee's discretion was not itself property.[149]

Essentially, the same argument was, prior to the case of Sachs v. The Queen,[150] used to support the proposition that the attribution rules would not apply when a beneficiary with a contingent or defeasible capital interest exercised a preferred beneficiary election[151] with respect to the accumulating income of the trust.

Notwithstanding the fact that the courts in subsequent cases have generally accepted the analysis in the Fasken case,[152] they have upheld assessments where trust income has been distributed by virtue of the exercise of a discretionary power[153] or has been included in the income of a beneficiary only by virtue of a preferred beneficiary election.[154] These conflicting opinions were not reconcilable: on the one hand, there could be no attribution unless a property right (from which income was derived) had vested irrevocably in the spouse or minor; on the other hand, a mere expectancy of receiving income under a discretionary trust was a property right from which income paid to a beneficiary could attract attribution.

Although the new provisions of subsections 74.1(1) and 74.1(2) retain the requirement that property be transferred (or loaned) to a beneficiary of a trust, the problems created by the contradictory decisions in the cases involving discretionary distributions of income appear to be dealt with now in subsection 74.5(9)[155] which provides, in effect, that a loan or transfer of property to a trust is deemed to be a loan or transfer of the property to or for the benefit of each person beneficially interested in the trust. Subsection 74.5(10)[156] provides that persons whose rights to receive income are conditional on an exercise of a trustee's discretion are to be "beneficially interested" in the trust for this purpose. In consequence, where beneficiaries receive distributions of income pursuant to an exercise of a trustee's discretion, they will have income from property that is at least deemed to have been transferred to them.[157]

(ii) No General Attribution of Trust Income

For the purposes of former subsections 74(1) and 75(1), the decision in Pichosky v. MNR[158] established that only trust income that would otherwise be income of a beneficiary of the trust could be attributed to a person who transferred property to the trust. Income accumulating in such a trust would not be subject to attribution. In view of the high flat rate of tax applicable to the income of trusts to which property has been transferred since June 18, 1971,[159] the significance of the Pichosky case is limited to trusts established before that date. The decision appears, however, to have been confirmed in subsections 74.1(1) and 74.1(2) since the income to be attributed is now expressly identified as

income that would otherwise be income of the spouse or minor from the property or substituted property.

(iii) Allocation of Sources of Income

Where, after May 23, 1985, an individual loans or transfers property to a trust in which the individual's spouse and/or a minor child (singularly referred to as a "designated person" for the purposes of attribution)[160] are income beneficiaries, subsection 74.3(1) provides specific rules which determine the amount of their incomes from the trust that is attributed to the individual for a taxation year. The effect of these provisions is that only the income relating to the transferred or loaned property will be attributed to the individual; that is, there will be no attribution if the income is taxable to the trust or to beneficiaries other than the individual's spouse and/or a minor child. Where the spouse is also a capital beneficiary, specific rules determine the portion to be designated as capital gains of the spouse which will be attributed to the individual. Subsection 74.3(1) states that:

> (1) Where an individual has loaned or transferred property (in this section referred to as "loaned or transferred property"), either directly or indirectly, by means of a trust or by any other means whatever, to a trust in which another individual who is at any time a designated person in respect of the individual is beneficially interested at any time, the following rules apply:
>
> (a) for the purposes of section 74.1, the income of the designated person for a taxation year from the property shall be deemed to be an amount equal to the lesser of
>
> (i) the amount in respect of the trust that was included by virtue of paragraph 12(1)(m) in computing the income for the year of the designated person, and
>
> (ii) that proportion of the amount that would be the income of the trust for the year from the property or

> from property substituted therefor if no deduction were made under subsections 104(6) or (12) that
>
> (A) the amount determined under subparagraph (i) in respect of the designated person for the year
>
> is of
>
> (B) the aggregate of all amounts each of which is an amount determined under subparagraph (i) for the year in respect of the designated person or any other person who is throughout the year a designated person in respect of the individual; and
>
> (b) for the purposes of section 74.2, an amount equal to the lesser of
>
> (i) the amount that was designated under subsection 104(21) in respect of the designated person in the trust's return of income for the year, and
>
> (ii) the amount, if any, by which
>
> (A) the aggregate of all amounts each of which is a taxable capital gain from the disposition by the trust of the property or property substituted therefor
>
> exceeds
>
> (B) the aggregate of all amounts each of which is an allowable capital loss for the year from the disposition by the trust of the property or property substituted therefor,
>
> shall be deemed to be a taxable capital gain of the designated person for the year from the disposition of property (other than listed personal property) that is loaned or transferred property.

The rules in subsection 74.3(1) apply whenever a "designated person"[161] is "beneficially interested"[162] in a trust to which another individual has transferred property. As noted above, the combined effect of subsections 74.5(9) and 74.5(10) appears to be that where a beneficiary has any interest (i.e. is "beneficially interested") whatsoever in the income of a trust (i.e. from an indefeasibly vested right to a contingent right which may never vest at all) and the trustee exercises his discretion in favour of the beneficiary, the beneficiary will be deemed to have received income from property transferred to the trust.

The amount determined under paragraph 74.3(1)(a) to be the income of a spouse or minor child which may be attributed to an individual is the lesser of:

(a) the income of the designated beneficiary from the trust, and
(b) the proportion of the income earned by the trust from the loaned or transferred or from property substituted therefor that the income of that person from the trust is of the aggregate income from the trust of all persons, each of whom is a designated person in respect of the individual.

Similarly, paragraph 74.3(1)(b) provides that, where the designated person is a spouse, the amount of capital gains subject to attribution will be the lesser of:
(a) the taxable capital gain designated by the trust in favour of the designated person for the year, and
(b) the net taxable capital gain for the year from the disposition by the trust of the property or property substituted therefor.
Thus, in order for an amount to be attributed to the individual under paragraph 74.3(1)(b), a taxable capital gains designation[163] must be made by the trustee in respect of a spouse who is a designated person under the trust.[164]

Where a trustee makes a designation in respect of amounts paid or payable to a spouse or minor, such designation will flow through to the individual.[165] For example, where an individual's spouse is deemed to receive a taxable dividend by virtue of a trustee's designation[166] and the amount of the trust's income from property acquired with the loan or transferred property is $1,000 of interest income, the individual will be deemed to have received a $1,000 taxable dividend. This will be the case notwithstanding that the actual interest income received by the trust may in fact be allocated or designated in respect of an adult child.[167] Where

more than one type of designation is made in respect of a beneficiary's income from a trust and the amount subject to attribution is less than the total amount of the beneficiary's income, some reasonable allocation based on the source of he income would presumably have to be made to determine the nature of the amount that would be taxed in the individual's hands.

(iv) Comment

While the provisions of subsection 74.3 are very specific in their nature, it is not altogether clear exactly what purpose or great significance this section serves, which is not already served by subsections 74.1(1) and (2). The subsection appears to be designed to ensure that if, under a trust, income from property A would be attributed back if it would be otherwise included in the income of a spouse or minor, while income from property B would not be subject to attribution in such circumstances, any amounts that would otherwise be included in the income of the spouse or minor will be deemed to have been derived first from property A. Thus, for example, if Mr. X and Mr. Y each transfer or loan the same amount of money to a trust under which each of their spouses is entitled to one-half of the income, it will not be possible for Mrs. X to claim that she received income from the property transferred by Mr. Y and vice-versa.[168] Assume that the trust has $20,000 of income in a particular year and distributes it equally between Mrs. X and Mrs. Y. In such circumstances, subsection 74.3(1) provides that Mrs. X will be deemed to have income from the property transferred by Mr. X equal to the lesser of: (i) the amount included in her income from the trust by virtue of paragraph 12(1)(m) (i.e. $10,000) and (ii) the proportion of

the trust's total income for the year before distributions to the beneficiaries ($20,000) that the amount of Mrs. X's income from the trust (i.e. $10,000) is of all such amounts received by Mrs. X and any beneficiaries under the age of 18 years (i.e. $10,000). In consequence, Mrs. X is deemed to have received $10,000 of income from the property transferred to the trust by Mr. X, and the provision would produce the same result for Mrs. Y.

Subsection 74.3(1) would also seem to apply where a trust is receiving income from property transferred or loaned to it by an individual and, in addition, income from income accumulated by the trust in previous years. In such a case, for example, because amounts that would otherwise be included in the income of a spouse or minor are deemed to be derived first from the transferred or loaned property, it would exclude an argument that the income from the prior years' accumulations was distributed to a spouse or minor beneficiary while other adult beneficiaries received the current year's income from the transferred properties.[169]

F. Transfers or Loans to Corporations

(i) General

Prior to May 23, 1985, many taxpayers, as an alternative to making a direct loan to a spouse or trust, sought to split income by indirect transfers through an investment holding company. The spouse or trust would acquire equity shares in the corporation, which either owned income-producing assets at the time, or acquired them shortly thereafter from the high-income spouse. The terms and conditions attached to the shares permitted dividends to be paid to the spouse or trust but not to the high-income

spouse.[170] Since the effective corporate tax rate paid by the holding company on investment income distributed as dividends was about 33 1/3%, a tax saving of about 16 2/3% could be achieved by having the high-income individual transfer cash or investments to a holding company structured this way.[171]

When Parliament amended the attribution rules to restrict income splitting loans,[172] it was obvious that this kind of tax avoidance could be perpetuated, and the attribution rules circumvented, by taxpayers loaning or transferring money or income-producing property to corporations in which their family members were shareholders. In order to prevent and/or curtail the practice of income splitting through corporations, Parliament introduced a complex set of rules with respect to loans and transfers of property made to a corporation which is not a small business corporation.[173] The main provisions of these rules are found in subsections 74.4(2) and 74.4(3) which provide as follows:

> (2) Where an individual has loaned or transferred property, either directly or indirectly, by means of a trust or by any means whatever, to a corporation (in this section referred to as the "subject corporation") other than a small business corporation, in computing the income of the individual for a taxation year, with respect to the period (in this section referred to as the "relevant period") in the year and after the time of the loan or transfer and throughout which the individual is resident in Canada and any shareholder of the subject corporation is a designated shareholder in respect of the individual, an amount equal to to the amount calculated under subsection (3) in respect of the property shall be deemed to be a taxable dividend received by the individual in the year from the subject corporation.
>
> (3) For the purpose of subsection (2), the amount calculated under this subsection in respect of the property with respect to the relevant period in the year is the amount, if any, by which the lesser of
>
> (a) the amount, if any, by which
>
> (i) the aggregate of

(A) the aggregate of all amounts each of which is the product obtained when

(I) the monthly designated benefit in respect of the property for a month, or a portion thereof, in the relevant period

is multiplied by

(II) 2/3 of the quotient obtained when the rate of interest prescribed for the purpose of subsection 161(1) that is in effect during that month is divided by 12, and

(B) the aggregate of all amounts each of which is an amount calculated under clause (A) in respect of the property with respect to a relevant period in a preceding taxation year

exceeds

(ii) the aggregate of

(A) the aggregate of all amounts each of which is a taxable dividend paid in the year or a preceding year to the individual or to a taxable Canadian corporation that is wholly-owned by him, on a share that is excluded consideration received by him as consideration for the loan or transfer of the property or excluded consideration substituted therefor, and

(B) 2/3 of the aggregate of all amounts each of which is an amount included in computing the income for the year or a preceding taxation year of the indivudual or a taxable Canadian corporation that is wholly-owned by him as interest on excluded consideration, received by him as consideration for the loan or transfer of the property or on excluded consideration substituted therefor

(b) the aggregate of all amounts each of which is

(i) a taxable dividend paid by the subject corporation in the relevant period or a relevant period in a preceding taxation year to a designated shareholder of the subject corporation in respect of the individual, or

(ii) a capital gain of the individual's spouse from a disposition of property occurring in the relevant period or in a relevant period in a preceding taxation year, to the extent that the gain may reasonably be attributed to an increase in the value of the property loaned or transferred or of property substituted therefor

exceeds

(c) the aggregate of all amounts each of which is an amount calculated under this subsection for the purpose of subsection (2) in respect of the property for a preceding taxation year.

Under subsection 74.4(2),[174] if an individual loans or transfers property to a non-small business corporation of which a

shareholder is a "designated shareholder"[175] with respect to that individual, and a taxable dividend is paid to that designated shareholder, or if the spouse of the individual realizes a capital gain which is reasonably attributable to an increase in the value of the transferred property or property substituted therefor, the individual will be deemed to have received a taxable dividend.[176] In turn, the amount of the taxable dividend included in the income of a designated shareholder is reduced by apportioning the deemed dividend included in the individual's income pro rata on the basis of the aggregate taxable dividends paid to all designated shareholders of the individual in the taxation year.

(ii) Terminology

Subsection 74.4(1) defines certain technical expressions which relate to transfers or loans of property to a corporation (other than a small business corporation) for the the benefit of a spouse or minor child.[177] Apart from the concept of a "designated shareholder" described above, the other terms relevant for the purposes of this provision are: "designated benefit;" "monthly designated benefit," and "excluded consideration."

(a) Excluded Consideration

"Excluded consideration" means consideration received by an individual that is indebtedness, a share in the capital stock of a corporation where the articles of the corporation provide for more than one class of shares at that time or a right to receive such a share.

(b) Designated Benefit

A "designated benefit" in respect of property loaned or transferred by an individual to a corporation means:

(a) in the case of a loan of property that is money, the principal amount of the loan outstanding at the particular time;

(b) in the case of a transfer of property other than money, the amount, if any, by which the fair market value of the property at the time of the transfer exceeds the fair market value of the consideration received therefor (other than excluded consideration). Excluded consideration can be disposed of in an arm's length sale for cash, on a redemption for cash or an exchange for common shares of the issuing or another non-small business corporation. If excluded consideration is disposed of in any of these manners, the designated benefit will be computed as the difference between the fair market value at the time the transfer was made to the company and the cash received on the arm's length sale, redemption or share exchange of the excluded consideration. The designated benefit will be reduced but may not be eliminated by the disposition of the excluded consideration.

(c) Monthly Designated Benefit

The term "monthly designated benefit" means the greatest amount that the designated benefit in respect of the property is at any time in the month.

(iii) Computation of the Attributed Amount

The attributed amount is computed as the amount, if any, by which the lesser of:

(a) (i) the monthly designated benefit for the relevant year and preceding years times 2/3 of the prescribed rate for the relevant periods; minus

(ii) the aggregate of all taxable dividends paid to the individual

or his holding company on shares that are excluded consideration and 2/3 of the interest paid to the individual or his holding company on excluded consideration that is a loan or a balance of sale, and

(b) the aggregate of

(i) all taxable dividends paid by the corporation to a designated shareholder, or

(ii) a capital gain of the individual's spouse from a disposition of property to the extent that the gain may reasonably be attributed to an increase in the value of the property loaned or transferred or of property substituted therefor,

exceeds

(c) amounts previously attributed under this provision -i.e. subsection 74.4(3).[178]

(iv) Comment

The computation of the attributed amount under subsection 74.4(3) is made each year with respect to the period in the year after the loan or transfer throughout which the individual is resident in Canada and any shareholder of the corporation is a designated shareholder in respect of the individual. Under the formula, dividends will be deemed to be received by the individual in any year up to a cumulative maximum of the amount of taxable dividends received by designated shareholders from the corporation in the year or any preceding year and attributable capital gains realized by the individual's spouse in the year or any preceding year.[179] If the aggregate attributed amount to the individual commencing with the year in which the loan or transfer of property is made is less than this maximum (which may be the case

as explained below), the balance of such attributable dividends or gains is carried forward to future years to be taken into account once again in the formula.

From the opposite perspective, it appears safe to presume that there is no attribution to the individual until such time as a taxable dividend is paid to a designated shareholder or an attributable capital gain is realized by a spouse. Therefore, even if there would have been attribution under an earlier corporate structure, the individual may take steps to avoid attribution prior to the payment of a taxable dividend. For example, a trust created primarily for the benefit of adult children may nevertheless be a designated shareholder if, under the terms of the trust, there are gifts over[180] to grandchildren or children who are minors at the time, because such grandchildren or minors would be considered to be beneficially interested in the trust.[181] Prior to the commencement of payment of dividends to the trust, which dividends would then be distributed to the adult children, it may be appropriate to exercise powers of encroachment and actually distribute the shares to adult children. Any dividends received directly by such children would not then be subject to attribution under any circumstances. In the case of a spouse who is a designated shareholder, it appears possible to freeze the effect of prior loans or transfers by repaying the loan or indebtedness or redeeming the share consideration for the transfer, but it does not appear possible to eliminate attribution, if dividends are ever received or capital gains are ever realized by the spouse.[182]

For the purposes of subsection 74.4(2), there is no general exception applicable to loans or transfers to the subject corporation (i.e. a non-small business corporation) which proceed on a commercial basis as is the case with direct loans or transfers to a spouse or minor. Instead, the formula used to compute the attributed amount must be applied, but the intended result of the formula is that there will be no deemed dividend included in the individual's income. In this respect, the formula has two key aspects. From one perspective, the maximum deemed dividend attributable in any year (subject to the overall cumulation of taxable dividends received by designated shareholders or capital gains realized by spouses as explained above) is calculated by reference to 2/3 of the prescribed rate of interest applied on a monthly basis to the maximum designated benefit in that month.[183] From the other perspective, this maximum deemed dividend of 2/3 of the prescribed rate is reduced (or eliminated) to the extent that the individual (or a corporation wholly-owned by him) receives the prescribed return on the loan made to the subject corporation or on the consideration received for the transfer of property to the subject corporation.[184] Therefore, in order to avoid attribution in respect of a loan to a subject corporation, the loan must bear interest at the prescribed rate.[185] In order to avoid attribution in respect of a transfer of property to a subject corporation, the fair market value of the consideration received must at least equal the fair market value of the property transferred,[186] and the consideration must consist either of cash or property (other than shares or indebtedness of the corporation which are "excluded

consideration")[187] or shares of the corporation, provided that the corporation is only authorized to issue one class of shares (in which case such shares are excepted from being "excluded consideration");[188] or, the individual (or a corporation wholly-owned by him) must receive a return on the excluded consideration equal to 2/3 of the prescribed rate on share consideration or the full prescribed rate on debt consideration.[189]

(v) Exclusion of the Attributed Amount from the Recipient's Income

Under the attribution rules of sections 74.1 and 74.2 applicable to direct loans or transfers to spouses and minors, income which is attributed to an individual is excluded from the income of the recipient spouse or minor. Given the complexity of the section 74.4 attribution rules applicable to loans or transfers to a corporation, it is not surprising that there are certain oversights in the equivalent rule designed to exclude attributed dividends and capital gains from the income of designated shareholders.

The general rule is that the portion of a taxable dividend received by a designated shareholder in the year or a capital gain realized by a spouse in the year that has been attributed to an individual will be excluded from the income of the recipient in that year.[190] If the amount to be included as an attributed dividend in the income of the individual is less than the taxable dividends actually received in the year, the taxable dividends to be included by the designated shareholders in their income are apportioned pro rata.[191] If the attributed amount exceeds all taxable dividends received by designated shareholders, the excess

is applied to reduce the capital gains of the individual's spouse for the year.[192]

The first deficiency in the exclusion rule is that, in contrast to the very careful cumulative calculations over a period of years when the attribution charge to the individual is being computed, the exclusion from attribution applies only when taxable dividends or capital gains are both attributed and received or realized in the same taxation year. As discussed above, the attributed amount in a particular year may be less than the dividend received or the gain realized by the designated shareholder in the year because the maximum attribution in a year is also tied to the prescribed return, but the unattributed portion of such dividends or gains is then carried forward under the formula to determine attribution in future years. There is no relief to exclude the dividend or gain in this situation, with the result that the same amount will be taxed twice.[193]

There are other deficiencies which relate to the limitation of the exclusion to the actual designated shareholder, even when such shareholder is a trust or corporation. In neither case do the rules in section 74.4 et. s. exclude the distribution by the trust or holding company from the recipient's income. One example is the attribution of taxable dividends received from a subject corporation by a trust which are then distributed to adult beneficiaries but remain taxable in the hands of the adult beneficiaries under subsection 105(1) (unless they are treated as distributions of capital).[194] Another example is the attribution to an individual of a dividend received by his wholly-owned holding company from a subject corporation to which a loan or

transfer is made followed by the imposition of tax again when the holding company actually distributes the cash by way of dividend to the same shareholder.[195]

(vi) Exception for Small Business Corporation

As noted above, there is no attribution under section 74.4 if an individual loans or transfers property to a corporation that is a small business corporation.[196] It seems clear, at least, that the corporation must be a small business corporation at the time of the loan or transfer in order for the attribution rules not to apply. It is unclear, however, whether the attribution rules will commence to apply at a later date if the small business corporation ceases to operate as such.

At least one commentator argues that so long as the small business corporation test is met at the time of the loan or transfer, there can be no attribution under section 74.4 even if the corporation subsequently ceases to qualify as such.[197] With respect, it is submitted that this view is incorrect, and that the correct view is that the corporation must satisfy the small business corporation test throughout the period in which the loaned or transferred property is held. The reason is that since subsections 74.4(2) and (3) contemplate an annual calculation of the attributed amount, whether or not the subsections apply depends, inter alia, upon whether or not the corporation can be classified as a small business corporation for the taxation year in question. It is submitted that where, for example, a corporation carries on an active business for several years, but then restricts its activities to passive investments, the

corporation would become a non-small business corporation for the purposes of subsection 74.4(2).

Whether or not a corporation qualifies as a small business corporation is obviously of paramount importance if taxpayers wish to achieve any measure of income splitting through a private corporation.[198] In determining whether a corporation falls within the statutory definition of a "small business corporation" under subsection 248(1), a key consideration is whether, inter alia, it, or a corporation controlled by it, carries on active business. In this respect, reference should be made to the discussion below concerning the distinction between "business income" and "property income."

(vii) Timing

It should be noted that the rules in section 74.4 et. s. will apply only during the period after the loan or transfer where there is a designated shareholder in respect of the individual. For example, assume that on January 1, 1986, an individual has transferred property to a wholly-owned non-small business corporation in exchange for non-interest-bearing promissory notes. Assume also that on December 1, 1986, the individual's spouse purchases one common share of the corporation at its fair market value with her own funds. Under these circumstances, the attribution rules under subsection 74.4(3) will commence to apply to the transfer of property in the 1987 taxation year since, until December 31, 1986, there was no designated shareholder of the corporation in respect of the individual.[199]

Since the rules in subsections 74.4(2) and (3) apply only to loans and transfers made after November 21, 1985, income splitting

arrangements in place on or before this date will not be affected. Where a post-November 21, 1985, loan or transfer is made and the corporation subsequently amalgamates with another corporation, the corporate attribution rules will continue to apply as they would if the amalgamated corporation were the same corporation as the predecessor corporation.[200] A similar provision applies where a non-small business corporation is later wound up into a parent corporation.[201]

(viii) Limits to the Corporate Attribution Rules

In addition to the small business corporation exemption and the continued viability of pre-November 22, 1985, income splitting structures, there are other limitations on the scope of application of the corporate attribution rules.

First, attribution in respect of a loan or transfer to a subject corporation can apply only when the lender or transferor is an individual, except where the back-to-back or indirect loan or transfer rule of subsection 74.5(6) applies. Therefore, it would seem that if a corporation controlled by the individual has substantial retained earnings, a portion of such earnings could be loaned to or invested by the corporation in another corporation in respect of which the individual's spouse or minor child are designated shareholders, but no attribution would result when dividends were paid to the shareholders.[202]

Second, there is no attribution of capital gains in respect of minors and the attribution of income ceases when a minor reaches the age of 18.[203] In contrast, spousal attribution continues during the lifetime of the lender or transferor spouse

while the spouses are married (and not separated) and, as noted above, may have the effect of converting a capital gain realized by one spouse (i.e. a spouse who is a designated shareholder) into a taxable dividend in the hands of the other spouse. Because one spouse can, in any event, bequeath assets to the other spouse on a tax-free basis on death, the focus of splitting investment income through corporations may be shifted to long-term arrangements involving children.

(ix) Anti-Avoidance Rules

Where a taxable dividend is paid by a non-small business corporation to a designated shareholder and it may reasonably be considered that the payment was made in contemplation of a loan or transfer of property subsequently made by an individual, the dividend will be deemed to have been paid immediately after the time of the loan or transfer of property.[204] This anti-avoidance rule, by deeming such dividend to be included in the computation of the attributed amount, ensures that attribution under subsection 74.4(2) cannot be avoided in this manner. Also, as in the case of transfers or loans to a spouse or minor, the anti-avoidance rules with respect to back-to-back loans and transfers,[205] loan guarantees[206] and artificial transactions[207] apply to loans and transfers made to a non-small business corporation. For example, where an individual guarantees a loan made to a non-small business corporation (after November 21, 1985) which has one or more designated shareholders, the individual will be subject to attribution under subsection 74.4(2) as if he himself had loaned the money to the corporation.

G. Repayment of Loans Outstanding on May 22, 1985

The attribution rules (in subsections 74.1(1) and (2)) do not apply to loans outstanding on May 22, 1985, that were made to or for a spouse or minor child, so long as such loans are repaid not later than December 31, 1987.[208] If such transitional loans are not repaid on or before that date, only the post-1987 income from the loaned property, or property substituted therefor, will be subject to attribution.[209] Similarly, only taxable capital gains or allowable capital losses realized by a spouse after December 31, 1987, on dispositions of property acquired with the proceeds of a transitional loan will be subject to attribution.[210] It seems clear, therefore, that individuals should leave transitional loans in place until December 31, 1987, if they wish to maximize the amount of income and capital gains that will not be subject to attribution. Nevertheless, it is important to commence planning in order to ensure that funds or property will be available to repay transitional loans. For example, if a transitional loan was made to a discretionary trust in which the individual's spouse or a minor child is a beneficiary, it may be possible to retain income in the trust over the transitional period to enable the trust to repay all or part of the loan without liquidating its investments entirely. The income retained in the trust may not be subject to tax in the transferor's hands if preferred beneficiary elections are filed in respect of each preferred beneficiary's share of the trust's accumulating income.[211]

Where it is not desireable or possible to transfer or dispose of property in order to repay a transitional loan before January 1, 1988, at least two methods appear to be available for avoiding

the attribution rules. For example, the debtor could borrow funds from a third party (E.g., a bank) and repay the transitional loan. Alternatively, the creditor (i.e. the individual) could make a new loan that bears a commercial rate of interest which would be used to repay his transitional loan. No purpose will be served by refinancing a transitional loan with a new loan that does not bear a commercial rate of interest since the new loan will be subject to attribution by virtue of subsection 74.1(3).[212] It also seems that it would not be sufficient to put the loan on a commercial footing on January 1, 1988, as the loans for value exception from attribution would not on its terms apply where interest was not paid in a prior year, notwithstanding that the attribution rules were not applicable in the earlier year due to the transitional rule.[213]

Where a transitional loan is refinanced with a bank loan on or before December 31, 1987, and this loan is then refinanced with an interest-free loan made by the individual, the attribution rules appear to be circumvented. For example, assume that an individual makes a $10,000 transitional loan to his wife who uses the money to acquire $10,000 of Canada Savings Bonds. On December 31, 1987, the wife obtains a bank loan and repays the transitional loan. Assume further that on January, 1, 1988, the individual makes a $10,000 interest-free loan to his wife and she then uses the funds to repay her bank loan. The rules regarding the repayment of loans[214] do not apply to the second loan made by the individual since it was not used to repay a loan with which other property (i.e. the Canada Savings Bonds) was acquired. The provisions of subsection 74.1(1) also will not apply to the

transitional loan because it was paid before January 1, 1988.[215]

The attribution rules involving loans by an individual to a corporation that is not a small business corporation are not retroactive in effect.[216] Accordingly, the rules can apply only if a loan (or transfer) of property is made by an individual to a subject corporation after November 21, 1985.[217] Where effective income splitting arrangements through a non-small business corporation are currently in place, the taxpayer should be cautious about making any new loans or transfers of property to the corporation. Although the operation of the corporate attribution rules will be prospective only and will operate only with respect to the prescribed return on a post-November 21, 1985 loan or transfer of property, the sheer complexity of the calculations required under subsections 74.4(3) and (4) indicate that there may very well be a substantial compliance cost in determining the benefit accruing to an individual from a relatvely minimal shift in income under these provisions.

H. Indirect Transfers

(i) Judicial Interpretation of "Indirect"

Apart from the 1985 amendments discussed above, which were designed to curtail or eliminate effective use of the income-splitting loan, it has been deemed necessary at various times to reword the attribution provisions in order to clarify certain areas of the law. In retrospect, one of the most significant changes appeared in the 1948 Act. Until that time, transfers to spouses were governed by subsection 32(2) of the Income War Tax Act (1927) which provided that:

> Where a husband transfers property to his wife, or vice-versa, the husband or wife, as the case may be, shall nevertheless be liable to be taxed on the income derived from such property or from property substituted therefor as if such transfer had not been made.

In the 1948 enactment, however, the words "transferred property either directly or indirectly by means of a trust or by any other means whatsoever..." were added.[218] Interpreted literally, this new phrase would cover any situation where property was in effect transferred between a taxpayer and spouse or minors. In other words, the amendment implied that the courts should now examine the substance and intention of the transaction and not consider themselves as being bound by the technical requirements of a transfer.

In one case where this expression was the subject of extended judicial comment, it was restrictively interpreted. In the Dunkelman case, Thurlow J. described the effect of these words as follows:

> In reaching this conclusion I have also considered the wide words 'or by any other means whatsoever' but I think that they are directed to the means or procedure by which transfers may be accomplished, rather than to the scope of the expression 'has transferred property' and that they do not expand that scope beyond the natural meaning of the expression.[219]

In making this statement, Thurlow J. appeared to be putting forward the proposition that the technical requirements of a transfer must still be proven by the Minister in every case -i.e. even an indirect transfer must produce the effect that property rights pass from the taxpayer to the other person.

Reference should also be made to the leading English authority on the meaning of "direct" and "indirect." In Potts' Executors v.

Inland Revenue Commissioners (IRC),[220] the House of Lords was asked to consider such terms in the context of subsection 40(1) of the Finance Act (U.K., 1938).[221] This section provided that any capital sum paid "directly" or "indirectly" by the trustees of a settlement to the settlor was to be treated as income of the settlor.[222] Subsection 40(5) further provided that any capital sum paid to the settlor in any year of assessment by any body corporate connected with the settlement should be similarly treated.[223]

The deceased taxpayer had made a settlement of money on his infant grandchildren and subsequently the trustees of the settlement invested the money in the purchase of almost all the issued share capital of a company of which the deceased was the controlling shareholder and director. After the settlement, the deceased continued an earlier arrangement with the company whereby it paid certain amounts on his behalf, such as income tax and charitable donations. In the taxation years in question, the IRC assessed the taxpayer's executors in respect of such amounts paid. The Crown argued that the payments made by the company at the settlor's request and upon his promise to repay were equivalent to "sums paid by way of loan directly or indirectly to the settlor."

The House of Lords held that these sums had not been "directly or indirectly" paid to the settlor. Lord Simonds was of the opinion that the word "indirectly" did not so enlarge the meaning of "paid to the settlor" so as to include "payment to some other person than the settlor for his own use and benefit."[224] Lord Normand's comments were more detailed:

> In a taxing statute designed to prevent tax evasion by affecting with liability to tax sums paid to a settlor otherwise than as income, it was obviously necessary to provide for the case where persons accountable to the settlor are interposed between the taxpayer and the settlor for the purposes of disguising the transactions. This is a satisfactory explanation of the use of the words "directly or indirectly."[225]

It is felt that, what Lords Simonds and Normand are stating is that, in the context of the attribution rules, the word "indirectly" does not encompass the situation where property is transferred to a legal entity which may use the property for its own benefit and which is not accountable to the transferor's spouse or any minor children. The necessary implication of such reasoning is that where that entity is accountable to any individual there will be a transfer to the latter, irrespective of the form of the transfer. The suggestion, therefore, is that the substance of the arrangement must be examined in order to ascertain whether the spouse or minor will in actual fact obtain the benefit of the transfer.

To the writer's knowledge, the House of Lord's decision in Potts' Executors has not been cited as authority in any Canadian case in which the question of an indirect transfer within the context of the attribution rules has been discussed. One Canadian tax service, Ward's Tax Law and Planning, in discussing the concept of a "transfer" for the purposes of attribution, refers to the Potts' Executors case as authority for the proposition that "... an indirect transfer [takes] place where a person accountable to the transferee is interposed between the transferor and the transferee."[226]

It is submitted that while there may well be an indirect

transfer in the foregoing situation (depending, of course, upon the facts in question), this notion of what constitutes an indirect transfer for the purposes of the attribution sections is unduly narrow. The Canadian jurisprudence (discussed immediately below) takes a more expansive view of the concept and does not restrict it to situations where such accountability is present. That is, so long as property which was previously vested in the transferor subsequently becomes vested in the transferee, then irrespective of how circuitous a route the property takes, and whether or not any intermediary accountable to the transferee is interposed between the transferor and transferee, there will be a transfer of property for the purposes of the attribution sections. The very broad phrase in subsections 74.1(1) and (2), "by any means whatever," would seem to support this view.[227]

It should be noted that under the Income War Tax Act[228] the Exchequer Court held that the simple phrase "transfer of property" included any "indirect or circuitous transfer."[229] If this is the case, then, it may be said that the amendment to the 1948 Act added nothing to the meaning of the words and was merely superfluous. Certainly it is arguable that the changes were made to achieve statutory certainty in conformity with the prevailing judicial opinion.

In analyzing the effect which the words "direct or indirect ... by any means whatsoever" have had in respect of the judicial interpretation of the attribution provisions, two issues have tended to dominate the discussion, both of which relate to the technical requirements of a "transfer:" first, the requirement

that the taxpayer must own any property which he transfers; second, the requirement that to complete a transfer within the attribution sections it is necessary for the property to vest in the spouse or minor child.

(ii) Requirement of Ownership

In everyday use of the word "transfer" it seems logical to assume that the transferor must own any property which is passed to the transferee. Otherwise, it seems impossible for him to be "divested" of it and to "vest" it in the transferee. However, in dealing with the attribution provisions the ordinary meaning of words is not always regarded as being decisive. In giving effect to the provisions, they should be construed in light of their basic aim -i.e. the prevention of income splitting within family members.

The authority for such an assertion is to be found in the Dunkelman case.[230] In this case, one of the points in issue related to the transfer of a building purchased by the trustees not from the taxpayer but from a third party. In reply to the Minister's submission that the building was transferred property within the meaning of former subsection 22(1).[231] Thurlow J. said:

> The means adopted in any one particular case to transfer property are of no importance, as it seems that the intention of the section is to hold liable for tax ... no matter what means have been adopted to accomplish the transfer ... It is also clear that the subject matter of a transfer that is within the section must be property of the transferor, not that of some other person.[232]

There are two basic issues flowing from Thurlow J.'s statement of the law: first, whether his strict interpretation of the section is consistent with other authorities and second, whether

his conclusion is correct in view of the objective of the attribution rules.

With respect to the first point, it would be incorrect to assume that the courts have failed to give any meaning to the concept of "indirect transfers." At various times they have found a transfer to have occurred notwithstanding the fact that only in a very loose sense could it be said that the spouse had received proprietary rights which had previously vested in the transferor. In Fasken Estate v. MNR[233] the taxpayer's executors argued unsuccessfully that there was no transfer between the husband and the wife where the husband released his rights against his debtor in consideration of the debtor assuming an obligation to a trust of which the wife was a beneficiary. In German v. MNR[234] the taxpayer sold his residence and his wife received $5,000 from the purchaser by virtue of her consent to the sale of the house. Subsequently, she invested the funds in a loan and received interest of $250 which the Minister attributed to her husband. It was held that notwithstanding the fact that the payment was made by the purchaser, there was a transfer of property from the taxpayer.[235] In Murphy v. MNR[236] (a case discussed in more detail below)[237] the taxpayer and his sister were entitled to one-half of the income under a trust created by their deceased father's will. By a variation of trust agreement, the taxpayer surrendered his vested rights under the will and became a member of a class of discretionary beneficiaries, which class included his wife. When the trustees subsequently paid income from the trust to the taxpayer's wife, it was held that such income should be attributed to the taxpayer under former subsection 74(1). This was the case

notwithstanding that whatever income may have been given up by the taxpayer and transferred to the trust could not be identified as the income received by the spouse from the trust. That is, if one regarded the property transferred to the spouse as the income from the one-half interest the taxpayer had in the trust before the variation, there was no way one could trace this particular income actually paid to his wife pursuant to the exercise of discretion by the trustees.

While the above decisions appear to adopt a very liberal attitude with respect to the application of the attribution provisions, they are quite reconcilable with the Dunkelman case. In each case there was at the very least a proprietary "interest" or "right" held by the taxpayer in the property transferred, even if this interest did not constitute ownership in the true sense.[238]

It is interesting to note that an inter-spousal transfer of property has been held to have occurred (under former subsection 21(1)) where the taxpayer had no prior interest or ownership in the transferred property (in this case, real property) but rather upon the purchase of such property, he took title thereto in the names of himself and his wife jointly. In Wertman v. MNR,[239] an initial investment in the purchase of land was taken in the names of both spouses jointly, although the purchase price was paid entirely by the husband from his own funds. Thurlow J. held that the rental income applicable to such investment in the land should be attributed to the husband since his taking of title in the name of his wife constituted an indirect transfer of property to her.

At least two commentators[240] have argued that the decision of Thurlow J. in Wertman v. MNR was subsequently ignored by the Tax Review Board in the case of Valitalo and Murillo v. MNR.[241] Here the taxpayers were business partners who purchased the building in which their company carried on business, with title thereto taken in the names of themselves and their wives as joint tenants. Following the purchase, the taxpayers proceeded to lease the building back to the company and the company then commenced paying rent to the taxpayers and their spouses in direct proportion to their respective shares of ownership therein. The Minister added back to the taxpayers' income the amount of rental income paid by the company to the wives on the ground that the one-quarter interest in the property taken in the name of each wife constituted a transfer of property under former subsection 74(1). The evidence indicated that both taxpayers had mortgaged their respective homes (which were jointly owned with their wives) in order to make a downpayment on the purchase price of the building. It was held that, in the absence of any proof which indicated that the wives had provided consideration for the one-half interest in the building which was registered in their names, such registration constituted a transfer of property under former subsection 74(1).

In analyzing the judgment in Valitalo, it is difficult to see in what respect it has deviated from the decision in Wertman. In fact, although the Board did not expressly refer to the Wertman case in its reasons for judgment, its holding is quite consistent with that of Thurlow J. since it reached the conclusion that, with respect to the purchase of real property, the taking of title in

the name of another, where the latter does not make an independent financial contribution to the purchase price, constitutes a transfer of property.

In arriving at its decision, the Board in Valitalo stated that it would have held in favour of the taxpayers if it could have been shown that the wives had made an independent financial contribution toward the purchase of their respective homes since this, in turn, would have translated into an independent contribution towards the purchase of the building. However, since the taxpayers could not adduce any written evidence in this respect, the Board had no alternative but to conclude that the entire financial consideration for both the homes and the building was provided by the husbands. Thus, the clear implication was that if it could have been shown that the homes (or the building, for that matter) had been purchased on the joint credit of the taxpayers and their wives, the Board would have ruled in favour of the taxpayers.[242]

The decisions in Wertman and Valitalo are not surprising. If such decisions had been otherwise taxpayers would, in effect, be able to accomplish indirectly what they could not achieve directly; that is, split income with their spouse (or a minor) by means of a transfer of income-producing property. If, for example, the taxpayers had made cash gifts to their wives, and the wives had subsequently used such cash (or property substituted therefor) to purchase the same rental property, any income derived from such property would have been attributed to the taxpayers. By taking title in the name of a spouse, the taxpayers could not avoid the

result that such transactions constituted a transfer of property to the spouse.

To weigh the reasoning of the courts in the decisions cited above against the policy considerations inherent in subsections 74.1(1) and 74.1(2) is difficult. There are innumerable transactions which might arise in this context but which may well demand different conclusions with respect to the objectives of the legislation. Consider, for example, the position of a taxpayer who holds property under a long-term lease. At the commencement of a particular taxation year, he subleases such property to his spouse. Assuming that the court would hold that the lease of a tangible asset constitutes a "transfer," should the fact that the taxpayer does not own the property prevent the attribution of income to him?[243] Presumably, the court's reply would be that the taxpayer does in fact own property: while beneficial title to the property may reside in a third party, the taxpayer does own the leasehold interest which would constitute property under the Act.[244] More importantly, however, such a transaction produces a result which the attribution rules are designed to prevent -i.e. the reduction of the taxpayer's income by transferring income-producing property to his spouse. It would be contrary to the spirit and intendment of the principles of attribution for the court to decide that no transfer had taken place because the technical requirement of ownership of the property had not been satisfied.[245]

It is submitted that the question of whether a transfer of property has occurred should not be dependent solely on whether or not the strict requirement of ownership is proven. On the other

hand, it seems, in all fairness, that there should not be a transfer every time the taxpayer is the catalytic agent in a transaction which results in property being transferred to a spouse or minor child. The inquiry should focus on the net effect of the property coming into the transferee's hands. If, for example, the transaction resulted in a reduction of the taxpayer's present or future income, then the fact that he did not own the property should not be considered of paramount importance. On the other hand, where the net result is simply an increase in the assets and income of the transferee without a corresponding reduction to the transferor, the attribution rules should not apply. Notwithstanding the fact that the taxpayer may have been responsible for the transfer to the spouse, there is no foreseeable loss of tax revenue.

I. The Requirement of Vesting

The problem of "vesting" has been analyzed almost exclusively in relation to transfers to trusts. For general purposes, as noted above,[246] it appeared safe to assume that there would be no transfer unless the property or right to income became vested indefeasibly in the recipient[247] -i.e. so long as some property right became vested, it did not appear to be important that the income generated therefrom was future or contingent in nature.[248]

The real problem lay in circumstances where there was no apparent vesting in the intended recipient. With respect to trusts, the most prominent issue concerned the discretionary trust; in this situation, it has been held, in the United Kingdom, that the beneficiary has no assignable interest and has no right

to demand distribution of the income or capital - in fact it would seem that he has no identifiable interest at all.[249]

This position taken by the English courts was never clearly adopted by the Canadian courts. The leading authority in this respect is the case of Sachs v. The Queen.[250] In this case, the facts were, inter alia, that a trust was established by the taxpayer for the benefit of his minor children under which the trustee had absolute discretion to pay any of the income to or for the benefit of one, some, or all of the children until the year 1991. While the basis of the judgment lay in the interaction between former subsection 75(1) and the preferred beneficiary election under subsection 104(14),[251] and it was held that the trust income (it was unclear whether or not such income had actually been distributed to the beneficiaries) was attributable to the settlor, the problem of vesting was not clarified to any great extent.

Thurlow C.J. was of the opinion that, for the purposes of attribution, the question was whether a "casual observer"[252] would say that there had been a transfer of property or of rights in property; it therefore did not matter whether technically the beneficiaries were vested absolutely or defeasibly,[253] or whether their rights were contingent only. In his view, on the creation of the trust deed, the children had acquired present beneficial rights to income and capital deferred as to payment until they attained certain ages, which rights would be lost in the case of either a non-exercise of the discretionary trust or if they predeceased. There was clearly a transfer of property, whether the beneficiaries' interests were vested or contingent, but his

lordship would say nothing about the beneficiary of a pure discretionary trust, that is, one who does not take any income or capital at any stage unless the discretion is exercised in his favour.

Heald J., however, held that the provisions of former subsection 75(1) (now subsection 74.1(2)) only applied where the minor beneficiary has a vested interest. He did not enlarge on this; he merely said that Thurlow J. himself (as he then was) in Dunkelman v. MNR[254] had required the section to apply to a "divesting" by the taxpayer and a "vesting" in the minor and he relied on Thorson P.'s similar views in Fasken Estate v. MNR.[255] He went on to find that the children had contingent interests (in which case he would not have applied former subsection 75(1)) but held that the making of the preferred beneficiary election had the effect of vesting the childrens' interest in the accumulating income.

The difficulty posed by the judgment in Sachs will now be clear. Thurlow C.J. certainly concluded that former subsection 75(1) did not require a vesting (in his view the subsection applied equally to contingent interests), but he abandoned this line of enquiry in favour of an argument based on the effect of the exercise of a preferred beneficiary election. Heald J. disagreed as to vesting; he considered that the subsection did require a vesting. Moreover, though he, too, had come to a conclusion unfavourable to the taxpayer because of the effect he discerned in a preferred beneficiary election, he could find no vesting in view of the fact that the only right a beneficiary has

under a discretionary trust before any distribution is made is merely to be considered.

The ratio decidendi of Sachs, therefore, (Kerr D.J. having said only that there was a liability to tax) is that what gives rise to attribution is the exercise of the preferred beneficiary election in favour of a minor child.[256] Whether vesting is required, a matter upon which the court was in disagreement, was obiter dicta. And not only did Heald J. consider that no vesting occurred for the purposes of former subsection 75(1) when a person is a mere object of a discretionary trust, but even Thurlow C.J., who was not concerned with more than a "transfer" in popular terms, declined to say that there is a transfer when the beneficiary in question of the discretionary trust class has no other rights, beyond that trust, to income or capital.

Subsequent to the decision in Sachs came the decision of Cattanach J. in Murphy v. The Queen,[257] a case which, however, did little more than to further cloud the already murky waters concerning the problem of vesting. Here the essential facts were that under the terms of the deceased's will, the trust provided that the widow was to receive an annuity from the estate, with the remaining income to be divided equally between her son and daughter. Subject to these annuities, the capital was to be held on the death of the son and daughter for the daughter's two sons on their attaining 30 years of age. By a subsequent variation of trust, however, it was agreed that the son and daughter should surrender their interest in the balance of the trust income. In place of those interests, the balance of the income would be held on a discretionary trust for a class of persons made up of the

son, the son's wife, the daughter, the daughter's husband, and the daughter's two sons. The trustees of the discretionary trust continued to be the son and daughter, as was the case under the testamentary trust. During the taxation years in question, income payments were made by the trustees to the son's wife and these sums were attributed by the Minister to the son pursuant to former subsection 74(1).

On appeal by the son, Cattanach J. held that by entering into the variation of trust agreement, the son had foregone his proprietary right under the former testamentary trust and the right, so foregone, reverted to the trust to be disposed of in accordance with the varied terms. That right generated income, and under the variation passed to the six discretionary beneficiaries, one of whom was his wife, who had never had this right before and who might now share in the income. The wife had in fact received income in the taxation years in question and "the son was well aware and must be taken to have anticipated that ... eventuality" when he gave up his vested rights in the unvaried trust. "The action by the trustees [was] but the concluding link in the chain of circumstances set up by the [son's] participation in the family agreement."[258] So former subsection 74(1) applied. A property right had been transferred - a word which is not technical - by the husband to his spouse by means of a trust, and that property - a right in income - had subsequently generated income which, in his wife's hands, was therefore attributable to him.[259]

In reaching this conclusion, Cattanach J. expressly followed Thurlow C.J.'s reasoning in the earlier Sachs case. This would

seem to be the point to be emphasized. The word "transfer" is not technical, his lordship said, and the [attribution] section does not employ the word "vest;" therefore, the niceties of vesting which have been developed and are recognized in courts of equity are not relevant. The matter was to be viewed broadly and stripped of its legal concepts.[260]

It will be seen, therefore, that in his judgment in Murphy, Cattanach J. went beyond Thurlow C.J.'s judgment in Sachs and said that A has transferred property to B when A conveys it to trustees who have absolute discretion among a class of beneficiaries, of which B is one, and then select and pay (either income or capital) to B. The connection of A to B is made by saying that A was well aware and must be taken to have anticipated that the trustees would select B; their action is but the concluding link in the chain of circumstances. Cattanach J. does indeed adopt the words familiar in older authorities to the effect that a taxing statute should be strictly construed, and that the onus is on the Crown to show that the person sought to be taxed falls clearly within its operation, but, having held that "transfer" is used in the popular sense to mean the giving or handing over of property from one person to another, he surely abandons the notion of strict construction. His statement that the word "transfer" should not be "construed as if it turned on the niceties of distinctions as to the vesting of property which have been developed and recognized by courts of equity"[261] clearly indicates that the well-established principles of property law were dismissed in favour of "concluding links."

(i) Comment

The decision in Sachs was, from a trust law point of view, somewhat anomalous since the minor beneficiaries had purely discretionary interests.[262] On the other hand, however, there was certainly a transfer of property (i.e. a sale of the shares of the family company) from the taxpayer to the trust. The question to be decided, however, (at least in the minds of the learned justices) turned on the nature and effect of the preferred beneficiary election. The important point, it is submitted, is that the preferred beneficiary election is purely a tax concept. In both Thurlow C.J.'s and Heald J.'s view, it was not possible for the trust income to be treated as the beneficiaries' income for tax purposes and still be income which was subject to the terms of the trust. With all due respect, however, it is submitted that this is precisely what the effect of a preferred beneficiary election is intended to achieve.[263] In fact, one might say that the nature of a preferred beneficiary election is a legal fiction in this respect, just as the attribution rules provide that income from property transferred by a husband to his wife continues to be taxed in the husband's hands notwithstanding that such income is physically received by the wife who owns the property for tax as well as non-tax purposes.

As a matter of principle, however, it is submitted that it would seem more proper to say that if a preferred beneficiary election is made, the trustee has exercised his discretion in favour of the beneficiary, thereby vesting the income in the beneficiary. For example, assume that a settlor establishes a discretionary trust under which his son and two of hs

grandchildren (minors) are beneficiaries. The trustees subsequently enter into preferred beneficiary elections with the two grandchildren, with the result that two-thirds of the income is taxed at the childrens' rates, and the same amount is deducted from the income of the trust, notwithstanding that no physical distribution of the income is actually made to the grandchildren. In the following year, the trustees pay the accumulating income by way of capital to the son, with the result that no attribution takes place, even though the settlor has, in effect, managed to split income with minor children.

The question to be asked now is whether the combined effect of subsections 74.3(1), 74.5(9) and 74.5(10) is to deem a discretionary beneficiary to have received income from a trust to which an individual has loaned or transferred property. In other words, in a factual situation such as that in Sachs, (assuming one accepts the Sachs case as a correct statement of the law with respect to the interaction of the attribution rules and the preferred beneficiary election), would it be necessary for a preferred beneficiary election to be made in order for there to be attribution to the individual? That is, would the foregoing provisions automatically attribute to the individual any income derived from the transferred property?

It is submitted that while the effect of subsections 74.5(9) and 74.5(10) would be to deem, in a case such as Sachs, the discretionary beneficiaries to be beneficially interested in the trust, the mechanics of the formula in subsection 74.3(1) would not apply to automatically attribute income from the transferred property to the individual. This appears to be the case since the

formula applies to attribute an amount which is equal to the lesser of: (i) the income of the discretionary beneficiary from the trust, and (ii) the income earned by the trust from the transferred property before making certain deductions times [the discretionary beneficiary's income from the trust divided by the aggregate incomes of all beneficiaries of the trust]. Thus, if no income is actually paid to the discretionary beneficiary from the trust, the amount attributed to the individual under the formula will be nil. Therefore, the question again reverts to whether or not a preferred beneficiary election is, for the purposes of the Act, equivalent to a distribution of the trust's income to the preferred beneficiary. If not, the income would not seem to be taxable in the beneficiary's hands, but only in the trust as accumulating income.[264]

With respect to the decision in Murphy there are, at least, two important technical aspects of the judgment which deserve comment. The first concerns the taxpayer's contention that he did not transfer anything to his wife, at least in his personal capacity. Cattanach J.'s reply to this argument has already been discussed above. The point to be noted, however, is that the taxpayer did concede (and the court agreed) that as a result of the variation of trust agreement, he did transfer his right to receive one-half of the income of the estate to the trust. Now, by virtue of new subsection 74.5(9), where a taxpayer has transferred property to a trust in which another individual is beneficially interested, the taxpayer is deemed, for the purposes of sections 74.1 to 74.4, to have transferred the property to the

other individual. And, by virtue of subsection 74.5(10), where an individual is a discretionary beneficiary of a trust, that individual is deemed to be beneficially interested in the trust. The result would seem to be that, for the purposes of the formula in subsection 74.3(1), the taxpayer would be deemed to have transferred property to a trust in which his spouse was a designated person, thus setting in motion the attribution formula contained therein.

The second technical aspect concerns Mr. Murphy's argument that on the particular facts of his case, it was not possible to say that the income actually paid to his spouse came out of the one-half share to which he would have been entitled but for the variation of trust. However, once again it seems that the combined effect of subsections 74.5(9) and (10) would be to deem Mrs. Murphy to be a designated person for the purposes of subsection 74.3(1). Once this is found to be the case, the formula in paragraph 74.3(1)(a) will subject the transferor to income attribution, and the amount attributed will be the lesser of the two amounts computed under subparagraphs 74.3(1)(a)(i) and (ii). Thus, once it is found that a taxpayer has transferred property to a trust of which his spouse is a designated person, the rule in subsection 74.3(1), while designed to exclude from attribution income not derived from property transferred by someone other than the taxpayer, will attribute to the taxpayer the first income paid to a designated person.

V. Antenuptial Gifts and Agreements

A. General

The term "antenuptial agreement" in its broadest sense

embraces all contracts made before marriage and in contemplation of it.[265] The term "antenuptial gift" generally refers to a gift inter vivos (E.g. a gift of furniture and household effects up to a fixed amount and/or a cash gift payable within a term of five to ten years), and/or a gift mortis causa (a cash gift made in contemplation of death), either or both of which may be contained in a marriage contract.[266]

Traditionally, the marriage of the child of a wealthy man was regarded as a proper occasion to pass some of the family wealth on to the younger generation. Accordingly, gifts or settlements of property were made in favour of persons within the "marriage consideration" namely, the parties to the intended marriage and their anticipated issue.

The donor or settlor of the property may be either one of the parties to the intended marriage or any person who has a genuine interest in seeing the marriage established such as a parent or relative.[267] In order to be "in consideration of marriage," the gift or settlement must be made:

(a) prior to the particular marriage and in contemplation of it; or

(b) immediately following the marriage, and in consideration of it; or

(c) at any time after the marriage but pursuant to an agreement made prior to it.

In this section, we are concerned with the situations described in "(a)" and "(c)," wherein, of course, the donor is one of the future spouses.

B. Gifts made Prior to Marriage

The attribution rules apply to a spouse or to a person who has since become the spouse of the transferor. This would appear to imply that if a fiance (or fiancee) makes an antenuptial gift, or sale (for consideration which is less than the fair market value of the transferred property) or other transfer of property to the intended spouse before marriage (whether under an antenuptial agreement or apart from it) and marriage ensues as was anticipated, any income or loss derived from the transferred property or from property substituted therefor, will be attributed to the transferor so long as he continues to reside in Canada and the transferee is his spouse.[268]

Prior to 1948, it was possible to transfer property to a spouse before marriage and successfully avoid the attribution rules; however, the insertion of the phrase "or to a person who has since become his spouse" has specifically provided for this situation.[269]

Such phrase was added to the attribution provisions with the apparent objective of overruling a series of decisions which held that transfers made by a taxpayer to his future wife did not attract attribution under the former subsection 32(2).[270] For example, in Molson v. MNR[271] the taxpayer made a pre-marital gift to his future wife pursuant to their marriage contract. The gift consisted of certain corporate securities from which the wife was to receive all dividends from the date of the marriage until the husband's death. After the husband's death, the Minister assessed his estate and added back to it the aforementioned dividends on the ground that the antenuptial gift was a "transfer of property"

within the meaning of former subsection 32(2). It was held that since there was no evidence to show that the gift was made with the intention of evading taxation, none of the dividends previously paid to the wife could be attributed to the husband's estate. While the Exchequer Court was of the opinion that there was no intention on the part of the husband to evade taxes since the facts indicated that the gift had been made before the Income War Tax Act[272] came into force, the Supreme Court was primarily concerned with the validity of the form of the gift itself and, having found the gift to be valid under the relevant provincial law, it refused to express any opinion with respect to whether or not subsection 32(2) was restricted to transfers made with an intention to evade taxes.[273]

Similarly, in Connell v. MNR,[274] the taxpayer executed a pre-marital settlement in favour of his future wife, with the actual transfer of property (corporate shares) effected before the marriage. Thorson P. held that for subsection 32(2) to apply, the transferor and transferee had to be married at the time of the transfer. Because of the opinion of Duff C.J.C. in Molson v. MNR (where the Chief Justice stated that the Supreme Court would not express any opinion with respect to whether or not section 32 only applied to transactions made with the intention to evade taxation) the President chose not to express any opinion with respect to the issue of the intention to evade taxation.[275]

C. Post-Nuptial Gifts

In some cases one spouse may promise to transfer certain property to his or her future spouse pursuant to an antenuptial

agreement, but with actual delivery of part or all of the property not taking place until after the date of the marriage. In this case, the attribution of income does not present any problem: the consensual nature of the marriage contract results in a transfer of property immediately upon the transferor's promise to do so, and income attribution will commence from the date the marriage is solemnized.[276]

The attribution of capital gains, however, presents a somewhat more difficult problem, and in this respect, reference may again be made to the case of Houghton v. MNR.[277] Here the taxpayer entered into a marriage contract under which he promised to transfer $10,000 to his future wife at any time during the marriage and up to his death. The marriage contract was signed in 1935, but it was not until 1951 that the taxpayer fulfilled his promise by transferring to his wife certain real property with a fair market value of $23,000. The Minister assessed the taxpayer to gift tax with respect to the transfer of real property, alleging that the transfer took place in 1951 and that therefore the fair market value of the property for gift tax purposes was $23,000. The taxpayer argued that there were two separate gifts - one of $10,000 in 1935, and one of $13,000 in 1951.[278] The Board agreed with the taxpayer and held that there were, in fact, two separate gifts.

The decision in Houghton would appear to have implications for transfers of capital property made pursuant to a marriage contract entered into before 1972. For example, under the terms of such a marriage contract, the husband agrees to transfer certain capital property with a fair market value of $10,000 to his wife at any

time during the marriage and up to the time of his decease. In fact, no transfer actually takes place until 1986, at which time he transfers certain stocks worth $15,000. Two basic questions arise: (a) When is the transfer of property deemed to take place?; and (b) Is there, in fact, attribution of capital gains and, if so, what is the adjusted cost base of the transferred property?

The opinion of the Board in Houghton indicates that the transfer of property takes place at the time the marriage contract is entered into, with the result that, in our example, no attribution of capital gains would occur if the transferee subsequently disposed of the property, since the marriage contract was entered into before 1972. However, the Board also held that if the actual delivery of the property does not occur at the time of the deed but only after marriage, and the property then delivered has a fair market value in excess of the value stipulated in the deed, there may be a separate transfer of property (i.e. a separate gift) with a fair market value equal to the fair market value at the time of actual delivery less the value of the gift stipulated in the deed. Thus, in our example, the adjusted cost base of the transferred property would appear to have a value of $5,000, and there would therefore be attribution of capital gains if the wife realized a gain upon the subsequent disposition of the property, or property substituted therefor.[279]

D. Wedding Gifts

With respect to wedding gifts, the question has arisen as to the ownership of the property given as such gifts.[280] The prevailing judicial opinion (in the United Kingdom) appears to be

that where there is no evidence of the intention of the donor, the court is entitled to infer that the money and gifts originating from friends and relatives of the husband were intended for the husband, and those from friends and relatives of the wife were intended for her. In Sampson v. Sampson,[281] the parties received cash and some gifts in kind as wedding gifts, most of which came from the groom's relatives. The marriage was of short duration and upon separation, the wife claimed that she was entitled to one-half of the cash and other property received as wedding gifts. Lord Hodson rejected the wife's claim on the ground that, in the absence of evidence indicating the donor's intention, there was no presumption of law that wedding gifts should be regarded as gifts made jointly to both spouses.[282]

There may, however, be circumstances in which a court is willing to find that wedding gifts have become joint property of the spouses. In Newgrosh v. Newgrosh[283] the parties received two sets of home furnishings and there was a dispute to the effect that one set was said to have been given to one spouse and one to the other spouse. It was held that, because the parties subsequently used both sets of furnishings interchangeably, such conduct enabled the court to conclude that the furnishings had become joint property.

In the United States (at least in the State of New York), the courts do not generally share the English viewpoint with respect to the ownership of wedding gifts.[284] For example, in Avnet v. Avnet[285] it was held that all wedding gifts whether from the bride's side or from the groom's, except such items which are peculiarly adaptable to the personal use of one of the spouses,

and those gifts which are specifically and unequivocally "earmarked" as intended exclusively for one or the other of the spouses, are deemed to be the joint property of both parties to the marriage.[286]

Depending upon whether one agrees with the English viewpoint that no legal presumption of joint ownership exists with respect to wedding gifts, or with the contrary view taken by the American courts, the implications for attribution are obvious. If a presumption of joint ownership exists, it would seem that income derived from property received as a wedding gifts (or from property substituted therefor), and/or capital gains resulting from the disposition of such property (or property substituted therefor) would be taxed one-half in the hands of each spouse. To the extent that one spouse was in a substantially higher tax bracket than the other, some income splitting would be achieved. Conversely, if no presumption of joint ownership can be said to exist, each spouse will be fully taxed in respect of all income and/or capital gains derived from cash and other gifts received by them from their respective friends and relatives. Of course, if the spouses' marginal tax rates do not vary widely, any potential loss of income splitting will not be very significant.[287]

E. Superficial Losses

A superficial loss is sustained by a taxpayer on the disposition of a property if the same or similar property is reacquired by him, his spouse, or a corporation controlled by him within the conditions prescribed by paragraph 54(i). Subparagraph 40(2)(g)(i) deems the amount of the superficial loss to be nil,

thereby preventing its deduction by the the taxpayer. In this event, the amount of the loss may be added to the cost of the substituted property by virtue of paragraph 53(1)(f).

A superficial loss exists if all of the following circumstances prevail:

(a) capital property has been disposed of by the taxpayer at a loss;

(b) the same or identical property (referred to as the "substituted property") is acquired during the period beginning 30 days before the disposition and ending 30 days after the disposition;[288]

(c) the substituted property is reacquired by the taxpayer, his spouse or a corporation controlled by him; and

(d) at the end of the period ending 30 days after the disposition, the substituted property was still owned by the taxpayer, his spouse or the corporation which had acquired it. Thus, if the substituted property is sold within 30 days of the original disposition, the loss arising from the original disposition is not deemed to be a superficial loss.[289]

The definition of superficial loss does not seem to require that the parties be spouses both at the time of the disposition of the property and at the time of acquisition of the same or identical property. Thus, it would appear that if the taxpayer shortly before his marriage disposed of certain marketable securities at a loss (perhaps in anticipation of additional cash requirements arising from the marriage and immediately following the marriage) and, following the marriage, his spouse, by way of purchase, gift or otherwise, acquired the same or identical

property, a superficial loss will result if the disposition and acquisition are within the thirty-day period. While it is true that the adjusted cost base of the substituted property acquired by the spouse will be increased by the amount of the superficial loss, the value of this adjustment will depend upon the spouse's marginal rate at the time of disposition of the substituted property, the marginal rate of the taxpayer who suffered the superficial loss, and the length of time between the acquisition of the substituted property and its subsequent disposition.[290]

F. Antenuptial Gifts in the Province of Quebec

In the Province of Quebec, the fiscal consequences of pre-marital transfers of property[291] appear to depend to a large extent upon the type of marital regime which governs the parties' marriage.[292] Spouses married without a marriage contract prior to July 1, 1970, are under the legal regime of community of property, while spouses married thereafter without a marriage contract are under the legal regime of partnership of acquests.[293] The legal regime may be varied by marriage contract entered into either before or after marriage.[294]

If the future consorts adopt the regime of separation of property or the regime of partnership of acquests, the transferee will become the absolute owner of the transferred property under the Civil Code,[295] having owned it from the day of celebration of the marriage, but from the taxation point of view, all income and capital gains derived from such property will be attributed to the transferor.[296] Such a division between a particular property, on the one hand, and income derived from such property, on the other

hand, is seemingly not recognized under the Civil Code.[297] For example, vis-a-vis his creditors, the transferee married under the regime of separation of property is the owner of all income derived from the transferred property, and therefore such creditors may legally seize such income in order to satisfy the transferee's debts.

With respect to the transferee married under the regime of partnership of acquests, while the income derived from the transferred property is deemed to be one of his acquests[298] and he is liable for all debts incurred in respect of his acquests,[299] the transferor will be responsible for the payment of tax in respect of such income, and the Minister will have a "droit de suite" on this same income.[300]

The situation becomes somewhat more complicated where the parties adopt the regime of community of property. Where the transferor transfers to his future spouse property which becomes the transferee's private property, the results are the same as those with respect to the regime of partnership of acquests.[301] For example, if the transferor transfers immoveable property to the transferee, such property remains as private property.[302] On the other hand, if the transfer consists of moveable property which becomes community property,[303] the attribution rules will operate as described immediately below.

(i) Transfer by Future Wife to Future Husband: Community of Property

If the future wife transfers to her future husband property which becomes community property, subsection 74.1(1) would appear to operate to attribute all income from the transferred property

back to the wife, who will be taxable in respect thereof. However, in the case of Sura v. MNR the Supreme Court held that income which is derived from community property must be taxed in the husband's hands. As Taschereau J. stated:

> Nothing in ... the Act changes the rule that it is not ownership of property which is taxable, but that the tax is imposed on a taxpayer, and the tax is determined by the income received by the person who is the legal beneficiary from employment, businesses, property or ownership.
> ... only he must pay tax who has absolute enjoyment of the income, unfettered by any restriction on his freedom to dispose of the income as he sees fit.[304]

In Sura, the parties married without a marriage contract and consequently became subject to the regime of community of property. The point at issue was whether income from community property, which consisted of the husband's salary and certain rental income, could be taxed as to one-half in the husband's hands and one-half in his wife's hands. Speaking for the court, Taschereau J. held that income derived from community property must be taxed in the husband's hands since he was the sole administrator of such property.[305] With respect to the wife, her right was said to be "stagnant, almost sterile" during the lives of the spouses.[306]

Notwithstanding the judgment of the Supreme Court in Sura, it seems that the principle enunciated therein cannot apply to our particular situation. Since the property in question has been transferred within the meaning of subsection 74.1(1) it will therefore be the transferor (i.e. the wife) who will be taxed on income derived from the transferred property. Faced with a legislative text as specific and precise as subsection 74.1(1) we

must, in this particular case, disregard the decision in Sura and conclude that income from the transferred property will be taxed in the wife's hands.[307]

With respect to the attribution of capital gains, several issues arise where the transfer involves community property. With respect to transfers of property made before 1972, subsection 74.2(1) does not apply and there appear to be two possible solutions: first, since it is the husband who, within certain limitations,[308] administers the community property, and since he alone can dispose of moveable property belonging to the community without his wife's prior consent, he is the one who should be taxed with respect to capital gains resulting from the disposition of the transferred property;[309] on the other hand, if one adopts the obiter dictum of Taschereau J. in Sura to the effect that the spouses are co-owners of the community property,[310] it is arguable that each spouse should be taxed with respect to one-half of the capital gain resulting from the disposition of the property.[311]

With respect to transfers of property after 1971, subsection 74.2(1) would clearly apply to tax the capital gain in the hands of the transferor, in this case the wife.

(ii) Transfer by Future Husband to Future Wife: Community of Property

If the future husband transfers to his future consort property which thereafter becomes community property, the husband will be taxed in respect of income derived from the transferred property by virtue of subsection 74.1(1) for the same reasons given in "(a)" above. In this case, the provisions of subsection 74.1(1) do not conflict with the principle enunciated in the Sura case to the

effect that it is the administrator of the community property who is subject to tax thereon.[312]

If the transfer occurs after 1971, any capital gain resulting from the disposition of the transferred property will be taxed in the husband's hands by virtue of subsection 74.2(1) However, as stated above, the obiter dictum of Taschereau J. in Sura provides a basis for arguing that such gain should be taxed one-half in the hands of each spouse. But in spite of such argument, it is felt that subsection 74.2(1) is a specific provision which would override Taschereau J.'s general comments in Sura.

If the transfer of property was made before 1972, subsection 74.2(1) would not apply. The same arguments which were put forward above with respect to an analogous transfer by a future wife to her future husband subsist: the capital gain will be taxed in the husband's hands by virtue of his administration of the community property, or the gain will be taxable one-half in the hands of each spouse.

VI. Substituted Property

The attribution rules apply not only to income generated by the transferred property, but also to income generated by property substituted for the transferred property. In MNR v. MacInnes[313] it was held that the attribution rules did not apply to income generated by property which had been substituted for a previously substituted property. In other words, the rule would apply only to the first property substituted for the transferred property but would not apply to further substitutions. This result was overcome by an amendment to the Act (prior to December 12, 1979 in

subsection 75(3); thereafter in subsection 248(5)) which provides that property substituted for the original property transferred shall be deemed to include any property acquired as a result of one or more further transactions after the first substitution.

It should be noted, however, that while the attribution rules apply to property substituted for the original property, any income resulting from the reinvestment of the original income derived from the transferred property is income of the transferee and not of the transferor.[314] Thus, if, for example, bonds are transferred by the taxpayer to his wife, the bond interest is taxable to the taxpayer but any income derived from the reinvestment of the bond interest will be considered to be income to the wife. Therefore, even though the purpose of subsection 74.1(1) is to prevent income splitting between husband and wife, since the subsection does not apply to income earned on the reinvested income, over an extended period of time some income splitting may be achieved.[315]

VII. Losses

Prior to 1975, the attribution rules applied only to income derived from the transferred property and did not refer specifically to any loss arising from the ownership of such property. This omission led to problems where the only income realized by the transferee spouse from the transferred property would be attributed to the transferor spouse but the losses would remain those of the transferee.[316] Consequently, if the transferee spouse had no source of income except the income from the transferred property, the transferee would have no income against which to offset the loss; nor would these losses be available to

reduce the amount attributed to the transferor. The amendment to subsection 74.1(1) effective for 1975 and subsequent years, adding the specific reference to losses from property makes it clear that the results of holding the property, whether positive or negative, are to be attributed to the transferor.

VIII. Residence

A. Transfers Effected outside Canada

It is clear that only income which accrues during a taxation year in which the transferor was resident in Canada can be attributed under subsections 74.1(1) and 74.1(2). Whether such income will be attributed if the property in question was transferred at a time when the transferor was not resident in Canada is perhaps not so clear. In Wertman v. MNR, Thurlow J. explicitly rejected "... the contention that [subsection 21(1) of the 1952 Act] did not apply to transfers made by the appellant to his wife prior to their coming to Canada..."[317] The learned judge found on the facts of the case that the taxpayer came into possession of a large sum of money while he and his wife were resident and domiciled in West Germany, and that he proceeded to deposit such money in a Swiss bank, in the joint names of himself and his wife, thereby transferring a one-half interest therein to her. When the spouses immigrated to Canada some years later, the funds in the Swiss bank were used to purchase certain real property, the title to which was taken in their joint names. Thurlow J. held that a portion of the income derived from such real property was attributable to the husband on the ground that it constituted income from property which was substituted for the

portion of the Swiss bank deposit made in the wife's name, notwithstanding that such deposit was made while the parties were resident in West Germany and before either of them became resident in Canada.

Perhaps because of its perceived inequitable result (i.e. the application of a Canadian statute to an inter-spousal transfer of property while neither the transferor nor the transferee was resident in Canada) the decision in Wertman v. MNR was not followed by the Tax Appeal Board in the case of Duplessis v. MNR.[318] In this case, the taxpayer transferred certain real property to his spouse while both of them were resident and domiciled in South Africa. The spouses subsequently immigrated to Canada and, after converting such real property to cash, they deposited the proceeds in a joint term deposit. The Minister attributed all the interest income earned in respect of the term deposit to the husband on the ground that it represented income from substituted property. The Board was of the opinion that subsection 21(1) did not apply to a transfer of property which a taxpayer might have made to his spouse before becoming a Canadian resident.[319] It characterized the decision to the contrary in Wertman as obiter on the ground that in the latter case there had been no transfer prior to the taxpayer's arrival in Canada. This reasoning is somewhat curious in view of the conclusion reached by Thurlow J.,[320] for it seems that the learned judge's finding that the attribution rules may apply in respect of transfers made before the taxpayer acquired a Canadian residence was an essential part of the reasoning on which his decision was based.

Reference may also be made to the case of Oceanspan Carriers

Ltd. v. The Queen,[321] which did not, however, deal with the attribution sections. Here the plaintiff corporation was incorporated in Bermuda in 1972. On June 15, 1976, the company became resident in Canada for tax purposes. For the taxation years 1976 to 1979, it sought to deduct, from its Canadian source income, a non-capital loss carryforward from the Bermuda corporation, and in addition it claimed a full year non-capital loss for the year 1976. In effect, the issue was whether a non-capital loss relating to a business not carried on in Canada, by a corporation not resident in Canada at the time the loss was incurred, might be applied against income earned by the corporation after it became resident in Canada.

The Minister, in denying the deduction of the loss carryforward, argued that his ability to tax did not begin until there was jurisdiction over the income of the person through residence in Canada or through income earned in Canada where the taxpayer was a non-resident.

Rouleau J. agreed with the Minister and held that the losses were not deductible by the plaintiff from its Canadian source income for the taxation years in question. In holding that the Minister's jurisdiction to tax depended on residence in Canada or income earned in Canada (where the taxpayer was a non-resident), he stated that:

> The mere fact of becoming a resident [in Canada] does not give the Minister - or Parliament - jurisdiction over the previous life or conduct of the corporation.[322]

With respect to the Wertman case, the learned judge stated that this decision did not support the plaintiff's argument that

the Act might extend its jurisdiction to the taxation of income earned outside Canada by a non-resident. While the writer agrees with this statement,[323] the learned judge's subsequent statement that "... [the Wertman case] had nothing to do with ... computing tax on assets transferred outside of Canada, nor did it extend the jurisdiction of [the Act] beyond our borders"[324] is somewhat strange, since that was precisely the main issue in that case.

It is submitted that the decision reached in Oceanspan Carriers is a correct one, since Parliament has no authority to tax a non-resident in respect of income earned, or losses incurred, outside Canada.[325] However, this judgment is distinguishable from that in Wertman because while the original transfer of property (in Wertman) did occur outside Canada, the substituted real property was situated in Canada and, consequently, the income derived from the substituted property was income earned in Canada. Also, the transferor was resident in Canada at the time the income was earned from the substituted property.

In spite of the obvious inequity which might result from a strict application of Thurlow J.'s decision in Wertman, it would appear that it does contain the more authoritative viewpoint. For although the revenue laws of one country may not be enforced by the courts of another country,[326] there is apparently no constitutional objection to extra-territorial taxation of non-residents where the income is derived from a Canadian source.[327] Moreover, the application of Thurlow J.'s opinion may not result in direct extra-territorial taxation since the taxpayer is being taxed while he is a Canadian resident, and there is

nothing in the wording of subsection 74.1(1) which provides that the transfer is subject to attribution only if it is made while the taxpayer is a Canadian resident.[328]

B. Severance of Residence

While it is accepted that the severance of Canadian residence by the individual will terminate the application of the attribution rules,[329] the residence of his spouse however, appears to be of no consequence.[330] Thus, if a wife severs her Canadian residence (or was a non-resident at the time when the property was transferred or loaned to her),[331] attribution from the transferred or loaned property will continue to be applied to the husband so long as he is a Canadian resident.[332] On the other hand, if the individual severs his Canadian residence and his wife continues to reside in Canada, she, and not he, will be taxed on the income derived from the transferred or loaned property.

In the case where both spouses are planning to emigrate from Canada and relinquish their Canadian residence, it may be feasible to arrange the emigration in such a manner that the attribution of capital gains (as well as income) is avoided.

Such planning will require that the transferor spouse (i.e. the high-income earner) sever his Canadian residence before the transferee does. Upon the transferor's cessation of residence, he will be deemed to dispose of certain property on which he must compute any capital gain (or loss) arising from the deemed disposition.[333] When the transferee spouse, who beneficially owns the transferred property, subsequently gives up her Canadian residence, she will also be subject to the application of

subsection 48(1), and since the transferor is no longer a Canadian resident, the capital gain, if any, which results from the deemed disposition rule, will be taxed in her hands and not in the hands of the transferor.[334]

IX. Transfer by Operation of Law

For the attribution rules to apply it is necessary that a taxpayer "has ... transferred ... property." This wording implies that some action on the part of the transferor is necessary in order to fall within the sections. Changes in the ownership of property resulting from the operation of law, in which the spouse legally owning the property before the change takes no part, may not involve the application of the attribution sections. In this regard, the attribution sections differ from section 73 which deals with capital property that "has been transferred" between spouses rather than with property that a taxpayer "has transferred."

For section 73 to apply, unlike the attribution sections, the direct participation of the transferor is not always necessary. For example, subsection 73(1.1) provides that, "for greater certainty," for the purposes of subsection 73(1), where under prescribed provincial laws, a person described in subsection 73(1):

(a) acquires or is deemed to have acquired,

(b) is deemed or declared to have or is awarded, or

(c) has vested in him,

capital property that but for the provincial laws would have belonged to another person, the property is deemed to be a capital property of the other person that has been transferred to that

person.[335] This statutory extension of the meaning of "transfer" applies only for the purposes of subsection 73(1), however, and a similar extension to the meaning of the concept as used in the attribution sections has not been made.[336]

The case of Reese v. MNR[337] illustrates the proposition that the attribution rules do not apply where the ownership of the property is transferred by operation of law. In this case, the taxpayer was a geologist, resident in Canada, but domiciled in California, who was in receipt of royalties from an American company. He treated one-half of the royalties as the income of his wife on the basis that the royalties formed part of the community of property under California law. The Minister attributed these royalties to the taxpayer. In holding that there was no transfer to which the attribution rules applied, the Board stated:

> I am of the opinion that neither of these provisions of Section 21 [now subsection 74.1(1)] is applicable in the circumstances of this case. Irrespective of whether any assignment was made by the appellant to his wife of one-half of his interest in the over-riding royalty which was given to him by the Humble Oil Company, it is my view that the laws of the State of California had automatically given to the wife a one-half interest in his over-riding royalty, as it was part of the community property of the husband and wife, and that she had a one-half interest in the over-riding royalty from its inception, quite apart from any assignment which her husband may have made as a matter of form.[338]

The decisions in Reese and Sura should be contrasted with that of Thurlow J. in Wertman v. MNR.[339] There the taxpayer and his wife had contracted into a regime of community of property under Polish law. The learned judge held, inter alia, that an undivided one-half interest in all property acquired by the husband both before and during the marriage was automatically transferred to

the wife by virtue of the pre-nuptial contract. He distinguished his decision from that of the Supreme Court in Sura by pointing out that under Polish law the husband was entitled to manage the property subject to the community but was liable to account strictly for his management. This difference in the status of the husband was sufficient to distinguish the Polish system from that in force in the Province of Quebec and, on that ground together with the fact that the community existed by virtue of a contract, he concluded that the decision in Sura was inapplicable.[340]

X. Only Income from Property is Subject to Attribution

As indicated above, the word "property" is, for the purposes of the Act, defined very broadly as: "property of any kind whatever, whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes a right of any kind whatever, a share or a chose in action and, unless a contrary intention is evident, money."[341] Thus, "property" would appear to cover anything which may be the subject of a transfer.[342]

Such a wide definition of "property" would clearly embrace a "business" or assets used in a business as being things capable of a transfer. In fact, this appears to be the view which was taken by the Board and the Exchequer Court on a number of occasions. In Goodman v. MNR[343] the taxpayer transferred her ownership in an unincorporated business to herself and her husband jointly. Thereafter, the husband managed the business and drew a regular salary therefrom. The Minister, while recognizing the existence of a business partnership, attributed the husband's share of the

profits to his wife on the ground that it constituted income from transferred "property." The Tax Appeal Board upheld this treatment except for the salary of the husband, which was held not to be income from the transferred property but from services rendered.[344]

The same result was reached by the Exchequer Court in MNR v. Minden[345] where the court, after rejecting the taxpayer's argument that the cash which he had advanced to his wife was a genuine loan, found that such money was used by the latter in several second mortgage transactions. It was held that, despite the fact that the profits earned by the wife could be characterized as business income, such profits were nevertheless attributed to the husband as income derived from transferred property.

It has been argued, however, that the provisions of subsections 74.1(1) and 74.1(2) apply only to income from property as distinct from a business (or office or employment).[346] This assertion holds that, for example, if a taxpayer makes a gift of money to his spouse who uses such money to purchase a business, the income (i.e. profit) from the business will not be attributed. Similarly, if the business itself, or an interest therein, is transferred to a spouse there will be no attribution of income or of capital gains.

While earlier decisions to the contrary are acknowledged,[347] the argument is supported by reference to the judgment of Noel J. in Robins v. MNR.[348] In this case the question was whether or not a genuine loan had been made from a wife to her husband and the court, having found that such a loan was, in fact, made, went on to hold that the income derived from the repayment of the loan

(which appeared to be business income realized in a real estate venture) was not subject to attribution.

With respect, it should be pointed out that, while the effective result of Noel J.'s decision was that business income was not attributed to the spouse in question, the learned justice based such decision on his acceptance of the ruling in Dunkelman v. MNR[349] that a loan was not a "transfer of property" under the income attribution provisions. His statement that "... what is deemed to be the income of the transferor [under subsection 74.1(1)] and this is clearly stated, is income from property only [and] there is no mention of income from a business ..."[350] was merely obiter dictum.

Nevertheless, there appears to be a general consensus that the attribution rules will not apply in respect of transfers of property used in a business, transfers of an interest in a business, and transfers of a business itself. Apart from the dicta of Noel J. in Robins, this view appears to be supported by the opinion of Urie J. as expressed in the case of Lackie v. The Queen.[351] Here the taxpayer sold to his wife certain farm property which contained gravel pits. The wife then entered into a contract with a construction company whereby the company agreed to pay the wife a specific sum of money over a defined period of time for the right to remove the gravel from the property. The Federal Court of Appeal upheld the Minister's assessment that the money paid to the wife by the company should be attributed to the husband under former subsection 74(1) since it represented income from property under paragraph 12(1)(g). With respect to the wife's argument

that there could be no attribution since she was carrying on the business of selling gravel, the court agreed that if this were actually the case, former subsection 74(1) would not have applied, but that since she had granted the company a licence to enter her property and extract the gravel, the payments she received were based on production or use of her property and therefore constituted property income.

While it is unarguable that the appeal court based its decision on the interpretation of paragraph 12(1)(g), Urie J. was unequivocal in his opinion that the attribution rules did not apply to business income:

> It is common ground that if the sums received [by the wife] are regarded as income from a business the attribution rules under subsection 74(1) of the new Act and subsection 21(1) under the old Act do not apply.[352]

Although unstated, it is felt that the rationale underlying the opinion of Urie J. lies in the singular nature in which the word "property" is used in subsections 74.1(1) and (2). Frequently throughout the Act (E.g. sections 3, 9, 12, 18, 20) the words "business" and "property" are used together, as though to distinguish between them, and this consequently raises a strong doubt as to whether, when "property" alone is used, it should be construed as including property that is, or that is used in, a business.[353]

A. Business Income vs. Property Income: The Basic Tests[354]

If it is accepted that only property income (and not business income) will be subject to attribution, then the taxpayer who contemplates a transfer of real property (E.g. rental real estate) or a transfer of personal property (E.g. a portfolio of stocks,

bonds, mortgages) to a spouse or minor child must be cognizant of how the receipt of income from such types of property will be characterized for tax purposes.[355] For most purposes, the Act treats income from a business and income from property in the same manner. Subdivision b of Division B of Part I contains the rules that apply to the determination of income from both sources and most of the rules in that subdivision apply equally to both types of income. For the purposes of the attribution rules, however, the distinction between the two types of income is critical.

B. Definition of Business

Subsection 248(1) provides an interpretative rule assisting in the definition of "business:"[356]

> 'business' includes a profession, calling, trade, manufacture or undertaking of any kind whatever and, except for the purposes of paragraph 18(2)(c), an adventure or concern in the nature of trade but does not include an office or employment.

In attempting to define what type of activities constitute "business" or the "carrying on of business," the courts have not, generally speaking, laid down hard and fast rules to be strictly adhered to, but have approached the problem on a case-by-case basis. In Martin v. MNR[357] O'Connor J., after stating that there was no principle of law which laid down what carrying on business is and that each case had to be decided upon its own facts, quoted from Erichsen v. Last where the Master of the Rolls said:

> I do not think there is any principle of law which lays down what carrying on of trade is. There are a multitude of incidents which together make the carrying on a trade, but I know of no one distinguishing incident which makes a practice a carrying on of trade, and another practice not a carrying on of trade. If I may use the expression it is a compound fact made up of a variety of incidents.

And Brett L.J. said:

> Now, I think it would be first of all nearly impossible and secondly wholly unwise to attempt to give an exaustive definition of when a trade can be said to be exercised in this country. The only thing that we have to decide is whether upon the facts of this case it can be said that this company is carrying on a trade, earning profits in this country.[358]

In spite of such judicial reluctance to lay down strict principles in respect of what constitutes the earning of business income, there have been attempts to draw the line between business and property income and to suggest certain salient factors to be taken into consideration in analyzing the problem.[359] In Hollinger v. MNR the taxpayer contended that the income derived by an inactive partner of a partnership which clearly carried on trading activities was income from property. In analyzing the possible approaches to the distinction between income from business and income from property Noel J. said:

> Counsel for the appellant further says that the question of whether income is from a business or property is one that must be resolved on the facts of each particular case and no simple criterion is determinative. The criteria which may be drawn from the authorities and which may serve as indicia are:
> (1) whether the income was the result of efforts made or time and labour devoted by the taxpayer;
> (2) whether there was a trading character to the income;
> (3) can the income be fairly described as income from a business within the meaning of that term as used in the Act and, finally
> (4) the nature and extent of services rendered or activities performed.
> I believe that most of those criteria are what may be termed subjective ones, i.e., which deal or apply to the person receiving the income rather than to the objective question of the source of the income which, in my view, is always the overriding consideration which must determine the matter. The source here is clearly a business source. If income from property has any meaning at all, it can only mean the production of revenue from the use of such property which produces income without the active and extensive business-like intervention of

> its owner or someone on his behalf. I have in mind, for instance, property such as bonds or debentures or shares or real property which do not require the exertion of much activity or energy in order to produce the revenue.[360]

Because a partnership is not a legal entity, the court in effect concluded that income from a partnership interest is to be characterized by reference to the nature of the partnership income, and that the extent of activity of a particular partner is immaterial so long as the income of the partnership is business income.[361]

(i) Transfer of Rental Real Property[362]

For whatever reason, the real property[363] investor is the main source of case law dealing with the passage of property income into commercial enterprise.[364] At least in the case of individuals, the basic principles seem clear. Mere ownership of real property together with the normal incidents of exploiting that ownership (seeking tenants, effecting repairs, collecting rents) will not constitute a business but will be considered to give rise to property income.[365] Rentals may, however, pass into the sphere of business income, and the test seems generally to be related to the nature and extent of the services that are rendered over and above the bare licence of occupation or lease. That is, where the services rendered by the property holder are in addition to those usually provided under a lease of that nature and the court is able to find that the rents can be regarded as having been paid in substantial measure for services as well as use of the property, the income will be regarded as business income.[366] This point was explained in Walsh and Micay v. MNR where Cattanach J. said:

> The services such as the provision of heat, electric stoves and refrigerators, janitorial services to the common hallways, snow removal, carpeting in some rooms of the suites and drapes for windows are those which tenants have come to expect and are those which landlords normally provide in living accomodation of this kind. There are refinements offered to the tenants in connection with the occupation of suites and, in most instances, are also property for the use of which, along with the suites themselves, rent is paid. The heating of the building and snow removal are ancillary to the property itself and are exercised in the landlord's capacity as owner of the property rather than as a service to the tenants although the tenants incidentally enjoy the benefits thereof. While the nature of services provided has a bearing on the question, the services above described are not such as would characterize the rentals received therefor as income from a business rather than income from property, as services such as the provisions of breakfast, maid linen, laundry, and such like services might do.[367]

In the case of real estate the occupation of which necessarily involves some additional services beyond maintenance of the property itself, there is a tendency to consider rentals as business income. For example, the operation of a marina, while it entails the storage of boats, also requires facilities for lifting and otherwise handling the vessels.[368]

To summarize, the above-cited jurisprudence seems to suggest that the source of rental income, where the landlord is an individual, is in the first instance property, but that the source may become a business where the receipts represent consideration, in a substantial part, for services that are beyond the normal range of services provided as part and parcel of the provision of the premises.

With respect to corporations, the tests described above have not generally been applied in a similar manner. Although the courts have approved the principle that a corporation may earn

income from property,[369] an analysis of the case law seems to lead to the conclusion that the circumstances in which a corporation with only one source of income (i.e. rental income) will be found to be earning income from property are rare.

The reasons for this appear to be two-fold. First, there exists a presumption that the corporate form itself affects the characterization of income.[370] Second, after an initial attempt in the early 1970s to put some meaning into new statutory concepts such as "active business income," and "Canadian investment income,"[371] the courts appeared to shift to the view that any business activity was sufficient to give rise to business income.[372]

As a result, the rule appears to be that where a corporation is formed for a certain purpose permitted by its objects and in fact carries out that intended purpose, income thereby generated will generally be business income for the purposes of the Act.[373] When this rule is applied in the area of ownership of rental real property, it seems to suggest that a corporation that is incorporated solely to hold and lease real property and that carries out the normal activities associated with exploiting that ownership will have its rental receipts characterized as business income.[374]

(ii) Transfer of Personal Property

The definition of "property" in subsection 248(1) includes "personal property" but as the expression "personal property" is not defined elsewhere in the Act, it must be given its private law meaning. In private law, property is either real or personal, (in the Province of Quebec, moveable or immovable) and all property

which is not real property is classified as personal property.[375]

Personal property is subdivided into two categories: (a) choses in possession - i.e. corporeal things, tangible, moveable and visible (E.g. an automobile, television set, etc.); and (b) choses in action - i.e. all rights and incorporeal things, not being choses in possession (E.g. an annuity, a stock or share in a corporation, an obligation for a debt, a mortgage,[376] a copyright or a patent).[377]

For the purposes of attribution, it seems most practical to confine the analysis to the transfers of personal property which are income-producing -i.e. transfers of choses in action. Generally speaking, it would appear that transfers of choses in action to a spouse or minor child will result in income attribution since income derived therefrom will most frequently be characterized as income from property. For example, where a taxpayer transfers a portfolio of corporate shares, the dividend income received therefrom by the transferee would be subject to attribution since dividends received from taxable corporations are normally characterized as income from property.[378] Similarly, a transfer of bonds or money-market certificates, or a transfer of a mortgage, would result in attribution since interest income, like dividend income, is normally characterized as property income.[379] In other words, where the transfer involves property the income from which is earned by a relatively passive process once an investment has been made, the yield is considered to be income from property.[380]

As we have seen, however, the attribution rules do not apply

where income from the transferred property can be characterized as business income and therefore a taxpayer may be able to avoid attribution where income derived from personal property is characterized as such. For example, where a transfer consists of a portfolio of corporate shares and the transferee subsequently engages in the extensive buying and selling of such (or additional) shares, such that gains (or losses) on dispositions thereof are held to be business income (or losses), it would appear that dividend income received in respect of such shares would also be characterized as business income.[381]

In this respect, reference should be made to the case of The Queen v. Marsh and McLennan Ltd.[382] Here the taxpayer carried on the business of an insurance broker. Its business practice was to invoice customers for premiums immediately after an insurer had agreed to underwrite the risk, although the taxpayer's obligation to pay the insurer the net premium (total premium invoiced less the taxpayer's commission) did not usually arise for an additional period of 60 to 90 days. All revenues (including gross premiums) the taxpayer received were commingled and deposited in bank accounts from which all liabilities of the brokerage business were paid. The taxpayer regularly withdrew cash from the accounts that were surplus to the company's current operating needs and made short-term investments with maturity dates chosen to coincide with due dates of liabilities of the business. The issue to be decided was whether the interest income derived by the taxpayer from these short-term investments constituted "Canadian investment income" within the meaning of the 1976 version of paragraph 129(4)(a).[383]

The court of appeal (Thurlow C.J. dissenting) held that the

interest income was from property used or held in carrying on the taxpayer's business (i.e. in effect, business income) and so excluded from Canadian investment income by virtue of subparagraph 129(4)(a)(ii).

In reaching this conclusion, Clement D.J. attempted to define the relationships between subparagraphs 129(4)(a)(ii) and (iii). He stated that in determining whether the exclusion in subparagraph 129(4)(a)(ii) applied, there were only two inquiries to be made:

(a) whether there was a business being carried on, and

(b) if so, whether the property in question was used or held in carrying it on.

He said that it was clear that the taxpayer was carrying on a brokerage business and that the investments in question were in fact property used or held by the taxpayer in the course of carrying on such business. The basis of this conclusion was that there was, between the taxpayer's business and the investments, an inter-connection, an interlacing, an interdependence and a unity embracing the investments and the business.[384] This was the case, it seems, because the funds which were used to make the investments were taken directly from the company's main fund which was essentially its working capital.

LeDain J. agreed with Clement D.J. that the unremitted premiums of the taxpayer were property used or held in the course of carrying on the business of the taxpayer. He concluded that the test to be applied was whether the property in question was "employed and risked" in the taxpayer's business. In his opinion,

it was so employed because an amount equal to the unremitted premiums was committed to the carrying on of business in order to meet the taxpayer's obligations to the insurers. His analysis stopped with that statement.

With all due respect, it is difficult to see how the decision in Marsh and McLennan has clarified the distinction between property income and business income to any great extent. There is no workable test developed for determining whether income is from property used or held in the course of carrying on a business. The conclusion of Clement D.J. that there was an inter-connection, an interdependence and a unity embracing the investments is, it is submitted, no more helpful than the wording of the statute itself.

LeDain J.'s opinion does, perhaps, provide the beginning of a test (i.e. whether the property is employed and risked in the taxpayer's business) but there is no elaboration with reference to the facts.

One might describe LeDain J.'s test in this manner: Is the making of short-term investments a part of the mode of conducting the business? If the answer is "yes," then the income from those investments would be considered business income.[385] Business income represents the income derived from a fund which is "employed and risked" in the taxpayer's business.

The converse of the issue raised in Marsh and McLennan was the subject of the decision in Canadian Marconi Co. v. The Queen.[386] The taxpayer, a manufacturer of electronic equipment, divested itself of its broadcasting division and found itself with surplus funds of approximately $20 million. While awaiting a suitable opportunity to invest in another business, the taxpayer

invested these surplus funds in short-term interest-bearing securities. During the period under assessment, the taxpayer earned substantial interest income (approximately $5 million) on which it claimed the manufacturing and processing credit on the basis that its interest income from the short-term investments represented "business income" and, therefore, "active business income."

In applying the "employed and risked" test, the court held that the short-term investments were not an integral part of the taxpayer's business operations. In a unanimous judgment, the court observed:

> The investments and the interest on them were being held by Canadian Marconi as a fund to purchase new capital assets (in the form of an ongoing business) for use in or in association with the manufacturing business... There was not ... between the investments and the manufacturing business ... 'an inter-connection, an interlacing, an interdependence, a unity embracing the investments' ... The short-term investments were not being used as working capital ... 'employed and risked' in the manufacturing business which [the taxpayer] carried on. The investments were 'at risk' [only] in the general sense that all assets of the company would ultimately be available to meet the claims of ... creditors.[387]

Thus, where a taxpayer has temporarily invested funds awaiting an opportunity for investment in a new business or capital asset, income derived from such funds will not constitute business income. However, income derived from the temporary investment of surplus working capital will constitute working capital.

It is not clear, however, whether the decisions in Marsh and McLennan and Canadian Marconi are readily applicable to our situation. The main problem, it is submitted, is that these cases involved the question of income earned by a corporation for the

purposes of "Canadian investment income" in former paragraph 129(4)(a). In our examples, we are concerned with income earned by individuals subsequent to a transfer of the income-producing property.

Nevertheless, it could be argued that the tests applied in Marsh and McLennan and Canadian Marconi are applicable to our circumstances since they are tests which were essentially applied in the distinction between business income and property income. Thus, for example, in the case where a transferee actively trades in corporate securities such that gains or losses incurred are characterized as business income, it could be argued there is an inter-connection, an interdependence, and an interlacing between such securities and any dividends and/or interest income derived therefrom, such that the dividends and interest income would also be characterized as business income, and therefore not subject to attribution. Put another way, since the trading of securities is the means of conducting business, the income from these securities is part of the business income.[388]

In summary, an analogy may be drawn with paragraph 125(7)(c) which provides that active business income, for the purposes of the small business deduction, includes any income pertaining to or incidental to that business.[389]

XI. Attribution of Capital Gains:[390] Spouses

A. Purpose and Effect of Section 74.2

When the tax reform legislation, effective January 1, 1972, which included one-half capital gains and losses in the tax base, was introduced it was evident that the absence of a rule

attributing gains realized by the transferee on a subsequent disposition of the transferred property could lead to a form of income splitting similar to that attacked by subsection 74.1(1). To avoid this possibility, subsection 74.2(1) was added which provides that where property is loaned or transferred, directly or indirectly, to a spouse or to a person who subsequently becomes the individual's spouse, the recipient spouse's taxable capital gains from the loaned or transferred property and net gains from loaned or transferred listed personal property minus allowable capital losses on loaned or transferred property are deemed to be taxable capital gains or net gains from listed personal property of the individual and not of the recipient.

Under the rule as originally introduced, losses served only to reduce the net amount attributed to the transferor. As a result, if the allowable capital losses suffered on the disposition of transferred property in a particular taxation year exceeded the taxable capital gains realized in that year, the excess was not subject to attribution. If the transferee spouse had no income or gains other than those attributable to the transferor there would be nothing for the loss to offset. To overcome the apparent harshness of this situation, subsection 74.2(1) was amended effective for 1975 and subsequent years. The subsection now provides that:

(a) the aggregate of taxable capital gains on loaned or transferred property and property substituted therefor (in both cases excluding listed personal property) minus allowable capital losses on loaned or transferred property or property substituted therefor (other than listed personal property) are deemed to be a

taxable capital gain of the individual;[391]

(b) the excess of allowable capital losses over taxable capital gains, if any, are deemed to be an allowable capital loss of the individual;[392]

(c) gains in excess of losses on the disposition of loaned or transferred listed personal property in the year, calculated as if the loaned or transferred listed personal property were the only listed personal property of the recipient, are deemed to be gains of the individual for the year from the disposition of listed personal property;[393]

(d) losses in excess of gains on the disposition of loaned or transferred listed personal property, calculated on the same assumption as that employed in (c) above, are deemed to be losses of the individual for the year from the disposition of listed personal property;[394] and

(e) gains or losses attributed to the individual by (a) to (d) are deemed not to be gains or losses of the recipient.[395]

(i) Transfers Covered

Because subsection 74.2(1) contains no separate definition of the word "transfer," it is submitted that the concept of transfer employed therein is identical with that used in subsection 74.1(1) in dealing with the attribution of income. In the case of attribution of gains and losses, however, the rule applies only to property transferred after 1971. Transfers made before 1972, before capital gains and losses were included in the tax base, are not affected by the subsection.

(ii) Transfer by Operation of Law

The general rule discussed above with respect to the meaning of the word "transfer," applies to the word as used in subsection 74.2(1). In the same manner and for the same reasons as previously discussed, property transferred by operation of law (E.g. as in the manner set out in subsection 73(1.1)) would not constitute a transfer which would result in the application of the rules contained in subsection 74.2(1).[396]

B. Inter Vivos Spousal Transfer of Property

Although the preamble to subsection 74.2(1) does not restrict its application, the detailed rules deal only with the result of the disposition of capital property. Transfers of capital property between spouses are also subject to the rules in subsection 73(1). This section provides that, in the absence of an election by the transferor, the transferor is deemed to have received proceeds of disposition of the property of, and the transferee is deemed to have acquired the property at a cost of:

(i) in the case of depreciable property of a prescribed class, an amount equal to the proportion of the undepreciated capital cost of the class to which the transferred property belongs, that the fair market value of the transferred property is of the fair market value of all the property in the class;[397] and

(ii) in the case of other capital property, an amount equal to the adjusted cost base of the property.[398]

The effect of this rule is to ensure that no capital gain or loss will be recognized on the transfer of capital property between spouses.[399] Some recapture of capital cost allowance may arise on such a transfer,[400] although in most situations this will not be the case; any recapture to which the transferor was

potentially liable is preserved as potential recapture to the transferee by subsection 73(2).[401]

Until 1979, the rollover treatment provided by subsection 73(1) was automatic, whether or not the transferor wished to defer the recognition of the capital gain. An amendment to the section applicable to transfers after 1979 now permits the transferor to elect not to have the provisions of subsection 73(1) apply. The effect of such an election, presumably, is that the rules in subsection 69(1) will apply to the transaction so that:

(i) in the case of a sale to a spouse, the vendor spouse is deemed to have received proceeds equal to the greater of the sale price and the fair market value of the property in question;[402] the purchaser spouse is deemed to have acquired it at a cost equal to the lesser of fair market value and the purchase price,[403] and

(ii) in the case of a gift, the donor is deemed to have received proceeds of disposition of an amount equal to the fair market value of the property[404] and the donee is deemed to have acquired it at a cost equal to that amount.[405]

The attribution rule in subsection 74.2(1) is applied both to property transferred in a rollover transaction under subsection 73(1) and where the transferor elects not to have the provisions of subsection 73(1) apply to the transfer.

C. Application of Subsection 74.2(1)

The rule in subsection 74.2(1), that capital gains or capital losses realized by the recipient spouse in respect of loaned or transferred property (or property substituted therefor) are attributed to the individual, applies only to transfers of capital

property that have taken place after 1971, and loans made after May 22, 1985. Transfers which took place before 1972, when capital gains and losses were not included in the tax base, are not subject to any similar rule.

The wording of former subsection 74(2) indicated that, if property had been transferred in 1972 or a subsequent year, any taxable capital gain, allowable capital loss, or gain or loss on the disposition of listed personal property, or property substituted therefor would be treated as a taxable capital gain, allowable capital loss, etc. of the transferor and not of the transferee. In fact, however, the subsection appears to be administered in a different way.

Interpretation Bulletin IT-258R2, dated May 11, 1982, contains the following statement:

> 22. Where a capital gain realized on disposition of transferred property by the transferee has been attributed to the transferor and a substituted property has been acquired by the transferee, the funds representing the portion of the capital gain which accrued after the property was transferred to the transferee are not considered as part of the substituted property. For example, assume that after 1971 a husband transferred to his wife capital property having a cost to him of $20,000 and a fair market value of $50,000. His wife later disposed of the property for $80,000 and the capital gain of $60,000 was attributed to the husband. If the wife then acquired a substituted property, only 5/8 of any income or capital gain realized from such property would be attributed to the husband.

Because this quotation refers to a capital gain of $60,000, it obviously presumes that the rollover rules in subsection 73(1) have applied to the transfer. Where the rollover is not applied, in the facts set out in the Interpretation Bulletin, the husband would be deemed to have received proceeds of disposition of

$50,000 and a capital gain of $30,000. If the wife acquired a substituted property, as in the example in the Bulletin, only 5/8 of the income or gain subsequently realized would be attributed to the husband.

In strict terms, it seems difficult to find authority to support the position which the Department has taken in paragraph 22 above. It seems that, in the context of the example which is used, the entire property purchased worth $80,000 from the proceeds of sale of the transferred property would constitute a substituted property. This appears to be the Department's position in dealing with the disposition of a property transferred prior to 1972 to a spouse which is disposed of in circumstances where the capital gain cannot be attributed to the transferor. In the same Interpretation Bulletin (i.e. IT-258R2), in dealing with this kind of case, the Department expresses the following view:

> 23. A capital gain or loss arising on disposition of property transferred before 1972 to a spouse or a person who has since become his spouse (or of a property substituted for such property) cannot be attributed to the transferor under subsection 74(2). While such capital gains or losses are those of the transferee, it should be noted that, subject to the comments in 1 and 6 above, all the income from such property or substituted property remains the income of the transferor. For these purposes, the Department considers substituted property to include property acquired with the gains realized on disposition of the original transferred property or a property substituted therefor. Thus, if the example in 22 above involved a pre-1972 transfer of property, all of the income arising from the substituted property acquired with the $80,000, but none of the capital gain or loss, would be attributed to the transferor.

It is believed that the Department has, as a concessionary matter, taken the position that the capital gain accruing subsequent to the transfer in respect of property transferred

after 1971 may be deducted from the substituted property because that portion of the gain is taxable to the transferor.[406] This would be consistent with the interpretation of subsection 74.1(2) to the effect that attributed income earned by a spouse but taxable to the transferor is not included in the concept of transferred property or substituted property.[407] However, there does not seem to be any authority for the Department to have drawn the distinction between capital property transferred after 1971 and capital property transferred prior to 1972.

D. Period During which Capital Gains Attribution Applies

As in subsection 74.1(1), the rule in subsection 74.2(1) applies where property has been loaned or transferred to a spouse or to a person who, after the date of the loan or transfer, becomes the spouse of the individual. The rule ceases to apply (as in subsection 74.1(1)) when any of the following events occur:

(a) the death of the individual;

(b) the individual ceases to be resident in Canada;

(c) the recipient ceases to be the spouse of the individual; or

(d) the spouses are separated pursuant to a decree, order or judgment of a competent tribunal, or pursuant to a written separation agreement, provided that the parties are living apart and a joint election of the spouses not to have subsection 74.2(1) apply is filed with the return of the individual for the taxation year in which the separation occurred.[408]

E. Identical Properties

Where a taxpayer owns "identical properties,"[409] such as corporate shares or debt obligations, and is contemplating the disposition of some or all of such property, a certain measure of

tax saving may result if certain identical properties are transferred to his spouse prior to the disposition. For example, where a taxpayer has shares issued by a particular corporation which he acquired before 1972, and also has shares of the same corporation which he acquired after 1971, the Act distinguishes between the pre-1972 shares and the post-1971 shares, and deems dispositions to be made first out of the pre-1972 and then out of the post-1971 shares.[410] The Act also provides different rules for determining the adjusted cost base of the shares of each set.[411] Accordingly, where the adjusted cost base of a pre-1972 share is lower than that of a post-1971 share, the taxpayer may, by transferring the pre-1972 shares to his spouse, effectively then dispose of his post-1971 shares first for capital gains tax purposes and therefore reduce his initial capital gains tax burden.[412]

F. Recapture of Capital Cost Allowance

One question which arises with respect to the transfer of depreciable capital property is whether recaptured capital cost allowance may be considered for tax purposes to be income from business or income from property.[413] At least in the case of an individual taxpayer, the rule appears to be that where depreciable property is disposed of, any recapture will be characterized as the same type of revenue as the depreciable property in question earns.[414] Thus, where the taxpayer earns income from real property which, for tax purposes, is classified as property income, any recapture upon a disposition will also be classified as such; and, where the real property income is characterized as business

income, recapture will also be characterized as such.[415]

G. Lifetime Capital Gains Exemption

The federal budget of May 23, 1985, introduced a lifetime exemption for individuals in respect of $500,000 of capital gains ($250,000 of taxable capital gains), to be phased in between 1985 and 1990.[416] The exemption is available as a deduction in computing the taxable income of an individual who is resident in Canada throughout a year.[417] The exemption is not available to a trust, except for a spousal trust on the death of the spouse for whom the trust was established.[418]

The maximum deduction that an individual can claim in any year is $250,000,[419] less amounts deducted in any preceding years. The available deduction is also subject to an annual gains limit for the year and a cumulative gains limit at the end of the year.[420]

The annual gains limit[421] reflects taxable capital gains (net of allowable capital losses) from dispositions of property, and is reduced by net capital loss carryovers actually deducted in computing taxable income for the year either against taxable capital gains or, where still permitted, against other income, and by allowable business investment losses for the year.[422] Only taxable capital gains from property disposed of by the individual in the year are included in the annual gains limit. Any portion of a gain deferred to a subsequent year by claiming a capital gains reserve[423] is therefore not eligible for the exemption, either in the year of disposition or in the subsequent year.[424]

The cumulative gains limit[425] at the end of a year reflects amounts included or deducted in computing the annual limit for

1985 and subsequent years[426] or amounts deducted under paragraph 3(e) for 1985,[427] less capital gains exemptions claimed in preceding years. Thus, this limit restricts the gains that qualify for the exemption to the cumulative net taxable capital gains realized after 1984 for which a capital gains exemption has not been previously claimed. The cumulative limit is necessary to account for capital losses that have been deducted against other income other than capital gains.

H. Capital Losses

The introduction of the capital gains exemption has necessitated changes in a number of provisions relating to capital losses. The deduction by an individual of allowable capital losses (net of taxable capital gains) realized after 1984 against $2,000 of other income has been eliminated for 1985 and subsequent years. Net allowable capital losses from dispositions between January 1, 1985, and May 22, 1985, however, can be deducted by an individual in 1985 against $2,000 of other income, but the amount deducted cannot exceed his net allowable capital loss position for all of 1985.[428] An amount known as the "pre-1986 capital loss balance" continues to be available as a deduction in computing an individual's taxable income under section 111 against $2,000 of income. The pre-1986 capital loss balance represents the undeducted net capital losses from 1984 and previous years and from January 1, 1985, to May 22, 1985, that are in excess of the capital gains claimed.[429]

With respect to the operation of subsection 74.2(1) where, in a particular taxation year, an individual loans or transfers

property (other than listed personal property) to his spouse, or to a person who subsequently becomes his spouse, and the recipient subsequently disposes of the loaned or transferred property (or property substituted therefor), then where the aggregate of taxable capital gains minus allowable capital losses in respect of the loaned or transferred property (or property substituted therefor) which would otherwise be attributed to the individual falls within the latter's cumulative capital gains exemption to date, the transaction would not result in any attribution of capital gains to the individual. Where, however, such aggregate of taxable capital gains minus allowable capital losses exceeds the individual's cumulative capital gains exemption to date, then obviously such excess will be subject to attribution pursuant to paragraph 74.2(1)(a).

Where the loan or transfer in question is one of listed personal property (which property is treated as if it were the only listed personal property of the recipient) then to the extent that any gains realized by the recipient upon the subsequent disposition of such property exceeds losses similarly realized, paragraph 74.2(1)(c) will not become operative if the gain otherwise attributable falls within the individual's cumulative capital gains exemption up to the time of the disposition.

Where, on the other hand, the recipient's disposition of loaned or transferred property (other than listed personal property) results in a net capital loss otherwise attributable to the individual then, although the individual may have no other capital gains against which to offset such loss, he may still utilize the $2,000 deduction in this respect, but his cumulative

exemption will be reduced by a corresponding amount.

I. Capital Gains vs. Business Income: The Basic Tests[430]

Where, subsequent to a loan or transfer of property from one spouse to another, the recipient disposes of the loaned or transferred property for a gain (or loss), the distinction between capital gains as opposed to business income becomes of critical importance since attribution will occur in the former case but not in the latter.[431]

Whether a particular profit is a capital gain or business income is a mixed question of fact and law which must be resolved on the basis of the circumstances of the particular case. The question to be decided is whether a profit has arisen from the realization of an investment, in which case it is taxed as a capital gain, or has been realized in a business or trading transaction (which, in statutory terms, includes "an adventure in the nature of trade") in which case the profit is taxed in full as business income. The jurisprudence indicates that if a transaction is speculative in nature, that is, the property was acquired with the intention of reselling it at a profit at a later date and not to be held as an investment, any profit from the transaction is generally treated as business income.

(i) Judicial Tests

The classical "test" used for distinguishing between business income and capital gains was set out by the Lord Justice Clerk (Macdonald) in the case of Californian Copper Syndicate v. Harris:

> It is quite a well-settled principle...that where the owner of an ordinary investment chooses to realize it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not

> profit ... assessable to income tax. But it is equally well-established that enhanced values obtained from the realization or conversion of securities may be so assessable, where what is done is not merely a realization or change of investment, but an act done in what is truly the carrying on, or carrying out, of a business ... What is the line which separates the two classes of cases may be difficult to define, and each case must be considered according to its own facts; the question to be determined being - Is the sum of the gain that has been made a mere enhancement of value by realizing a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?[432]

The Californian Copper test, however, did not provide any guidelines for determining whether, in a particular case, a taxpayer is realizing an investment or trading for profit. This is a question of fact and degree, and there is no simple test which has been laid down. In resolving this issue in particular cases, the courts have considered the following factors:

(a) the taxpayer's intention;

(b) the length of ownership of the property in question;

(c) the number and frequency of transactions;

(d) the transaction in relation to the taxpayer's ordinary business;

(e) the subject matter of the transaction; and

(f) whether the taxpayer acted as a dealer in similar property would.[433]

(ii) Intention of the Taxpayer

In most cases, a taxpayer's intention vis-a-vis acquired property is treated as an important factor in determining the nature of a gain or loss realized on the disposition of that property. Thus, where a taxpayer acquires property with the intention of reselling it at a profit, a gain on disposition will

generally constitute business income. Conversely, where a taxpayer acquires property with the intention of benefiting from its use or deriving income from it (E.g. in the form of rentals, dividends or interest), a gain realized upon its disposition will generally constitute a capital gain.[434] It should be noted that the reference to the taxpayer's intention signifies his intention at the moment of acquisition of the subject property unless, as discussed below, his original intention changes from one of investment to one of trading or vice-versa.[435]

In some cases, predominantly involving the disposition of real estate, the courts have focussed on a taxpayer's intention as the primary test of the nature of the transaction, and have considered other factors only insofar as they shed light on that intention. This approach is particularly evident in the doctrine of secondary intention. Under this doctrine, a secondary intention, at the time of acquisition, to sell a property at a profit if a primary investment intention cannot be carried out renders a subsequent disposition of that property a trading transaction.[436]

In other cases, intention has been treated as just one of many factors. In Irrigation Industries Ltd. v. MNR,[437] a gain realized upon a disposition of securities was held to be a capital gain, in spite of the fact that the securities in question were sold shortly after they were bought, were purchased with borrowed money and were speculative in nature. The court rejected intention as the sole test of the nature of a transaction.[438] It should be noted, however, that because of their inherent nature (i.e. they are a source of revenue) shares are generally treated as an investment as opposed to a trading asset.[439]

Conversely, it has been held that a transaction may be a trading transaction even though the taxpayer had no intention to resell at a profit, if there are other factors which clothe the transaction with the character of a trading transaction. In MNR v. Taylor, a case involving the sale of lead by the general manager of a metal manufacturer, Thorson P. stated:

> And a transaction may be an adventure in the nature of trade although the person entering upon it did so without any intention to sell its subject matter at a profit... The considerations prompting the transaction may be of such a business nature as to invest it with the character of an adventure in the nature of trade even without any intention of making a profit on the sale of the purchased commodity.[440]

(iii) Change of Intention

Both intention at the time of acquisition and intention at the time of disposition are relevant, since it is possible for a taxpayer's intention to change from an initial investment intention to a subsequent trading intention, in which case any gain on disposition will constitute business income.[441]

However, the courts appear to be less willing to find that a taxpayer's intention has changed from a trading intention to an investment intention. In Peachey Ltd. v. The Queen[442] the taxpayer purchased raw land for future subdivision and use in its house-building operations and treated the land as inventory. The taxpayer subsequently ceased building houses and sold the land. The taxpayer then argued that profits from the sale constituted capital gains on the ground that its intention had changed from a trading intention to an investment intention after it ceased building houses. The court rejected the taxpayer's argument, stating that "a clear and unequivocally positive act implementing

a change of intention would be necessary to change the character of the land in question from a trading asset to a capital asset."[443] The court concluded that there was no evidence of such a positive act and that the taxpayer had intended to resell the land from the time of purchase to the time of sale, whether as developed or undeveloped land.

(iv) Doctrine of Secondary Intention

Under the doctrine of secondary intention, a disposition of property will be a trading transaction if the taxpayer, at the time of acquisition, had an alternate plan, or a "secondary intention," of selling the property at a profit if his primary investment plan was thwarted.[444]

The doctrine of secondary intention was sanctioned by the Supreme Court of Canada in Regal Heights Ltd. v. MNR.[445] In the Exchequer Court decision in Fraser v. MNR, Cameron J. expressed the doctrine in this manner:

> It is now settled law that even if the primary intention of the promoters of a scheme for buying land and developing it is for the construction of buildings to be leased by the promoters (i.e. an intention to create a revenue producing investment), there may in certain circumstances be also an alternative intention to sell at a profit if the promoters are unable to carry out their primary aim. If, in fact, the alternative intention is carried out, the profit arising on the sale may be of a revenue character as profit from a business or an adventure or concern in the nature of trade.[446]

While, as a decision of the Supreme Court, the holding in Regal Heights is unassailable, certain subsequent cases have attempted to qualify or limit the scope of the doctrine of secondary intention. In Racine v. MNR[447] Noel J. made the following points with respect to this doctrine:

(a) A taxpayer buying a property as capital does not have a secondary intention to trade just because he could be induced to sell it if a sufficiently high price were offered; and

(b) A taxpayer does not have a secondary intention to resell at a profit unless the possibility of reselling is an "operating motivation" for the acquisition.

In Hiwako Investments Ltd. v. The Queen[448] Jackett C.J. stated that the doctrine of secondary intention was not a principle of law but merely a practical approach for determining certain issues that arise in connection with "trading cases." In his opinion, the mere fact that a taxpayer contemplated that an investment property he was acquiring would appreciate in value did not amount to a secondary intention to trade.[449]

The different results reached in the Regal Heights and Hiwako cases would seem to illustrate that the courts are more likely to find a secondary intention to trade in cases involving the disposition of vacant land than in cases involving the disposition of income-producing property.[450]

In the Hiwako case, Jackett C.J. also stated that an intention at the time of acquisition of an investment property to sell it in the event that it did not prove profitable did not make the subsequent sale of the investment the completion of an adventure in the nature of trade. This view is consistent with that expressed by Martland J. in Irrigation Industries where the learned judge said:

> It is difficult to conceive of any case, in which securities are purchased, in which the purchaser does not have at least some intention of disposing of them if their value appreciates to the point where their sale appears to be financially desireable. If this is

> so, then any purchase and sale of securities must constitute an adventure in the nature of trade, unless it is attempted to ascertain whether the primary intention at the time of purchase is to retain the security or to sell it.[451]

To summarize, the doctrine of secondary intention seems to be firmly entrenched in Canadian tax jurisprudence and the following principles appear to be well-accepted:

(a) The secondary intention is a question of fact to be determined by all surrounding circumstances and the taxpayer's conduct;[452]

(b) The taxpayer has a secondary intention to trade if the possibility of early resale at a profit is a motivating consideration at the time of acquisition of the property;[453]

(c) Secondary intention must be determined at the time of purchase of the particular property in issue;[454]

(d) The fact that a taxpayer who disposes of property had in mind at the time of acquisition that changed circumstances (E.g. capital appreciation of property or unsolicited offer to purchase) might dictate a change of investment does not necessarily imply a secondary intention to trade;[455]

(e) A finding that the taxpayer had expected, when purchasing the property, that the property could always be sold if the purchase proved unprofitable, will usually lead to the conclusion that any resulting profit is business income.[456] This situation is different from (d) above where the taxpayer is merely responding to a changing investment or economic climate.

(v) Length of Ownership

The period of time for which an asset is held is one of the factors relevant to whether the asset is a trading asset or a capital asset in the taxpayer's hands. Generally speaking, trading

assets are disposed of soon after they are acquired whereas capital assets are held for a longer period in order to generate a flow of income.[457]

Nevertheless, an asset may be held for a long period and still retain its trading character. In Smith v. MNR[458] the taxpayer purchased property in 1930 and 1931, which he then proceeded to sell in parcels, making 219 sales over a 30-year period. Profits from the sales in the four taxation years under review were held to be business income. In Leaside Realty Co. v. MNR,[459] the taxpayer acquired certain land in 1958 and sold it 18 years later for a profit. During the 18-year period of ownership no business (E.g. subdivision, advertising) whatsoever was conducted in respect of the land. It was held that, notwithstanding the lengthy period of ownership, the profit on the sale constituted business income because the taxpayer's original intention at the time the property was purchased was to hold it for eventual resale. This intention was inferred, it seems, mainly from the fact that no income was derived from the land at any time during the period of ownership and therefore the only way for the taxpayer to recover its investment was by way of the sale of the property.

On the other hand, property may be held for a very short period and nevertheless constitute an investment. In Warnford Court (Can.) Ltd. v. MNR[460] the taxpayer purchased a parcel of developed, income-producing real estate and resold it within two weeks at a profit. The court accepted the taxpayer's submission that the possibility of resale was not contemplated at the time of purchase and that a generous unsolicited offer to purchase could

not be resisted, and concluded that the transaction was not an adventure in the nature of trade.

(vi) Number and Frequency of Transactions

(a) Repeated Transactions

A transaction which may result in a capital gain if undertaken only once may nevertheless generate business income if it is repeated so often that it becomes part of a general scheme of profit-making. In Pickford v. Quirke, Rowlatt J. stated:

> Now of course it is very well known that one transaction of buying or selling a thing does not make a man a trader, but if it is repeated and becomes systematic, then he becomes a trader and the profits of the transaction, not taxable so long as they remain isolated, become taxable as items in a trade as a whole, setting loss against profit, of course, and combining them all into one trade.[461]

The more frequently a transaction is repeated, and the greater the number of transactions, the more likely it is that a taxpayer will be found to be trading. In Morrison v. MNR[462] a member of a partnership which carried on business as grain commission merchants entered into 260 transactions in one year, purchasing and selling grain on his own account. The resulting profits were held to be business income.[463]

(b) Isolated Transactions

The fact that a particular disposition is an isolated transaction may be a factor which influences a court to conclude that the disposition involves the realization of a capital asset.[464] However, because of the expanded definition of "business" in subsection 248(1), which includes "an adventure or concern in the nature of trade," an isolated disposition may constitute a trading transaction.[465]

The leading case on the issue of whether an isolated disposition constitutes an adventure in the nature of trade is MNR v. Taylor[466] where Thorson P., after reviewing the leading English cases dealing with the meaning of the expression "adventure in the nature of trade,"[467] concluded that whether a particular transaction constituted an adventure in the nature of trade depended on the facts and surrounding circumstances of each particular case and that no singular criteria can be formulated. His lordship laid down the following negative and positive guidelines:[468]

Negative Points

(a) The singularity of a transaction does not prevent it from being an adventure in the nature of trade. The word "adventure" implies an isolated transaction;

(b) It is not necessary that an organization be set up to carry out a transaction in order for the transaction to be an adventure in the nature of trade;

(c) The fact that a transaction is unrelated to the taxpayer's other activities does not prevent it from being an adventure in the nature of trade; and

(d) An intention to sell a property at a profit is not of itself a test of whether the transaction is an adventure in the nature of trade. A transaction may result in a profit on income account even though there is no intention to make a profit.

Positive Points

(a) If a taxpayer deals in property in the same way as a dealer in such property normally would, then the dealing by the taxpayer constitutes an adventure in the nature of trade; and

(b) The nature and quantity of the subject matter of a transaction may exclude the possibility that it constitutes the realization of an investment.[469]

(vii) Relation to Ordinary Business

The fact that a particular profit has been realized in a transaction closely allied to the taxpayer's main business activity has often been referred to as a significant factor in concluding that the transaction gave rise to ordinary income.[470] In Atlantic Sugar Refineries v. MNR, a company in the business of purchasing, refining and selling raw sugar engaged in transactions on the raw sugar futures market in order to offset possible future losses from the imposition of sugar price controls. Gains realized from these transactions were held to be business income because of the direct connection between the transaction and the company's ordinary operations. Kerwin J. stated:

> The Company was not investing idle capital funds nor was it disposing of a capital asset. In no sense may it be said that the operations were unconnected with the appellant's business and it is at least an added circumstance that the speculation was made in raw sugar. Even if it were the only transaction of that character, it should be held, in the light of all evidence, that it was part of the appellant's business or calling and therefore a profit from its business within section 3 of the Act.[471]

Although it is not usually difficult for a court to determine whether a transaction is related to a taxpayer's ordinary business, sometimes past related business activity may affect its perception of subsequent attempts by the taxpayer to deal as an investor in similar assets. In Gairdner Securities v. MNR,[472] the taxpayer had discontinued its business as a securities dealer and had confined its activities to its own holdings. Nevertheless, its

history of previous dealings influenced the court in finding the taxpayer to be a trader in the particular transaction in question.[473]

There are, however, cases where taxpayers have been successful in having a transaction characterized as the realization of an investment in spite of the relation between the transaction and the taxpayer's regular business activity. In these cases, the courts have simply found, on a determination of the facts, that the taxpayer had been a bona fide investor in the property in question.[474]

To summarize, there is a strong presumption that if a transaction is connected in any way with the taxpayer's usual business, it is intrinsically part of that business. This presumption may be rebutted, but only if there is convincing evidence that the transaction was not part of the taxpayer's ordinary business but was an investment.[475]

(viii) Subject-Matter of Transaction

In some instances, the type of property disposed of may stamp a transaction as a trading or capital one. Generally speaking, property which yields income, such as shares, debt obligations or rental real estate, is more likely to constitute an investment asset than a trading asset in the hands of someone other than a dealer in such assets.[476]

On the other hand, property which does not provide a return, such as commodities, is more likely to constitute a trading asset in the absence of special circumstances.[477]

Assets other than investment assets or commodities fall into a

middle ground in which the nature of the asset is not as important as the taxpayer's intention in dealing with the asset. Vacant land would appear to fall into this category. In general, the courts have been reluctant to consider vacant land as an appropriate subject of an investment. Thus, in Irrigation Industries, Martland J. distinguished the decision in Regal Heights on the basis that the property purchased and sold in Regal Heights was 40 acres of vacant land.[478]

(ix) Whether the Taxpayer Acts as a Dealer Would

If a taxpayer deals with property much in the same way as a dealer in such property would, any resulting profit will likely be characterized as business income. That is, a transaction although isolated and not related to the taxpayer's ordinary business activity, may be stamped with a business purpose if it is organized and carried on in a business-like manner. In CIR v. Livingston, Lord Clyde stated:

> I think the test which must be used to determine whether a venture such as we are now considering is, or is not, 'in the nature of trade', is whether the operations involved in it are of the same kind, and carried on in the same way, as those which are characteristic of ordinary trading in the line of business in which the venture was made.[479]

This test was applied by Thorson P. in MNR v. Taylor as one of the two positive guidelines laid down by the learned President in determining whether an isolated transaction constituted an adventure in the nature of trade.[480]

If steps are taken prior to the disposition to render an asset more marketable (E.g. by actual improvement to the asset or by advertising), this is an indication of trading (i.e. a badge of trade - the sort of step a trader would take in the conduct of his

trade). The more effort and organization that is directed towards realizing a gain from the disposition of an asset, the more likely it is that the disposition will be viewed as a trade, since trading consists of an organized effort to earn income.[481] By contrast, the lack of an organized effort is, prima facie, indicative of a capital disposition.[482]

XII. Principal Residence[483]

A. General

The general rule under the Act is that a capital gain can arise on the disposition of a personal-use property where the proceeds of disposition exceed $1,000.[484] A taxpayer's home is one type of personal-use property that has been given special treatment. With the introduction of the taxation of capital gains in 1972, the government adopted the general principle that a taxpayer who ordinarily inhabits his residence throughout the time he owns it is not subject to tax on any capital gain realized on the disposition of his residence.[485] This is accomplished by providing an exemption applicable to a principal residence as defined in the Act[486] and by a supplementary provision relating to the change of status of a principal residence to an income-earning use.[487]

B. Definition of Principal Residence

Not all residential property owned by a taxpayer will be a "principal residence." The term "principal residence" is defined in paragraph 54(g), which sets out four separate requirements - relating to the nature of the property, ownership of the property, habitation and designation - before a property can qualify as a

principal residence. Each of these four requirements must be met for each taxation year in which a property is to qualify as a principal residence.

(i) Nature of Property

A principal residence may consist of one of three types of property: a housing unit, a leasehold interest in a housing unit, or a share of the capital stock of a cooperative housing corporation.

The term "housing unit" is not defined in the Act and can be considered to include a house, apartment, mobile home, houseboat or any other structure of a relatively permanent character used for human habitation.[488]

With respect to leasehold interests, in times of rising real estate values, a lease for a number of years may have a value of its own and may be transferred for value to an incoming tenant by a tenant who is moving. If the subject matter of the lease is a housing unit, the leasehold interest itself can constitute a principal residence.[489]

With respect to a share of a cooperative housing corporation, although this type of corporation is not defined in the Act, the essential test is whether, by acquiring the share, a shareholder acquires the right to inhabit a housing unit owned by the corporation and whether that right was the sole purpose of acquiring the share. If the test is satisfied, the share can constitute the principal residence.[490]

(ii) Nature of Ownership

The owner of property is generally the person in whom the property is beneficially vested for the time being and who has the

occupation or control or right of enjoyment of the use or advantage of the property.[491] A tenant will be considered the owner of a leasehold interest in the property leased to him.

A principal residence may be owned solely by the taxpayer or may be owned jointly with another person or persons (usually the taxpayer's spouse and/ or children). Examples of joint ownership include joint tenancy,[492] tenancy in common[493] and, in the Province of Quebec, co-ownership under the laws of that Province.[494] Moreover, the ownership of the property must be direct. ownership by a controlled corporation or a trust, even if the taxpayer is the sole shareholder or beneficiary of the company or trust will not be sufficient.[495]

The time of ownership is also important, as a principal residence is determined on a year-by-year basis and the property must be owned by the taxpayer in a year (although not necessarily throughout the year) to qualify as his principal residence for that year.[496]

(iii) Ordinarily Inhabited

To qualify as a principal residence, the particular housing unit must be ordinarily inhabited by the taxpayer, his spouse or former spouse or a dependent child in respect of whom a deduction is claimed by the taxpayer under section 109.[497] In each particular case, this will be a question of fact.

Although there is no definition contained in the Act or in any jurisprudence with respect to the meaning of the expression "ordinarily inhabited," it may be instructive to consider the meaning which the Canadian courts have given to the expression

"ordinarily resident" as that expression was used in former subsection 139(4). This jurisprudence would seem to suggest that "ordinarily inhabited" means having been occcupied as living accomodations with some degree of continuity and apart from accidental or temporary absences.[498] Occupancy of a housing unit for only a short period of time in a taxation year - as where a home is sold early in the year or bought late in the year - will generally satisfy the requirement of ordinarily inhabiting the home in the taxation year.[499] Similarly, if a cottage or ski chalet is ordinarily inhabited by a taxpayer for a seasonal period, the Department has indicated that the test will be satisfied.[500] However, in each of these two cases the principal reason for owning the property, in the Department's view, must not have been for the purpose of earning income from it although incidental income from a seasonal residence will be ignored.[501]

There is, however, an exception to the rule that a principal residence must be ordinarily inhabited by the taxpayer or his spouse (or former spouse) or dependent child. This exception is found in subparagraphs 54(g)(ii) and (iv), and could apply if, for example, the taxpayer moved temporarily to another place in Canada and commenced to rent out his home to another person. In this case, the change in the housing unit to an income-earning property will normally constitute a deemed disposition of the property at its fair market value and a deemed reacquisition at a cost equal to the same fair market value.[502] However, there is an election procedure available to the taxpayer under subsection 45(2) whereby the change of use will be deemed not to have occurred, even if the property is rented out. This election procedure will dispense with

the necessity of satisfying the "ordinarily inhabited" requirement, and so long as the election is not rescinded, the fact that the taxpayer has ceased to inhabit his residence would be ignored and the housing unit would be considered for the intervening period, not exceeding four years, to have been his principal residence.[503]

(iv) Designation

Where a housing unit satisfies each of the foregoing three tests for a particular taxation year, it must still be designated in the prescribed manner as a principal residence of the taxpayer for that year for the exemption to apply.[504] It should be noted that each of the above tests must be satisfied in each of the taxation years for which the property is to qualify as a principal residence. The fourth test is not satisfied until a designation is made following a disposition and then only to the extent that the designation is made in respect of each of the relevant years. It is the designation that crystallizes the exemption which results in the application of a formula to determine whether all or part of the gain is exempt from tax.[505]

(v) Surrounding Land

"Principal residence" is defined in paragraph 54(g) as including, except in the case of a share of the capital stock of a cooperative housing corporation, the land "subjacent to" the residence and "such portion of any immediately contiguous land as may reasonably be regarded as contributing to the taxpayer's use and enjoyment of the housing unit as a residence," except that where the land exceeds one-half hectare, the taxpayer must

establish that the excess land was necessary to such use and enjoyment.[506] In this respect, the issue is whether it is necessary to the use and enjoyment of the housing unit and not whether it contributes to such use and enjoyment.[507]

C. Status of a Dwelling as Capital Property

Not every dwelling owned and ordinarily inhabited by a taxpayer will qualify as his principal residence for tax purposes. Since the exemption relates to tax on capital gains, the property must be capital property of the taxpayer.

The cases determining the status of a dwelling as capital property have followed the decisions distinguishing between dispositions of real estate giving rise to business income and those giving rise to capital gains.[508] If a dwelling is disposed of by a trader or dealer in real estate or by any individual in circumstances indicating that the disposition was an adventure in the nature of trade, the property will not qualify for the principal residence exemption, and any profit from the disposition will be taxable as income from a business.[509]

D. Determination of Gain

A gain on a disposition of a principal residence is not tax-exempt per se. As stated above, a principal residence is personal-use property, and a gain on a disposition of a dwelling will be taxable unless the property is designated as a principal residence. If a property is designated as a principal residence for a particular taxation year, the formula in paragraph 40(2)(b) will apply to determine the portion of the gain which is tax-exempt.

Paragraph 40(2)(b) requires that the capital gain on the

disposition of a principal residence be calculated in accordance with the rules applicable to the disposition of any personal-use property. There is then deducted from any capital gain so determined an amount calculated by multiplying the gain by the following fraction:

> one plus the number of taxation years ending after the later of December 31, 1971, and the date on which the property was last acquired or reacquired (the "acquisition date") for which the property was the taxpayer's principal residence and during which the taxpayer was resident in Canada
>
> divided by
>
> the number of taxation years ending after the acquisition date during which the property was owned by the taxpayer, whether jointly or with another person or otherwise.

If a taxpayer has ordinarily inhabited the property and has been resident in Canada throughout his entire period of ownership of a dwelling, the entire gain on the disposition of the property will be tax-exempt.[510]

Where a residence is sold and a new residence is acquired in the same year, both properties will be eligible for the exemption as a principal residence in the same year, although only one property may be designated as such for that year.[511]

E. Change in Use

(i) Deemed Disposition

Paragraph 45(1)(a) provides that where a taxpayer:

(a) has acquired property for some other purpose and at a later time begins to use it for the purpose of gaining or producing income from property or income from business, or

(b) has acquired property for the purpose of gaining or producing

income from property or from business and at a later time begins to use the property for some other purpose, the taxpayer is deemed to have disposed of the property at the time of the change in use for its fair market value at that time and to have immediately reacquired it at that value.

If a taxpayer ceases to occupy a residence, it generally will no longer be considered to be "ordinarily inhabited" by him.[512] If he decides to let the property rather than dispose of it, he will be deemed to have disposed of the property at the time he commenced to use it to earn income, although paragraph 40(2)(b) will operate to reduce or eliminate any capital gain resulting from the deemed disposition.

If a property is acquired by a taxpayer for rental or business purposes and thereafter it becomes his principal residence, it will be deemed to have been disposed of at the time of the change in use. This deemed disposition may result in recapture of capital cost allowance or taxable capital gains or both. By virtue of subsection 45(3), however, the tax on the capital gain (which accrues during the income-producing years) on such a change of use may be postponed until the principal residence is actually disposed of.[513]

(ii) Subsection 45(2) Election

If a taxpayer begins to use his residence to earn property or business income, he may elect pursuant to subsection 45(2) to be deemed not to have changed the use of the property. The "change in use" election under subsection 45(2) is particularly significant in relation to a principal residence. The election has two effects. First, the property may be designated as the taxpayer's

principal residence for four years following the change in use or until the election is rescinded, whichever is the earlier, even if the taxpayer does not ordinarily inhabit the property during those years.[514] Second, the election deems the taxpayer not to have changed his use of the property.[515] Hence, if he changes use of the property again, the second change will not give rise to a deemed disposition.[516] This is because while the election is still in effect, the taxpayer is deemed to be using the property for his own personal use (whether or not the property still qualifies as a principal residence) and when he moves back into the property, he will actually be using it for his own personal use. As such, there is no change in use upon the subsequent repossession of the house.

If the taxpayer does not rescind the election, he will not recognize any capital gain until he actually disposes of the property or is deemed to have disposed of it pursuant to other provisions of the Act. If the taxpayer does rescind the election before the expiry of the four-year period or at any time thereafter, the property in respect of which the election has been made will be deemed to have been disposed of and immediately reacquired at fair market value on the first day of the taxation year in respect of which the election is rescinded. The taxpayer may, however, take advantage of paragraph 40(2)(b) to eliminate or reduce any capital gain resulting from the deemed disposition.[517]

Where a taxpayer does not live in his house before using it to earn income, he will be entitled to make an election under subsection 45(3) provided that he occupies the house as his

principal residence before selling it. This provision accomodates the situation where an individual acquires a property which he ultimately uses as his principal residence but, before occupying it, rents it out. An amendment to subparagraph 54(g)(ii), applicable to the 1982 and subsequent taxation years, adds a reference to subsection 45(3) so that a taxpayer may designate as his principal residence a property in respect of which he has made a subsection 45(3) election. The maximum number of years for which a taxpayer may so designate a property as his principal residence under subsection 45(3) (as under subsection 45(2)) is limited to four by subparagraph 54(g)(iv).

Where a taxpayer effects a partial change in the use of a residence without any structural change, such as the rental of one or two rooms or the use of a room for the care of children or for an office or work area, the Department's position is that such a partial change will not result in a deemed disposition, and the entire residence will qualify for designation as a principal residence so long as the taxpayer does not claim any capital cost allowance in respect of any portion of the residence.[518]

F. Transfer of Principal Residence to a Spouse

As discussed above,[519] subsection 73(1) contains special rules whereby capital property may be transferred on a rollover basis by a taxpayer during his lifetime to his spouse or to a trust that is for the exclusive benefit of the spouse during the spouse's lifetime.[520] Where a transfer of a principal residence is made pursuant to these rules, the provisions of subsection 40(4) will be applicable to ensure the continuation of principal residence status as follows:

(a) The transferee spouse is deemed to have owned the residence throughout the period during which the transferor owned it;[521]

(b) The residence is deemed to have been the transferee's principal residence for the same period that it was the principal residence of the transferor;[522] and

(c) Where the transferee is a "spouse trust," the trust is deemed to have been resident in Canada during each taxation year during which the transferor was himself resident in Canada.[523]

The net effect of the foregoing provisions is to permit the transferee spouse (or trust) to include the period of occupation and ownership of the transferor in determining the length of the principal residence status on any subsequent disposition of the property by the transferee. Consequently, when the spouse (or trust) subsequently disposes of the property, the formula for determining the exempt portion of the capital gain will take into account the period during which the transferor himself owned and occupied the residence.[524]

(i) Principal Residence and the Attribution Rules

In analyzing the effect of the attribution rules in respect of an inter-spousal transfer of a principal residence, there appear to be three basic situations in which the rules may become operative:[525]

(a) The transferee subsequently disposes of the transferred property for a capital gain or a capital loss;

(b) The transferee disposes of the transferred property in a trading transaction, thereby earning business income or suffering a business loss; or

(c) The transferee does not dispose of the transferred property but rather changes the use of the property and commences to earn income therefrom.

In the first case, when the transferee subsequently disposes of the transferred property (while the transferor is resident in Canada and the transferee is his spouse) any taxable capital gain will be attributed to the transferor by virtue of subsection 74.2(1), but such gain may be reduced or eliminated by the operation of paragraph 40(2)(b). Where the subsequent disposition results in a loss, such loss would appear to be nil, and therefore there would be no amount to attribute to the transferor.[526]

In the second case, where the transferee disposes of the transferred property in a trading transaction, any income or loss resulting from such transaction would not be attributed to the transferor but rather would be taxable only in the hands of the transferee.[527]

In the case where the transferee changes the use of the transferred property in order to earn rental income therefrom, the initial consideration involves the resulting deemed disposition of the property.[528] Any capital gain resulting from such deemed disposition, to the extent that it is not eliminated by paragraph 40(2)(b), will be attributed to the transferor.[529] However, the transferee may avoid a deemed disposition of the residence by making a subsection 45(2) election whereby he or she will be deemed not to have changed the use of the property, with the result that subsection 74.2(1) will not become operative.

It would appear, however, that upon a change of use, and irrespective of whether or not a subsection 45(2) election is

made, any rental income which the transferee receives in respect of the transferred property, which income can be properly characterized as property income, will be attributed to the transferor pursuant to subsection 74.2(1).[530] If, however, the rental income takes the form of business income or if, for example, the transferee commences to use the property, or a portion thereof, as a business office, such business income will not be subject to attribution.

G. Joint Ownership of Principal Residence

Prior to May 9, 1985, where married persons jointly owned more than one principal residence (i.e. each spouse owned a part interest in each of two properties otherwise eligible for designation as a principal residence), they were able to maximize the exemption from tax on pre-1982 accrued gains by transferring each spouse's part interest in one of the residences to the other spouse, so that each residence was separately owned before any sale. In this respect, paragraph 40(4)(b) did not limit the transferee in designating the whole property as his or her principal residence. Rather, the property was eligible for designation by the transferee as his or her principal residence for all the years during which he or she had a part interest in the property. However, an amendment to subsection 40(4) (effective after May 9, 1985) extends its scope to apply to a property that was a depreciable property of the transferor before it was transferred to his spouse. The result is that the formula in subsection 40(2) will no longer exempt capital gains on a property for the period during which it was used to earn rental income

before the transfer to a spouse who thereafter used the property as a principal residence.

XIII. Registered Retirement Savings Plan

A. General

Registered retirement savings plans were introduced in 1957 to afford self-employed persons the right to provide for their retirement with similar tax advantages to those enjoyed by employees through registered pension plans. Registered retirement savings plans are also available to individuals whose employers have instituted their own pension plans. While the contribution limit will differ where an employee is, or may become, entitled to benefits under an employer-sponsored pension fund or plan,[531] any contributor to a registered retirement savings plan benefits from the immediate tax deferral through the deduction permitted in computing his income for the year of contribution (or the previous year if the contribution is made within 60 days after the end of the previous year).[532] In addition, and perhaps more importantly, income earned in a registered retirement savings plan is not subject to tax until distributed to the taxpayer.[533]

While the funds in a registered retirement savings plan are held for the purpose of providing retirement income, these funds are not "locked in" and may be withdrawn from the plan, in which case the entire amount in the plan will be subject to tax. In this respect, a registered retirement savings plan is more akin to a savings plan than to a retirement plan.[534]

A registered retirement savings plan is a retirement savings plan accepted by the Minister for registration as complying with the requirements in section 146. A contribution made to a

registered retirement savings plan at any time in the year in which registration is granted is considered to have been paid as a premium to a registered plan, regardless of the date of acceptance of the application for registration.[535]

A registered retirement savings plan accepted for registration by the Minister may be one of two types:

(a) A contract between an individual and a person licensed or otherwise authorized under the laws of Canada or a province to carry on in Canada an annuities business (usually a life insurance corporation) under which, in consideration of payment by the individual or his spouse of any periodic or other amount as consideration under the contract, that person agrees to pay a retirement income (in the form of an annuity) to the individual, commencing at maturity; or

(b) An arrangement under which payment is made by an individual or his spouse:

(i) in trust to a licensed trust company, of any periodic or other amount as a contribution under the trust, or

(ii) to an approved corporation licensed to issue investment contracts which provide for payment of a fixed or determinable amount at maturity, or

(iii) as a deposit with a credit union or bank, to be used invested or otherwise applied by that corporation, person or credit union, etc., for the purpose of providing a retirement income, in the form of an annuity, to the individual, commencing at maturity.[536]

B. Maturity of Plan

Under paragraph 146(1)(d), "maturity" of a registered retirement savings plan means the date fixed under the plan for the commencement of any retirement income. Subparagraph 146(2)(b)(iii) requires that the plan not provide for maturity after the end of the year in which the annuitant attains 71 years of age, or before the earliest of the time when:

(a) the annuitant attains 60 years of age;

(b) the annuitant or his spouse receive a disability pension under the Canada Pension Plan or a provincial pension plan; or

(c) where the spouse of the annuitant has died, the annuitant receives a survivor's pension under the Canada Pension Plan or a provincial pension plan.

C. Retirement Income

Upon maturity of a registered retirement savings plan, steps must be taken to arrange for the fund to be used to provide the taxpayer with "retirement income" (in the form of an annuity) or to acquire a registered retirement income fund. Failure to so use all of the funds in a plan by the maturity date will result in the inclusion in income of the amount not so used pursuant to subsection 146(12).

Retirement income may take the form of a life annuity commencing at maturity with or without a guaranteed term, an annuity commencing at maturity for a fixed term or a combination of the two. In the case of a fixed term annuity, the term must be equal to the number of years remaining before the annuitant reaches age 90; in the case of a life annuity having a guaranteed term, such term cannot exceed the same number of years. In either case, where the annuitant's spouse is younger than the annuitant,

and the annuitant so elects, the term may be based on the spouse's age. Either form of annuity may be a joint and last survivor annuity. Generally, the annuity must be payable in equal annual or more frequent periodic amounts.[537]

If a taxpayer does not wish to use the funds in his plan at maturity to purchase an annuity to provide him with retirement income but still wishes to avoid including the funds in his income in the year of maturity his other option is to transfer the plan funds to a registered retirement income fund pursuant to subsection 146(16). Such transfer must occur not later than the day the plan matures. A registered retirement income fund shelters the amount transferred thereto from tax but requires the taxpayer to withdraw and include in his income a portion of the fund in each year.[538]

D. Spousal Registered Retirement Savings Plans

A limited but nevertheless useful opportunity for income splitting arises through the use of a spousal registered retirement savings plan. Applicable to the 1974 and subsequent taxation years, a taxpayer may make deductible contributions to his spouse's registered retirement savings plan whether or not he is a contributor to a plan of his own and regardless of whether or not his spouse is also making contributions to her plan.[539] A taxpayer of any age may contribute to the registered retirement savings plan of his spouse provided that her plan has not yet matured.

The amount deductible for payments made by a taxpayer to the registered retirement savings plan of his spouse cannot exceed the

amount that would otherwise be deductible under subsection 146(5) if the payment had been made by him to his own registered retirement savings plan.[540] Thus, if the taxpayer contributes to his own registered retirement savings plan and also to that of his spouse, the maximum amount deductible by him cannot exceed the amount that would be deductible if the combined contributions were made solely to his own registered retirement savings plan.[541]

The maximum amount deductible by a taxpayer in respect of his spouse's plan is not affected by the fact that the taxpayer is entitled to deduct additional payments to his own registered retirement savings plan because he was in receipt of one of the types of income described in paragraph 60(j), such as a pension benefit or a retiring allowance. However, paragraph 60(j) does not entitle a taxpayer to deduct thereunder amounts of the type therein described that have been paid into a registered retirement savings plan for the taxpayer's spouse.

(i) No Attribution on Payments to a Spousal Registered Retirement Savings Plan

Once a taxpayer has made contributions to a spousal registered retirement savings plan pursuant to subsection 146(5.1), such contributions become the property of the spouse and the contributor loses control over them. Moreover, by virtue of paragraph 74(5)(a) any income derived from payments made by a taxpayer to a spousal registered retirement savings plan is not subject to income attribution under subsection 74.1(1).[542] That is, an annuity received by a husband out of his registered retirement savings plan is his income and an annuity received by his wife out of her registered retirement savings plan is her

income, regardless of the fact that one may have made part or all of the payments into the plan of the other.

The non-application of the attribution rules in respect of transfers to a spousal registered retirement savings plan offers the possibility of minor income splitting in the short-term whereby the higher tax bracket spouse contributes amounts to the registered retirement savings plan of the lower tax bracket spouse with the lower income spouse then deregistering the registered retirement savings plan and withdrawing the funds. However, by virtue of subsections 146(8.3) and (8.6) where a taxpayer has contributed to his spouse's plan and such plan is dissolved, other than to acquire a life annuity, any contributions made by the taxpayer to such plan which were deducted by the taxpayer in computing his income in the year of dissolution or in the immediately preceding two years are included in the contributing taxpayer's, and not the spouse's, income.[543] To avoid this income inclusion, where deductible contributions have been made to a spousal plan, dissolution of the spousal plan should not be undertaken until the third taxation year folllowing the year in which a deduction was claimed in respect of such contributions.[544]

The significant advantage of a spousal registered retirement savings plan requires a much longer term approach. Because a taxpayer may continue to make contributions to a spousal registered retirement savings plan for a spouse who is under the age of 71, even though the contributor himself is over the age of 71 (so long as the contributor still has earned income), this allows payments to accumulate in plans for the benefit of two

persons so that the amounts eventually paid out will be divided between the spouses and presumably taxed at lower marginal rates than would be the case if only one person received all the return. In addition, each annuitant will be eligible for the $1,000 pension income deduction if he or she is 65 years of age or older at the end of the taxation year.[545]

XIV. Preservation of Assets

If a spouse (or minor child) has some assets available for investment purposes which were acquired independently (E.g. salary, wages, inheritance, gifts from someone other than the spouse where income splitting with a spouse is the objective, gifts from a non-resident where income splitting with a minor child is the objective, income from property which may itself have been subject to attribution, and family allowance cheques), everything possible should be done to preserve those assets for investment purposes as opposed to having them spent on personal expenses. For instance, one may give one's spouse money to pay his or her income taxes, and no attribution will apply with respect to that money because no income will be earned from it. The low income spouse will be able to retain what assets he or she has for investment purposes rather than dispose of them in the form of income tax payments. In addition, the higher income spouse should pay all of the family expenses, again to permit the lower income spouse to retain what assets he or she owns. The same principle applies with respect to the assets of minor children which might otherwise be available for investment.[546]

With respect to family allowance payments, it seems that income which arises out of the investment of such payments will be

income of the child rather than income of the parents. For this to occur, however, the allowances should be deposited in a bank account (or other income-producing security or fund) in the name of the child, or in trust for the child's benefit, such that the investment can be readily identified as property of the child.[547]

XV. Marriage Break-Ups[548]

A. Income Attribution

Historically, the attribution rules applied where income generating property was transferred by one spouse to the other and the transferor lived, remained a resident of Canada and the transferee remained his spouse. Until relatively recently,[549] the separation of the parties, if it was not accompanied by dissolution of the marriage,[550] did not cause the cessation of the application of the attribution rules.

Paragraph 74.5(3)(a) now provides, however, that subsection 74.1(1) will not apply to income or losses from loaned or transferred property or substituted property that relates to a period during which the individual is living apart and is separated from his spouse pursuant to a decree, order or judgment of a competent tribunal or pursuant to a written separation agreement.[551] Where the transferor and his spouse are living apart pursuant to a written agreement only, subsection 74.5(5) provides that this exception will not apply if, within twelve months from the date of the agreement, the spouses cease to live apart.

B. Capital Gains Attribution

For 1980 and subsequent taxation years, paragraph 74.5(3)(b) provides that (similarly to paragraph 74.5(3)(a)) there will be no

attribution with respect to dispositions of property, or property substituted therefor, resulting in capital gains or capital losses in respect of the period that the spouses are separated pursuant to a decree, order or judgment of a competent tribunal, or pursuant to a written separation agreement, provided that a joint election of the spouses not to have subsection 74.2(1) apply is filed with the return of the individual for the taxation year in which the separation occurred.[552] As in the case of income attribution, the election under paragraph 74.5(3)(b) will have no effect if the spouses cease to live apart within twelve months from the date on which a written separation agreement was entered into.[553]

C. Loans or Transfers to a Corporation

With respect to transfers of property made by an individual after May 22, 1985, and with respect to loans that are outstanding on or after May 22, 1985, where such loaned or transferred property has been made either directly or indirectly, or by means of a trust, to a corporation the shareholders of which include:

(a) a person who is or who has since become the individual's spouse;

(b) a partnership of which such a person (i.e. in "(a)" above) is a member;

(c) a trust in which such a person is beneficially interested; or

(d) another corporation of which such a person is the sole shareholder,

then any taxable dividend or any capital gain which would have otherwise been attributed to the individual by virtue of subparagraph 74.4(3)(b)(i) or (ii) respectively, will not be so

attributed where the parties are living separately and apart pursuant to a decree, order or judgment of a competent tribunal or a written separation agreement.[554]

D. Tax Planning for Marriage Break-Ups

(i) Property Transfers

Since the attribution rules cease to apply upon separation of the spouses, any income, capital gains or deemed dividends arising after separation will be taxed in the hands of the recipient and not in those of the individual.[555] Proceeding on the assumption that the individual (i.e. husband) is subject to a higher marginal rate of tax than the recipient (i.e. wife), and that he wishes to transfer some of his property to her for a release of her marital and support claims, there are certain aspects which should be considered before effecting such transfer.

If the husband transfers capital property to his wife before separation,[556] any accrued gains or losses will not be recognized on the transfer, unless he elects not to have the automatic rollover apply.[557] And if the wife disposes of the transferred property prior to separation, any income derived from such property before the disposition, and any capital gains or capital losses resulting therefrom, will be attributed back to the husband and included in his income. Thus, the timing of the transfer is most important if the husband wishes to avoid attribution: if he transfers property prior to separation, he should secure a covenant from his wife, as part of the separation agreement, not to dispose of such property (or property substituted therefor) until after separation;[558] or, if possible, he should not transfer

any property to his wife until after the parties separate, thus avoiding attribution completely.[559]

Where the husband owns capital property, some of which has appreciated since the time of its acquisition, and certain of which has depreciated, then it may be desireable for the wife to receive the appreciated property and take the gains into her income, while the husband should realize the losses himself on the property which has declined in value.[560] With respect to the appreciated property, it should be transferred to the wife subsequent to separation in order to preclude attribution of income and capital gains back to the husband. With respect to the property which has accrued losses, the husband may realize these losses by: (a) selling the property in the market before or after separation and transferring the cash to the wife or, (b) transferring the property to the wife and electing not to have the subsection 73(1) rollover apply. Alternatively, the husband could transfer the property to the wife before separation and if the wife disposed of the property before separation, the capital loss would be attributed to the husband.[561]

As the reader may have observed, the foregoing discussion admittedly makes, perhaps, a bold assumption, namely, that the parties, on breaking up, will be on terms sufficiently compatible to undertake any form of tax planning. As noted above, this type of planning may best be assumed by the parties' respective counsel. In this manner, presumably, a settlement will be reached which will strike a balance between the spouses' competing interests.

(ii) Principal Residence

When a marriage breaks down, the husband usually moves out of the family home leaving his wife and children remaining there. If he owns the house either absolutely or jointly, he may continue to treat the house as his principal residence and claim the usual exemption on gains, even though he no longer inhabits it, so long as his former spouse or dependants continue to do so.[562] By simply moving out of the house, he has not made a disposition of his interest in the home so as to trigger the recognition of any capital gain thereon -i.e. his capital gain position has not changed. If he subsequently transfers his interest to his wife, no gain will be taxable in his hands because of the operation of subsection 73(1), or subsection 73(1.1), if the transfer is made pursuant to a decree, order or judgment of a competent tribunal).[563]

If, after leaving home, the husband commences to receive rent from his wife for her occupation thereof, he will have converted the property from personal use to income production, with the consequence that he will be deemed to have disposed of the property, or his respective interest therein, for proceeds of disposition equal to fair market value on the date of the conversion, unless he elects under subsection 45(2) to be deemed not to have commenced to use the home for the purpose of producing income. If he so elects, he may continue to treat the home as his principal residence for up to four years while the election remains in force. Thereafter, since he cannot claim the home as his principal residence, increments in the value of the house will become exigible upon its eventual sale. If the husband does not

make a subsection 45(2) election, he will be deemed to have disposed of his home or interest therein for proceeds of disposition, and to have reacquired it at a cost equal to the fair market value at the time of the conversion. The net result is that he will lose the exemption in respect of subsequent capital gains on the home. Thus, the decision to charge rent in these circumstances must be carefully considered.

XVI. Non-Tax Considerations

Before the tax planner embarks on what could be an irrevocable course of action in attempting to achieve a degree of income splitting between spouses, there are non-tax considerations which should be taken into account.[564] For example, one should consider the relative stability of the parties' marriage before recommending that valuable assets be placed in the hands of the transferee, for such assets may be non-recoverable since a transfer of property will usually involve a transfer of title to the property. Even if the marriage is stable, one must ascertain whether a spouse without any experience in money management will be capable of managing the property in question or, if incapable of such management, will he or she entrust such management to those with the requisite experience and capability? One must also consider whether the spouse will devote his or her new-found wealth to family purposes or dissipate it on capricious and whimsical endeavours. As well, the planner should inquire as to what extent the spouses are in the habit of consulting with each other in respect of financial matters and, if one spouse holds all the financial strings, whether he is prepared to discuss or divulge his financial secrets with the other spouse.

XVII. Loans and Transfers to Minors

A. General

Subsection 74.1(2) continues the theme introduced in subsection 74.1(1) to prevent avoidance of income tax by the loan or transfer of property to others. Whereas subsection 74.1(1) deals with inter-spousal loans or transfers of property, subsection 74.1(2) deals with loans or transfers of property to minors -*i.e.* children under the age of 18. The subsection provides that:

> (2) Where an individual has transferred or loaned property, either directly or indirectly, by means of a trust or by any other means whatever, to or for the benefit of a person who was under 18 years of age, any income or loss, as the case may be, of that person for a taxation year from the property or from property substituted therefor, that relates to the period in the year throughout which the individual is resident in Canada, shall be deemed to be income or loss, as the case may be, of the individual and not of that person unless that person has, before the end of the year, attained the age of 18 years.[565]

In the circumstances described by subsection 74.1(2) (as in subsection 74.1(1)), income or loss from the loaned or transferred property (or from property substituted therefor) continues to be taxed in the hands of the individual and not in those of the minor child just as if the loan or transfer had not taken place. As well, since the conditions for the application of subsection 74.1(2) are worded in substantially the same terms as are to be found in subsection 74.1(1) it seems that, for the purposes of these provisions, the accumulated case law which bears on the meaning of words and phrases such as "transfer," "property," and "substituted property," on the significance of the distinction between income from property and business income, and on the

requirement of the individual's residence in Canada, is presumably applicable to subsection 74.1(2). There are, however, certain important differences between the two subsections and such differences are examined below.

B. Relationship of Individual and Minor Child

An important aspect of subsection 74.1(2) is that it operates to attribute the income on loaned or transferred property to the individual if the child is under 18 years of age, regardless of the family relationship or lack thereof, between the individual and the minor child. Thus, for example, a transfer of property by the individual to his minor niece or nephew[566] or to the child of a friend, even though in the latter situation no family relationship exists, would result in the application of the attribution rules, if the loaned or transferred property generated income.

The reason for this broad application, which to the writer's knowledge has not been discussed in any of the relevant literature, appears designed to prevent indirect transfers which might otherwise circumvent the attribution rules if such rules were otherwise restricted to loans or transfers made to the individual's own minor children.

A clear illustration of the type of mischief which subsection 74.1(2) was designed to avoid can be found in the English case of CIR v. Clarkson-Webb.[567] Here, two brothers appointed one another as trustees for their minor children with the result that each brother became a trustee for his minor nephew. The terms of the trust deed provided that each brother would pay a certain sum to

the other brother in trust for his own child. It was held that the transfers made by each of the brothers were each part of one indivisible transaction and that the sums paid in trust by one brother to the other were in substance transfers made indirectly by each brother to his own son.[568]

The implication which appears to flow from the Clarkson-Webb case is that even if subsection 74.1(2) was phrased in terms such that the attribution rules would only apply to loans or transfers of property to the individual's own minor child, where the individual loaned or transferred property to his minor child by means of the interposition of a third party, such an indirect loan or transfer would be ineffective to circumvent the attribution provisions. In other words, the individual would not be able to achieve indirectly what he was unable to accomplish directly - that is, avoid attribution.

C. Period During Which Income Attribution Applies

For the rule in subsection 74.1(2) to apply, the loan or transfer must be made at a time when the child is under 18 years of age. If that condition is satisfied, the income or loss from the loaned or transferred property (or property substituted therefor) will continue to be attributed to the individual during his lifetime so long as he is resident in Canada, until the year in which the child reaches the age of 18. In order to avoid the attribution of income it is not uncommon for taxpayers to arrange that the property in question will not yield income (or will not yield income in the child's own name) until the year in which the child attains the age of 18. For example, a trust may be created to hold the shares of a corporation controlled by the

individual with a provision to withold the payment of dividends until the beneficiary attains 18 years of age.[569]

D. Capital Gains

In the case of property loaned or transferred to a minor child, there is no provision in subsection 74.1(2) which is analogous to that in subsection 74.2(1) (relevant to a loan or transfer to a spouse) under which a capital gain realized by the child may be attributed to the individual.[570] As noted above, the technical reason for this omission seems to be that since there is no automatic rollover -i.e. no rollover analogous to the spousal rollover provided by subsection 73(1) - provided on transfers of property by a parent (or other adult) to his child (or any minor), it would be inequitable to further attribute capital gains or losses when the child subsequently disposed of the transferred property.[571] Thus, subject to one exception which is discussed below, any capital gain or capital loss which is realized at the time of the transfer will be taxed in the hands of the transferor and not in those of the transferee. When the child subsequently disposes of the transferred property, any capital gain or loss realized at such time will be taxed in his hands and will not be attributed to the transferor.

The one exception referred to above concerns the transfer of shares of a small business corporation[572] by a taxpayer to his child. Under the rules set out in the transitional provisions of subsection 73(5),[573] a taxpayer may make a limited tax-free inter vivos transfer of shares of a small business corporation to a child[574] who was resident in Canada immediately before the

transfer.[575] Until December 31, 1987, these provisions can be used to defer tax otherwise payable on a capital gain of up to $200,000. Thereafter, the provision will cease to be effective since the transferor parent, in any event, will be able to utilize his lifetime capital gains exemption in respect of any accrued gains which might otherwise be realized upon the transfer.[576]

As a result of the 1984 amendments which simplified the small business provisions, the definition of "active business"[577] was made less restrictive, and the definitions of "personal service business"[578] and "specified investment business"[579] were modified such that a business will not be considered to be either a personal services or a specified investment business if it employs greater than five full-time employees. For the purposes of this employee test, all employees, including specified shareholders,[580] are now considered.

These changes to the definition of an active business mean that shares of some corporations may now qualify for the small business rollover where previously they were not eligible because they fell into the category of a non-qualifying business.[581] A management service company providing services to a related business or a specified investment business, for example, will now be considered to be an active business (if it employs at least six full-time employees), even though all its employees are related to the principal shareholder.[582]

It may be possible, through careful planning, for a taxpayer to double the deferral and achieve a $400,000 capital gains deferral on the transfer of shares of a small business corporation to a child. For example, a taxpayer would make an inter vivos

transfer (or a testamentary bequest) of a block of shares with an accrued gain of $200,000 to his child. Assuming the taxpayer has not used any of his cumulative small business gains account,[583] the entire $200,000 gain on the transfer to the child will be sheltered. The remaining block of shares would be bequeathed outright to the taxpayer's spouse on a complete rollover based under subsection 70(6). Because the widow would then have her own $200,000 cumulative small business gains account, she could make a transfer (testamentary or inter vivos) to the same child and defer a capital gain on a second $200,000. Obviously, this technique works only if the transferee spouse survives the transferor.[584]

With respect to estate planning, where the taxpayer wishes to effect an inter vivos transfer of shares of a small business corporation to a child, it is advisable to ensure that there is an agreement stipulating what will happen to the shares should the child predecease one or both of his parents. This agreement should be drafted to ensure that the family can take advantage of the rules permitting a tax-free rollover of the shares to a parent.[585] Since the cumulative small business gains account will be restored only if the shares revert to the parent who made the original transfer, the agreement should provide for a transfer to the transferor parent, if alive. This is particularly important when both parents have assets eligible for the small business corporation rollover.[586]

Finally, it should be noted that whether or not the transferor utilizes the inter vivos rollover under the transitional rules of subsection 73(5), any dividends which his child receives in

respect of the transferred shares will be attributed to the transferor until the year in which the child attains the age of 18.[587] However, since there is no capital gains attribution with respect to transfers to minors, any capital gain realized by the child on a subsequent disposition of the transferred shares will be taxed in the hands of the child, notwithstanding that he has not yet attained the age of 18, and not in the hands of the transferor. Therefore, while the transferor may effectively achieve a certain amount of capital gains splitting in respect of the transferred shares, he will not be able to achieve income splitting in respect of dividends paid, if any, on the transferred shares.

E. Loans to Minor Children

As in the case of subsection 74.1(1), subsection 74.1(2) provides for the attribution of income from property acquired with the proceeds of a loan made by an individual to a minor child after May 22, 1985. However, as in the case of a loan to a spouse, where an individual makes a loan to a minor on a commercial basis within the meaning of subsection 74.5(2), there will be no attribution of income back to the individual. Thus, as noted above, some degree of income splitting may be achieved where the minor child, using the proceeds of the loan for investment purposes, earns a net return on such investments which exceeds the amount of interest paid to the individual in respect of the loan. For this reason, an individual may wish to attempt to split income with his minor child by means of a commercial loan. To this extent, the individual should be familiar with the rules regarding the capacity of a minor to enter into a contract of loan which, in

certain cases, may be unenforceable against the minor.

(i) Capacity of Minor to Contract

An important issue involving loans to minor children is the question of whether such a loan is legally enforceable against a minor child or is void ab initio in view of the relative incapacity of a minor to enter into a binding contract.

The general rule at common law, which arose from the basic desire to protect minors from exploitation, is that an infant's contract is voidable at the infant's option.[588] However, certain exceptions developed to the general rule. First, contracts for "necessaries," including beneficial contracts of service, have been held to be enforceable, for the reason that no supplier would provide the infant with necessaries and no employer would provide employment and training, unless an agreement to pay were enforceable.[589]

The second major exception permits the infant himself to ratify his contracts after attaining the age of majority.[590] In cases where the infant's contract concerns, for example, a long-term interest in property such as a lease of land,[591] or shareholding in a company,[592] ratification is, in effect, presumed unless the infant disaffirms the contract within a reasonable time after attaining his majority.[593] In effect, therefore, there are two classes of voidable contracts - those binding unless disaffirmed and those not binding unless ratified.[594]

With respect to the contractual validity of a loan to a minor, application of the common law rules suggests that such a contract is voidable at the child's option, unless the proceeds of the loan

are used to purchase "necessaries,"[595] in which case the contract would appear to be prima facie valid,[596] or unless the loan is used to acquire an interest in some subject-matter of a permanent nature (E.g. lease of land, shareholding in a corporation), in which case the contract is not binding unless ratified upon the child's attaining majority. In the latter case, ratification is presumed unless the contract is repudiated within a reasonable time atter the child attains majority.[597]

There have been relatively few reported cases concerning the validity of loan contracts involving minor children and those reported have dealt primarily with the liability of the child's parent as a guarantor of such loan and not the child's contractual liability as such. In Wauthier v. Wilson[598] the plaintiff loaned money to a minor child on the basis of a promissory note under which both the child and his father were jointly and severally liable for repayment. It was held, inter alia, that the loan to the child was void and without any legal effect since the child was a minor at the time he contracted the loan.[599] In First Charter Financial Corp. v. Musclow,[600] a Canadian case, the plaintiff financed the purchase of an automobile by the defendant, a minor, with the defendant's mother acting as guarantor of the conditional sale. While the main issue concerned the legal effect of a guarantee of a loan contract made by a child, it was also held that under the Infants' Act,[601] a contract of loan entered into by a minor child was absolutely void unless it related to a "necessary" and that an automobile was not a "necessary" within this context.

While the foregoing cases concur in holding that a contract of

loan entered into by a child is unenforceable against him, it should be noted that they were both decided upon the particular terms of the statute in question, which provisions have not been adopted by the remaining common law provinces -i.e. all common law provinces apart from British Columbia. In these provinces, therefore, the common law rules prevail and it would appear that a contract of loan entered into by a minor child is voidable at the child's option unless the proceeds of the loan are used to purchase "necessaries" or to acquire an interest in some subject-matter of a permanent nature.

In the Province of Quebec, the Civil Code accords a certain amount of legislative protection to minor children[602] in respect of negative consequences which may flow as a result of contracts entered into by them.

Within this context, the Civil Code distinguishes between two different types of minors: (a) the non-emancipated minor, and (b) the emancipated minor. With respect to the latter, emancipation may result by marriage[603] or by judicial pronouncement.[604] Essentially, the emancipated minor may enter into a limited number of contracts wherein he will not be relievable from his obligations so contracted unless he can prove a cause of nullity[605] which would otherwise apply to contracts entered into by persons of full age.[606] In all other cases, the emancipated minor may demand the rescission of a contract under which he suffers "lesion,"[607] so long as he entered into such contract alone and the contract required the legal assistance of his curator.[608]

With respect to loans, article 321 of the Civil Code specifically provides that an emancipated minor cannot contract a loan without the assistance of his curator. Where the loan involves a large sum of money by way of hypothec, such loan also requires the authorization of a judge, except in the cases where the minor is a banker, trader or mechanic and such loans are made in the ordinary course of his business or trade.[609] Where the minor seeks to relieve himself of obligations incurred under a contract of loan, such relief may be obtained simply by showing that the transaction was made without the intervention of the curator, without any proof of lesion.[610]

With respect to the unemancipated minor (i.e. a minor who is not married and/or has not been emancipated by virtue of a court pronouncement), the general rule is that, apart from certain juridical acts which require the intervention of a tutor, the minor may obtain rescission of a contract by proof of lesion,[611] except, as in the case of an emancipated minor, in the circumstances described in articles 1004-1008 of the Civil Code.[612] In the case of a loan, it seems that an unemancipated minor may not contract a loan without the assistance of his tutor and, moreover, the tutor must, in order to contract a loan on behalf of the minor, obtain the prior authorization of a judge.[613]

If the minor, having contracted a loan without the assistance of his tutor, seeks to rescind such loan, the question is whether such rescission may be granted without proof of lesion. As stated above, the answer depends upon one's interpretation of article 1009 of the Civil Code -i.e. whether article 1009 is limited to the two specific instances provided therein or whether it is

merely illustrative and applies to all juridical acts entered into by minors without the assistance of their tutors or curators.[614]

It should also be noted that when a minor attains majority, he may validly ratify any contract under which he may have suffered lesion during his minority.[615] Such ratification may be express (i.e. a writing which contains the contractual obligations and the causes for annullment) or tacit (i.e. failing to seek annullment of the contract within a reasonable time after attaining majority).[616]

F. Deferred Interest Securities

It has been stated that subsection 74.1(2) operates to attribute income with respect to property transferred (or loaned) to a minor prior only to the year in which the minor attains the age of 18 years. Accordingly, it was once popular for parents to acquire long-term deferred interest securities in their children's names which would begin payment of the interest during or subsequent to the year in which the particular child attained 18. So long as the child used the "cash method" of computing his income, as permitted by paragraph 12(1)(c), and provided that no interest income was actually received by him prior to the year in which he reached 18, there would be no interest income which could be attributed to the individual.[617]

With the introduction of the concept of an "investment contract" in paragraph 12(11)(a),[618] the advantage of acquiring long-term deferred securities in the name of a minor child has been significantly reduced. The provisions of paragraph 12(11)(a) basically require an individual to include in income all interest

that has accrued in respect of an investment contract to the extent that such interest was not previously included in computing income. The paragraph applies to interest accruing after December 31, 1981, and requires the accrued interest to be reported every third year[619] unless the taxpayer makes an election under subsection 12(8) to report the accrued income on an annual basis.[620]

Notwithstanding the three-year accrual rules in subsection 12(9) et.s., it may still be somewhat advantageous to acquire deferred interest securities in the name of a child who is at least 15 years of age. So long as no interest is received by the child from the security prior to the year in which he attains 18, there will be no interest income to attribute to the individual since even the three-year accrual rules will not deem him to have realized interest income prior to the year in which the attribution rules cease to have effect.[621]

G. Gifts and Sales to Adult Children

Since the provisions of subsection 74.1(2) apply only until the year in which the minor attains 18, it is possible to split income with adult children (i.e. children over the age of 18) by either gifting to them or selling them income-producing assets. For example, shares of an incorporated business could be given by the individual to his adult child and there would be no attribution of the dividend income therefrom.

There are, however, at least two problems associated with this type of income splitting: (a) the individual may lose control of the transferred assets, and (b) a disposition by way of gift or sale will (subject to the limited rollover provisions referred to

above under the transitional provisions subsection 73(5)) trigger a realization of any accrued capital gains on the asset.

In the former case, if, (for example) the shares disposed of represent control of the corporation the child will, in the absence of any special provisions in the constating documents of the corporation or in the shareholders' agreement, control the Board of Directors and may use such voting power to vote his parent off the Board of Directors and out of the corporation. The child may also, due to a lack of experience or poor business judgment, prove to be an inept manager, causing the business itself to suffer. The parent may very well be powerless in this situation, since he will not be able to recover the transferred shares. Because of the foregoing problems associated with loss of control of the assets, it is generally not advisable to gift or sell valuable assets to an adult child until such time as he has proven himself to be a mature and capable business manager dedicated to the success of the corporation.

With respect to the problem of the realization of accrued capital gains, an outright gift of property will result in the operation of subsection 69(1), which will deem the transfer to take place, from both the transferor's and the transferee's point of view, at the fair market value of the property at that time. Where the transfer involves shares of the capital stock of a small business corporation, the transitional provisions of subsection 73(5) provides for a limited deferral of recognition of the accrued capital gain so long as the conditions of the subsection are met.[622]

If the transfer of assets is accomplished by way of sale with deferred payment provisions, subsections 40(1) and (1.1) limit the extent to which recognition of capital gains may be deferred. Under subsection 40(1), the general rule is that under an instalment sale, the capital gain may be spread over a maximum of five years. The vendor is required to include in income at least one-fifth of the total taxable capital gains each year, but since the reserve claimed cannot exceed a reasonable amount considering the proportion of the proceeds which are not due until after the end of the taxation year, he will pay tax on the capital gain at a faster rate if he receives payment more frequently than in five equal annual instalments. With respect to transfers to one's own child of shares of a small business corporation which qualify for the rollover under transitional subsection 73(5), subsection 40(1.1) modifies the general rule in subsection 40(1) and provides a more generous deferral of capital gains by permitting the gain to be spread over a period of ten years on a basis similar to the five-year reserve provisions of subsection 40(1).

H. Investments on Behalf of Minors in Capital Gains Securities

The provisions of subsection 74.1(2) apply only to income or loss from the loaned or transferred property and do not apply to capital gains or capital losses. Accordingly, a certain degree of income splitting may be achieved by acquiring non-dividend or low-dividend paying growth securities in the name of the child.[623] Any capital gain realized on the disposition of such security will be taxed in the child's hands only.

As previously noted, the technical reason for the exclusion of capital gains attribution with respect to transfers to minors is

that the transferor will realize any accrued capital gain upon the transfer to the child. Thereafter, any subsequent capital gain realized by the minor in respect of the transferred property will be taxed in his hands only and not in the hands of the transferor. In this respect, a problem of valuation has arisen in certain cases where a parent has attempted capital gains splitting by transferring to his children shares of a company which he controlled immediately prior to the sale of such shares to an unrelated third party. In the case of Joseph Simard Ltd. v. MNR[624] a father sold all the shares of a private company which he owned to his children (their exact ages not indicated in the report) for $1.40 a share. Approximately three months later R Co., a public company, purchased all of the same shares from the children at $30 a share. The Minister assessed the father to gift tax under the former section 111[625] on the ground that he had made a gift to his children equal to the difference between the sale price of the shares to R Co. and the transfer price of the shares to his children (i.e. ($30-$1.40) x (number of shares sold to R Co.)). The Exchequer Court decided in favour of the Minister and held that the value of the shares on the date of their transfer from the father to his children should be $30 a share since, at the time of such transfer, all the parties were aware that R Co. would subsequently offer $30 a share for the entire lot. Such an offer, the court felt, could not be ignored in determining the value of the shares at the time of their transfer to the children.[626]

When, some years later, a similar issue of share valuation arose in the case of The Queen v. Littler,[627] the Federal Court of

Appeal appeared to take the same position. Here, the taxpayer, in April, 1968, sold certain shares to his children (again, their ages not specified in the report) for $24 a share which was slightly above the stock exchange price at that time. However, at the time of the sales, the taxpayer was in the process of negotiating with an unrelated third party for the sale of the majority of such shares and one month later a take-over bid was made to all shareholders to purchase their shares for $68 a share which offer was accepted by the required number of shareholders, including the taxpayer and his children. The Minister assessed the taxpayer for gift tax on the contention that he was deemed to have made a gift to his children to the extent of the difference between these two prices, in accordance with the former section 111.

The majority of the court were of the opinion that the only transfer of property was by the sale of shares and any additional benefit or advantage conferred on the children was not "property" and hence could not come within the definition of "gift."

With respect to the question of valuation of shares at the time of their sale from the taxpayer to his children, LeDain J. was of the opinion that the shares should be valued at $68 each since, at this point in time, the taxpayer had every reason to believe that the shares would be resold by the children to the third party in the near future for the same price. Therefore, by selling the shares to his children at $24 a share, the taxpayer conferred a benefit on them equal to the difference between $24 a share and $68 a share. However, since the Crown did not plead the application of subsection 137(2) (the present subsection 245(2)),

but only pleaded the application of section 111, and since LeDain J. did not feel that section 111 applied to the impugned transaction (although he felt that a benefit was conferred on the children under subsection 137(2)), he went on to dismiss the Crown's contention that the taxpayer had made any gift to his children.[628]

It will be noted that in both Joseph Simard Ltd. and Littler, the Minister took the fair market value of the shares at the time of their transfer from the taxpayer to his children to be the price which was subsequently paid by the third party purchaser upon completion of the take-over. But, in the writer's opinion, it is surprising that the Minister should resort to the price paid by a third party purchaser one or more months after the transfer to the children. It seems evident that the Minister had taken for firm commitment, that is, contractual obligations binding upon the purchaser, talks or negotiations that in fact, in both cases, were only exploratory or conditional to the possibility of an eventual sale. In fact, in Littler, the purchaser's offer was conditional upon two-thirds of the shareholders tendering their shares for sale. Clearly, in these two cases, the Minister has gone much further than using hindsight in valuing the quoted shares. Since the purchasers' offers in both cases had not been accepted at the time of the transfer to the children, they could not, on this account, serve as a basis to establish the market value of the shares acquired by the children prior to the take-over and before the offers might expire.

I. Non-Tax Considerations

Before the tax planner commences a course of action which may result in one or more irrevocable transfers of property to a child, he should consider the child's age and degree of maturity and responsibility. It is often an error to place large sums of money or valuable property under the care and control of a child who does not appreciate its true value and who may not have the ability and understanding to manage it properly. Therefore, even though the child may have attained the age of 18, it may be advisable to use a vehicle such as a discretionary trust to split income, at least for tax purposes, until the child is more mature and settled.[629]

XVIII. Tax Liability on Property Transferred not at Arm's Length

A. General

There is a popular saying that one should not "look a gift horse in the mouth." While this may have been true at one time, it is questionable whether the saying still has any practical relevance (at least for taxpayers) since the enactment of subsection 160(1).[630]

Essentially, subsection 160(1) provides that where a taxpayer has transferred property on or after May 1, 1951, to his spouse, to a person who has since become his spouse, to a person under 18 years of age or to any other person with whom he did not deal at arm's length, the transferor and the transferee are jointly and severally liable for certain taxes for which the transferor would otherwise alone be liable.[631]

B. Purpose

The purpose of subsection 160(1) is two-fold:

(a) to make the transferee and transferor jointly and severally

liable for tax on the income from, or gain from the disposition of, property transferred to a spouse or a person who has since become a spouse, a person under 18 years of age, or a non-arm's length person, where such income or gain has been attributed to the transferor pursuant to the operation of sections 74.1 to 75.1; and

(b) to make such transferee and transferor jointly and severally liable for any tax (not exceeding the fair market value of the property transferred) which the transferor was liable to pay in the year of the transfer or any preceding taxation year.[632]

In the former case, since the income or capital gain from the transferred property will be received by the transferee but under sections 74.1 through 75.1 the liability for the tax thereon is the liability of the transferor, the purpose of the provision is clearly to enable the tax authorities to recover the amount of the tax liability from the actual recipient of the income or gain as well as from the person liable for the tax under sections 74.1 through 75.1. In the latter case, the purpose of the provision is to prevent a person with substantial income tax liability from defeating the claims of the tax authorities by transferring his property to a spouse, an intended spouse, a person under 18 or any non-arm's length party at less than fair market value consideration. In other words, the purpose of the provision, in particular, is to ensure that both the transferor and transferee are liable for the payment of tax even if the transferor no longer has any assets which might otherwise be seized for the payment of such tax.[633]

C. Application

Section 160 is applicable to direct or indirect transfers of property,[634] including transfers of property by way of trust. Two distinct types of joint tax liability may result from the operation of section 160 and they are discussed separately below.

(i) Joint Liability for Tax on Income or Gain Attributed to Transferor

Under sections 74.1 through 75.1, when property has been transferred to a spouse or to a person under 18 years of age, the transferor continues under the circumstances described in those sections to be liable for the tax payable on the income subsequently derived from such property or property substituted therefor. For transfers of property on or after May 1, 1951, paragraph 160(1)(d) provides that although the transferor continues to be primarily liable for payment of the taxes on such income, the transferee will be jointly and severally liable for such tax.

With respect to transfers of property occurring after November 12, 1981, paragraph 160(1)(d) also provides that the transferor and transferee are jointly and severally liable for the payment of tax on any capital gain arising from the disposition of the transferred property or property substituted therefor which is attributed to the transferor under subsection 74.2(1).[635]

The joint and several liability of the transferor and transferee under paragraph 160(1)(d) is limited to the amount by which the transferor's tax for the year is greater than it would have been were it not for the operation of any of sections 74.1 through 75.1 in respect of income from, or gain from the

disposition of, the property so transferred or from property substituted therefor. It would seem, therefore, that where a transferor transfers property to his wife and for example, to a child under 18 years of age, it may be argued, based on the initial wording of paragraph 160(1)(d), that each transferee is jointly and severally liable to pay the additional tax payable by the transferor under any of sections 74.1 through 75.1. Such a construction, however, would seem to lead to an illogical situation in that one transferee might become liable for an amount of tax far in excess of the value of the property transferred to him. Accordingly, the better view would appear to be that the particular transferee is jointly and severally liable with the transferor to pay the amount of the tax payable by the transferor on the income from, or gain from the disposition of, the property transferred to him alone and not property transferred to any other transferee.[636]

(ii) Joint Liability for Transferor's Tax in Year of Transfer

Where the transferor transfers property after November 12, 1981, to a spouse or a person who has since become a spouse, a person under 18 years of age, or a person with whom the transferor was not dealing at arm's length, the transferor and transferee are jointly and severally liable for any amount which the transferor was liable to pay under the Act in respect of the taxation year or any prior taxation year.[637] The transferee's liability is limited to the amount by which the fair market value of the transferred property exceeds the fair market value of the consideration, if any, given for the property, with "fair market value" to be

determined as at the date of the transfer.[638] Thus, where the fair market value of the consideration given by the transferee is equal to or exceeds the fair market value of the transferred property, the transferee will not be liable for any amount under paragraph 160(1)(e).[639]

The rules applicable to transfers of property occurring between May 1, 1951, and November 12, 1981, were somewhat different from those discussed above. First, joint and several liability under this provision only extended to transfers of property to a spouse or a person who had since become a spouse, or to a person under 18 years of age, and did not include other non-arm's length transfers. Second, the joint and several liability of the transferee and transferor was only in respect of the amount of tax which the transferor was liable to pay on the date of the transfer, thereby leading to the problem of determining the amount that the transferor was liable to pay on the date of the transfer. If the transfer took place, for example, in the middle of the year, it was clear that the transferor would not be liable to pay tax on that date for the whole of the year. In fact, it was open to question whether he would have been liable to pay tax on that date for any part of the income earned in the year.[640] The final difference is that while the transferee's joint liability was limited to the fair market value of the transferred property, no "credit" was given against this liability for the value of the consideration provided by the transferee in exchange for the transferred property.

Before an assessment under paragraph 160(1)(e) can be made, the transferor must have been liable to pay an "amount" under the

Act. Since under subsection 152(3) liability for tax is not affected by an incorrect or incomplete assessment or by the fact that no assessment has been made, it would seem that the amount for which the transferor was liable need not be an amount that has been fixed by an assessment on or prior to the date of the transfer, or for transfers of property occurring after November 12, 1981, on or prior to the end of the taxation year in which the property was transferred. Thus, an assessment of tax made subsequent to the taxation year in which the property was transferred, but establishing a tax liability which arose on or prior to the date of the transfer, or on or prior to the end of the taxation year in which the property was transferred (for transfers after November 12, 1981) would be effective to bind the transferee. Authority for this proposition may be found in the case of No. 605 v. MNR[641] where the husband, in 1953, transferred certain shares of a private company to his wife. In 1956, the husband was reassessed in respect of taxes owing for his 1952 taxation year. The Minister, upon the dismissal of the husband's appeal, then assessed the wife for the taxes owed by the husband pursuant to the former section 49A (now subsection 160(1)). It was held that the wife was liable to pay her husband's 1952 income tax notwithstanding the fact that her husband's liability for this tax was not formally determined until the date of reassessment in 1956. The notice of reassessment in 1956, with its retroactive effect, made the husband liable for the unpaid taxes of 1952. Thus, when the transfer to the wife was made in 1953, the husband did owe back-taxes to the Minister.[642]

It should also be noted that a taxpayer may not use a private law statute to avoid the application of section 160. In Brazeau and Brazeau v. MNR[643] the taxpayers were convicted of tax evasion in 1978. In 1979, both taxpayers entered into covenants to modify their matrimonial regimes pursuant to which they partitioned their property in accordance with the relevant provisions of the Civil Code. As a result of such partition, certain real property was transferred to the taxpayers' wives. In 1980, the Minister assessed the wives and included in their income the value of the real property which they received pursuant to the partition. The wives disputed the assessment and argued that there was no transfer within the meaning of section 160 since the modification and partition were both registered before the date of the assessment. It was held that the parties had no bona fide intention to partition and divide the property in question, but rather that they used the Civil Code to avoid having the Minister seize the taxpayers' property in payment of their tax liabilities. The fact that the taxpayers had not been assessed before they registered the deed of partition was immaterial since the assessment did not create the taxpayers' obligation to pay the tax but merely confirmed the existence of the debt.

(iii) Procedure for Assessing the Transferee

Subsection 160(2) gives the Minister the same powers of assessment as against the transferee as in the case of any other assessment and the provisions of Division I are applicable to any assessment made under section 160 as if it had been made under section 152.[644]

D. Discharge of Joint Liability

Where a transferor and transferee are jointly and severally liable in respect of part or all of the liability of the transferor, a payment by the transferee discharges to that extent the joint liability.[645] However, a payment by the transferor only discharges the transferee's liability to the extent that the payment reduces the transferor's liability to an amount less than the amount in respect of which the transferee was made jointly and severally liable.[646] In other words, the last liability to be discharged by a payment by the transferor is the joint and several liability imposed by subsection 160(1).[647] Where there are two or more transferees who are jointly and severally liable with the transferor the Act is silent as to the sequence in which the liabilities are discharged.

E. Exception

Subsection 160(4) provides an exception from the rules respecting joint and several liability (i.e. paragraphs 160(1)(d) and (e)) in the case of property transferred between spouses who are separated. Where property is transferred to a spouse pursuant to a decree, order or judgment of a competent tribunal or pursuant to a written separation agreement, and at the time of the transfer the transferor and his spouse were separated and living apart as a result of marital breakdown, the transferee spouse does not become liable under subsection 160(1) either in respect of the transferor's tax liability arising as a result of the income or capital gains attribution rules or in respect of present and past liability of the transferor. This rule applies with respect to property transferred after February 15, 1984; moreover, where

property has been transferred before February 16, 1984, and the transferee spouse would be liable to pay tax by virtue of the operation of subsection 160(1), the transferee spouse's liability under that subsection is deemed to have been discharged on February 16, 1984.[648]

XIX. Burden of Proof

A. General

On several different occasions the issue of the burden of proof rule[649] has arisen in respect of inter-spousal transfers of property where the Minister has invoked both subsection 74.1(1) and section 160.[650] Our purpose here is to determine whether the holdings in these cases are consistent with the prevailing state of the law with respect to the burden of proof.[651]

The question of onus of proof in a tax case first came before the Supreme Court of Canada in Anderson Logging Co. v. The King,[652] a case which arose under the Income and Property Taxation Act[653] of British Columbia. One of the first issues for determination was which party had the onus to show that profit from a sale of timber was or was not earned in an operation which was part of the business carried on by the company. Duff J. (as he then was) dealt with the issue as follows:

> First, as to the contention on the point of onus. If, on an appeal to the judge of the Court of Revision, it appears that, on the true facts, the application of the pertinent enactment is doubtful, it would, on principle, seem that the Crown must fail. That seems to be necessarily involved in the principle according to which statutes imposing a burden upon the subject have, by inveterate practice, been interpreted and administered. But, as concerns the inquiry into the facts, the appellant is in the same position as any other appellant. He must shew that the impeached assessment is an assessment which ought not to have been made; that is to say, he must establish facts upon

> which it can be affirmatively asserted that the assessment was not authorized by the taxing statute, or which bring the matter into such a state of doubt that, on the principles alluded to, the liability of the appellant must be negatived. The true facts may be established, of course, by direct evidence or by probable inference. The appellant may adduce facts constituting a prima facie case which remains unanswered, but in considering whether this has been done it is important not to forget, if it be so, that the facts are, in a special degree if not exclusively, within the appellant's cognizance; although this last is a consideration which, for obvious reasons, must not be pressed too far.[654]

The onus of proof on the taxpayer, according to Duff J. in the Anderson Logging Co. case, was to show that the assessment "ought not to have been made," either by establishing facts that demonstrate that the assessment "was not authorized by the taxing statute" or, that create "a state of doubt" so that it could not be said that the subject had been brought within the letter of the law. Clearly, Duff J. placed the onus on the taxpayer to dislodge the assessment, as later cases would also establish.[655]

Twenty-five years after the Anderson Logging Co. case, the Supreme Court had to deal with the question of onus of proof in Johnston v. MNR. In what were to become time-honoured words, Rand J., after stating that taxation is based on "certain facts" and "certain provisions of law," either or both of which are being challenged by the taxpayer, went on to say:

> Every such fact found or assumed by the assessor or the Minister must then be accepted as it was dealt with by these persons unless questioned by the appellant. If the taxpayer here intended to contest the fact that he supported his wife within the meaning of the Rules mentioned he should have raised that issue in his pleading and the burden would have rested on him as on any appellant to show that the conclusion below was not warranted. For that purpose he might bring evidence before the Court notwithstanding that it had not been placed before...the Minister, but the onus was his to demolish the basic fact on which the taxation

rested...[656]

In effect, what Rand J. said was that the taxpayer has the burden of proof with respect only to the findings or assumptions of fact of the Minister at the time of the assessment.[657] This "limitation" was in the same words as Duff J.'s qualifying words in the Anderson Logging Co. case: There is a limit beyond which the taxpayer should not be required to carry the burden of proof, even where he has the exclusive knowledge of the facts.[658]

In determining that the burden of proof in an income tax case is on the taxpayer, the Supreme Court in both Anderson Logging Co. and Johnston applied the underlying rationale that it was the taxpayer who was appealing the assessment. As Duff J. put it in the Anderson Logging Co. case, "as concerns the enquiry into the facts, the appellant is in the same position as any other appellant."[659] And, as Rand J. observed in the Johnston case, "notwithstanding that it is spoken of...an action ready for trial and hearing, the procedure is an appeal from the taxation...and the burden would have rested on him [the taxpayer] as on any appellant to show that the conclusion below was not warranted."[660] In other words, it seems that, apart from any specific provision of the legislation, the courts' decision was ultimately based on the general scheme of the Act, whereby the initiative is placed on the taxpayer to invoke the jurisdiction of the courts if he feels aggrieved by an assessment.[661] Since he is coming to the courts for a remedy, it falls on him to show that either as a matter of fact or as a matter of law there is a ground for intervention.[662] For the reader interested in a more detailed discussion of the concept of the burden of proof in tax cases, see Appendix "C."

B. Attribution and the Burden of Proof

It has been argued that where the Minister assesses the taxpayer pursuant to section 74.1 or 74.2, on the ground that a "transfer of property" has taken place, the burden of proof is on the Minister to adduce evidence from which it may be inferred that a transfer of property has in fact taken place.[663] The basis for this assertion stems from two decisions of the Tax Appeal Board, namely Del Grande v. MNR[664] and Maziade v. MNR.[665] In Del Grande, while the Minister's findings and assumptions of fact were not reproduced by the Board verbatim, it seems that the sole assumption made in the assessment was that certain rental income received by the taxpayer's wife in the taxation year in question should be attributed to the taxpayer on the ground that it was income derived by the wife from rental property transferred to her by the taxpayer.[666] However, in disputing the assessment, the taxpayer proceeded to prove to the satisfaction of the Board that the rental property in question (which was registered in the wife's name) was fully paid for by the wife with funds which she had received from a dowry in Italy approximately one year before the couple came to Canada. Since the Minister did not contradict or rebut such evidence, the Board held that the assessment could not be supported under former subsection 32(2).

While a literal interpretation of the Board's judgment might indicate that it felt that the burden of proof rested on the Minister,[667] in fact the opposite seems to be the case -i.e. the Board accepted the taxpayer's evidence that his wife purchased the rental property in question with her own dowry money as sufficient

to upset the assessment. This being the case, the Board's remark to the effect that no evidence was adduced in respect of any transfer of property by the taxpayer to his wife can be taken to mean that, once the taxpayer had established a *prima facie* explanation as to the manner in which his wife acquired the property, the failure by the Minister to rebut or disprove such explanation resulted in the assessment being vacated.[668]

In the *Maziade* case, a relatively brief and undetailed judgment, the facts were similar to those in *Del Grande*. The Minister assessed the taxpayer under the former subsection 21(1) (now subsection 74.1(1)) and added to his income certain income which he alleged was derived from property transferred by the taxpayer to his wife. The Board, in vacating the assessment, accepted the taxpayer's evidence that he did not transfer any property to his wife and that all the income which his wife had, she derived entirely from profits realized in the operation of her own business. As in *Del Grande*, the Board did not specifically deal with the question of the onus of proof as such, but it was implicit in the judgment that it felt that the initial (*i.e.* legal) burden of proof was on the taxpayer since it held that the taxpayer's evidence, in the absence of any contradiction by the Minister, was sufficient to upset the assessment.

It would appear, therefore, that the decisions in the *Del Grande* and *Maziade* cases are consistent with the principle that the onus is on the taxpayer to demolish the basic fact upon which the assessment rests. This conclusion may be said to be reached by reasoning *a contrario sensu* -*i.e.* if the Board, in either case, had been of the opinion that the legal burden of proof was on the

Minister, there would have been no need for it to consider evidence offered by the taxpayer as to how the property in question came into the wives' possession. For if, in fact, the Board had felt that the onus of proof rested with the Minister, the assessments in both cases would have been vacated as soon as it was shown that the Minister could not prove that any transfer of property had taken place; there would have been no reason for the taxpayers to demonstrate how the property came into their wives' hands.

In the case of joint liability for tax on income or capital gains attributed to the transferor pursuant to section 160, it seems that, where the Minister assesses the transferee in respect of such taxes owed by the transferor, the onus of proof lies on the transferee to discharge the assessment.[669] The statutory basis for this submission lies essentially in the wording of subsection 160(2) which gives the Minister the same powers of assessment as against the transferee as in the case of any other assessment and the provisions of Division I are applicable to any assessment made under section 160 as if it had been made under section 152.[670]

That the onus of proof lies on the transferee in an action to collect unpaid taxes under section 160 was implicitly accepted by the Tax Review Board in Thorsteinson v. MNR[671] and by the Tax Court of Canada in Thalheimer v. MNR.[672]

In Thorsteinson, the Minister assessed the husband for previous unpaid taxes, and when the husband subsequently declared bankruptcy in the same year, the Minister assessed the wife (under subsection 160(2)) as the transferee of the family residence, for

the taxes owing by the husband at the time of such transfer. While the Board did not state specifically that the burden of proof rested on the wife, this was implicit in its opinion that it is open to a transferee (under subsection 160(2)) to challenge the bona fides of the Minister's claim that the transferor was actually liable for tax at a particular point in time. The Board also said that the transferee has the right to dislodge the basis for the liability under the assessment, thus implying that the burden of proof was on the transferee to upset the assessment.

In Thalheimer, the husband deposited certain cheques in his wife's bank account at a time during which he owed back-taxes. The Minister assessed the wife, as the transferee of such cheques, for the husband's unpaid taxes. On appeal by the wife, the court held that the wife could not succeed since she could not prove that the money in her account was her own. In so holding, the court simply assumed that the burden of proof was on the wife to prove that the money in her bank account was not transferred to her by her husband.

XX. Attribution and Family Law

A. Marital Regimes in the Province of Quebec

(i) Formation of the Marital Regime

In the Province of Quebec, there exist three matrimonial regimes: separation of property,[673] partnership of acquests,[674] and community of property.[675] As indicated above, spouses married without a marriage contract prior to July 1, 1970, are subject to the legal regime of community of property, while spouses married thereafter without a contract are subject to the legal regime of partnership of acquests.

(a) Separation of Property

Since the regime of separation of property exists only as a conventional regime, the parties must stipulate their wish to be governed by this regime in their marriage contract. Under this regime, each consort remains owner of all of his property, moveable as well as immovable. Therefore, no property is transferred from one spouse to the other by virtue of the parties' adoption of this marital regime. However, one spouse may choose to make a gift of property to the other under the marriage contract, in which case the transfer will take place at the time of the marriage. In this case, the transfer (whether it be from the husband to the wife or wife to husband) does not involve any conflict between the provisions of the Civil Code and those of the Income Tax Act. Such transfer will be subject to the automatic rollover under subsection 73(1), unless an election is made not to have the rollover apply. Following the transfer, the attribution rules will apply to attribute both income and capital gains back to the transferor.[676]

(b) Partnership of Acquests

Under the regime of partnership of acquests, each spouse has full powers of administration and alienation over his or her private property and acquests during the subsistance of the marriage[677] and all property which a spouse owns at the time of the celebration of the marriage remains as his or her private property.[678] Neither spouse may, however, dispose gratuitously of his or her acquests without the consent of the other spouse.[679]

The characteristic of the regime of partnership of acquests

that each spouse retains, as private property, all property owned by him or her at the date of the marriage implies that, upon formation of the marital regime, the spouses will not incur any fiscal consequences since there will not be any transfer of property.[680]

It is possible, however, that the spouses may adopt the regime of partnership of acquests by virtue of a marriage contract under which they make inter vivos gifts. Assuming that such gifts take effect on the day of the celebration of the marriage, and given that the property which each spouse possesses at the time of the marriage remains as his or her own private property, the attribution rules will apply, as previously indicated, to each gift of property made by the spouses.[681]

(c) Community of Property

Under the regime of community of property, three types of property must be distinguished: (a) the private property of each spouse;[682] (b) the community property;[683] and (c) the wife's reserved property.[684]

With respect to property which retains its status as private property, each spouse exercises the complete right of ownership in respect thereof without any limitation.[685] The result is that this class of property does not present any particular taxation problem. However, upon formation of the marital regime, certain property may become community property by sole operation of law.[686] This is the case, for example, with respect to moveable property which each spouse possesses at the time of celebration of the marriage. Is there a transfer of property within the meaning of subsection 74.1(1) at this time?

Let us examine, for example, the case where one of the spouses owns certain corporate stocks before the marriage. Under the Civil Code such stocks automatically become community property on the day that the parties are married.[687] If this is so, can we conclude that there has been a transfer of property within the meaning of subsection 74.1(1)? And if we conclude that there has been a transfer of property, would such transfer consist of the entire value of the property or only one-half of its value?

It has been submitted that a transfer by operation of law does not constitute a transfer for the purposes of the attribution rules.[688] If this submission is accepted, then the fact that the moveable property which the consorts possess on the day of the marriage becomes community property does not result in a transfer of property for the purposes of the attribution rules.[689]

However, where the parties execute a marriage contract under which one spouse transfers an interest in certain property to the other spouse, this would appear to constitute a positive act resulting in the operation of the attribution rules. In this regard, it was held in Wertman v. MNR[690] that income derived from certain property owned by the husband before the marriage, which property had been transferred to his wife by reason of the spouses' adoption of a conventional regime of community of property, should be attributed to the husband by virtue of the former subsection 21(1) (now subsection 74.1(1)). Thurlow J. stated:

> ...insofar as the funds brought by the appellant to Canada represented property which the appellant had on hand at the time of his marriage in 1938 or property later substituted therefor, any

> interest which the appellant's wife had in them as a co-owner of the community property came to her by virtue of her husband having entered into the prenuptial contract and the marriage and thus transferred such interest to her...
>
> ...whatever interest the appellant's wife had in the funds in the Swiss banks must for the purposes of this case be regarded as property transferred to her by the appellant within the meaning of subsection 21(1)...[691]

It is felt that a valid distinction may be made between the foregoing analysis of the relationship between the attribution rules and the formation of the community of property regime, on the one hand, and the decision in Sura v. MNR[692] on the other. At the time the Sura case was decided, the community property regime was a legal regime, and it was not necessary for the future consorts to carry out any positive act to fall under this regime, which is contrary to what has transpired since July 1, 1970. Moreover, in his judgment in Sura, Taschereau J. had this to say:

> Moreover, when it is a question of community by agreement, it is certain that the situation can be different, for, while stipulating the community of property which must settle the system of marital finances, the spouses may always by contract enter into all kinds of other agreements, which, of course, must not be contrary to morality or public policy (1257, 1262, 1268 C.C.). For the purpose of the case before us it is not necessary to discuss them.[693]

If it is accepted that the adoption of a conventional regime of community of property may result in an inter-spousal transfer within the meaning of subsections 74.1(1) or 74.2(1) (i.e. where one spouse gifts property to the other spouse), will the attribution rules apply to attribute to the transferor the entire amount of income and/or capital gains derived from the transferred property, or only one-half of such sums? If we apply the obiter dictum of Taschereau J. in Sura to the effect that the spouses are

co-owners of the community property during the existence of the regime, the necessary conclusion is that only one-half of the income and/or capital gain will be subject to attribution. In other words, if the husband is the owner of the transferred property, he should be taxed on the entire amount of income and capital gains derived therefrom because, on the one hand, he will be taxed in respect of a one-half interest by virtue of his administration of the community and, on the other hand, he will be subject to tax in respect of the one-half interest which he transfers to his spouse. If the wife is the owner of the transferred property, then it seems that she should be taxed in respect of one-half of the income and capital gains derived therefrom and, with respect to the one-half interest in the property which has not been transferred, the income and capital gains derived therefrom should be taxed in the husband's hands on the basis of the decision in Sura.[694]

It may also be argued, however, that the spouse who owns the property which subsequently becomes community property during the formation of the marital regime should be taxed in respect of the entire income derived therefrom as well as the entire capital gain upon disposition. As support, it could be argued that the Sura case should not apply in this situation since that decision dealt with community property governed by a legal regime of community of property. Moreover, this argument is supported by the words of Taschereau J. himself in Sura.[695]

Finally, when we consider the community of property regime prior to July 1, 1970, certain distinctions must be made. In this case, since the spouses have not carried out any positive act

which would result in a transfer of property (community of property being the legal marital regime during this period), it seems that a spouse who owned moveable property could not be said to have transferred such property to the other spouse, since the attribution rules do not encompass a transfer by operation of law. That is, the former subsection 21(1) would not apply to attribute income to the original owner of the community property.[696] The result is that, irrespective of which spouse actually owned the property, any income derived therefrom during that period and even today, should be taxed in the husband's hands by virtue of the decision in Sura.[697]

(ii) Existence of the Matrimonial Regime

(a) Separation of Property

The regime of separation of property does not present any particular problem with respect to the taxation of income and capital gains during the existence of the regime. Since each spouse is the owner of any property which he acquires during the marriage, it is the spouse to whom such property belongs who will be taxed in respect of any income and capital gains derived therefrom. This being the case, the possibilities for statutory income splitting are virtually non-existent. Any direct transfer of property from one spouse to another will be subject to the attribution rules in subsections 74.1(1) and 74.2(1).

(b) Partnership of Acquests

Under the Civil Code, each spouse married under the regime of partnership of acquests has the administration, enjoyment and free disposal of all his private property and acquests.[698] The only

limitation on the rights of the consorts is the prohibition against the disposition of acquests by gratuitous title without the consent of the other consort.[699]

With respect to income derived from the spouses' acquests it seems reasonable to apply the principle enunciated in the Sura case, namely, that the spouse who has the administration and free disposal of the property in question should be taxed in respect of any income derived therefrom. The fact that one spouse may not, without the consent of the other, dispose of his acquests by gratuitous title would not seem to negate this assertion for, at the time of the Sura decision in 1962, the husband could not make any gifts inter vivos of immovable property belonging to the community unless it was for the establishment of the children of the marriage.[700]

With respect to the taxation of capital gains, the results are not as clear. It is arguable that the capital gain resulting from the disposition of an acquest may be treated in the same manner as the income derived from such acquest.[701] In this sense, applying the principle in the Sura case, it may be argued that the spouse who has the administration and free disposition of such property should be taxed in respect of any capital gain resulting from its disposition.

On the other hand, a different argument recognizes that a capital gain does not constitute income from property, but rather an increase in the value of the property.[702] In this view, we must determine the nature of the right which one spouse possesses in respect of the acquests of the other spouse. As indicated above, under the Civil Code one spouse cannot, without the consent of the

other spouse, dispose of his acquests by gratuitous title. It has been argued that this limitation confirms the right of each spouse in the acquests of the other spouse.[703] For example, Mr. Comtois states that:

> Les droits des époux dans les acquets de l'un et de l'autre sont en tous points assimilables aux droits des époux sur les biens de la communauté. La femme mariée sous le régime de la société d'acquets a, sur les acquets de son conjoint, des droits aussi actuels et sérieux que ceux de l'épouse commune en biens sur les biens de la communauté.[704]

If one accepts the proposition that the spouses are co-owners of each other's acquests, the result is that each spouse should be taxed in respect of one-half of the capital gain resulting from the disposition of an acquest. In this respect, reference may be made to the sections of the Act dealing with capital gains which refer to "property owned by him"[705] as support for the proposition that the capital gain should be taxed in the hands of the owner of the property, and not in the hands of the one who has the free disposal of the proceeds from the property.[706]

With respect to property over which neither spouse can establish exclusive ownership, such property is deemed to be an acquest held in undivided ownership each for one-half,[707] and each spouse has the right to administer such property.[708]

With respect to transfers between spouses of property which is an acquest, two considerations arise:

(a) such transfer will benefit from the automatic rollover under subsection 73(1) if the property consists of capital property, unless there is an election not to have the rollover apply; and

(b) the attribution rules under subsections 74.1(1) and 74.2(1)

will apply to attribute income and capital gains back to the transferor.[709]

It should also be noted that whether the transferred property becomes private property or an acquest of the transferee, the same principle will apply.[710]

(c) Community of Property

Although income derived from the spouses' private property becomes an asset of the community,[711] it would appear that the taxation of such private property should follow the same rules as those governing the regime of partnership of acquests because under the community of property regime each spouse possesses all the rights of ownership in respect of his private property,[712] with the other spouse possessing no rights therein, except that the wife may be called by the husband to turn over to the community the revenues received by her which remain unconsumed.[713]

With respect to the wife's private property, she alone administers the income from such property as well as any property acquired with the proceeds of her personal work, so long as the husband does not require her to turn over any unconsumed revenues.[714] Thus, the wife alone will be taxed in respect of such property, but once she turns over such revenues to the husband, he alone will be taxed in respect thereof, since he will now be administering such property.[715]

With respect to the wife's reserved property, while such property is included in the partition of the community,[716] she enjoys the administration and free disposition thereof.[717] Consequently, according to the Sura case, the wife should be taxed in respect of all income derived therefrom. With respect to

capital gains derived from the disposition of the wife's reserved property, two arguments have been advanced in respect of their taxation. First, since the wife has the administration, enjoyment and free disposition of income derived from the disposition of such property, any capital gain should be taxed in her hands only.[718] In this sense, the decision in Sura dictates that taxation is not imposed with respect to ownership but rather in respect of the person who benefits from the property.

On the other hand, given the fact that reserved property enters into a partition of the community,[719] then it seems that capital gains resulting from a disposition of such property should be taxed in the same manner as other community property. However, since reserved property does not always enter into a partition,[720] it seems preferable to support the first position to the effect that capital gains realized on the disposition of reserved property should be taxed in the wife's hands only.[721]

With respect to income derived from community property acquired during the marriage, the principle enunciated in the Sura case would seem to apply here. Such income will be taxed in the husband's hands, since he administers the community property. However, since the spouses are now entitled to contractually modify the community of property regime, may they insert a clause in the marriage contract to the effect that the wife shall administer a portion of the community property with the result that she alone will be taxed in respect of the community property which she so administers?[722] Such an argument against the application of the Sura case would appear to retain some validity

in this situation since Sura dealt with a legal regime of community and Taschereau J. specifically stated that his decision might have been different had he been dealing with a conventional regime of community of property.

The problem is somewhat more complicated with respect to the treatment of capital gains resulting from the disposition of community property. Since a capital gain consists of an increase in the value of property, it is normal for the spouses to attempt to split such gain between them. The Sura case did not deal with this question. However, the addition of capital gains as a source of income does not appear to have modified the principle stated by Taschereau J. to the effect that:

> ... it is not ownership of property which is taxable, but the tax is imposed on a taxpayer, and the tax is determined by the income received by the person who is the legal beneficiary [of the income]...[723]

Since the proceeds of disposition of community property remain as such,[724] the wife does not derive any benefit therefrom and consequently she cannot be taxed on such amount.[725]

However, in view of the fact that several sections of the Act provide that it is the owner of capital property who is taxed with respect to capital gains derived therefrom,[726] and in view of the obiter dictum of Taschereau J. in Sura to the effect that the spouses are co-owners of the community property during the marriage, it is arguable that capital gains should be taxed in the hands of the owner of the property, and not solely in the hands of the one who enjoys the gain realized from the disposition of such property. The result is that the capital gain resulting from the disposition of community property may be split between the

spouses, with each being taxed in respect of one-half thereof.[727]

B. Family Law Reform in the Common Law Provinces

(i) General

The impetus for the high level of activity in recent years in the reform of the law respecting matrimonial property in the common law provinces may be attributed to a number of changes in the economic and social climate of the country. In general, it could be said that the common law rules were felt to give an undue advantage to the male partner on the break-up of the marriage, and that these rules did not adequately recognize the value of the contribution of the female partner to the family prosperity and accumulation of wealth. These rules generally required, for a spouse who was not the legal owner of a property to be granted a share in that property, evidence of an intention that the non-owning spouse was to have an interest in the property and a contribution by that spouse to the acquisition or improvement of the property. If those conditions were satisfied, the spouse who was the legal owner would be treated as holding the property on resulting trust for the other spouse. The difficulties encountered in the application of these principles are indicated in the following excerpt from Rathwell v. Rathwell:

> The difficulty experienced in the cases is the situation where no agreement or common intention is evident and the contribution of the spouse without title can be characterized as performance of the usual duties growing out of matrimony... There are many examples of this. There is the class of case where one spouse spends weekends or evenings making small repairs to the family home: Appleton v. Appleton, supra; Pettitt v. Pettitt, supra; or contributes money to such repairs: Re Taylor and Taylor [1971] 1 O.R. 715. There is the case where one spouse may go out to work, making contributions to family expenses enabling the other spouse to acquire and pay for the matrimonial home: Rimmer v. Rimmer, supra;

> Fribance v. Fribance [1957] 1 All E.R. 357 (C.A.); or the case where one spouse may work in a family business and receive no wage or title to property: Re Cummins and Cummins [1971] 3 All E.R. 782 (C.A.). There is also the case where a business may be a joint effort such as a farm and, though title may issue to one spouse only, the business succeeds only through the efforts of both husband and wife: Trueman v. Trueman [1971] 2 W.W.R. 688 (Alta. C.A.); Murdock v. Murdock, supra. Some of these situations may be analyzed as agreements or common intention situations. Such intention is generally presumed from a financial contribution. The doctrine of resulting trust applies. In others, a common intention is clearly lacking and cannot be presumed. The doctrine of the resulting trust then cannot apply.[728]

The principles of constructive or resulting trusts appear to be no longer applicable in those jurisdictions (E.g. Ontario,[729] Manitoba,[730] Saskatchewan,[731] Alberta,[732] and British Columbia[733]) which have implemented statutes providing for what is considered to be a more equitable distribution of property on the break-up of a marriage.[734] Under the new provincial statutes, the division of property between spouses, or former spouses, is not dependent upon a finding that such a trust exists. In fact, it seems that where property questions are determined under the relevant legislation, it is doubtful whether such a finding would be made.[735]

(ii) Characteristics of Marital Property Reform Legislation

The common thread running through the family law reform legislation of the common law provinces with respect to property, is the approach to marriage as, inter alia, a form of economic partnership. This approach, explicit in some statutes and implicit in others, varies in the extent to which it is applicable, from application only to assets defined as "net family property" to situations where it is applied to property of all types acquired during marriage.[736]

An explicit statement of the objectives of the partnership

approach is contained in the preamble of the Ontario Family Law Act, which states:

> And Whereas for that purpose it is necessary to recognize the equal position of spouses as individuals within marriage and to recognize marriage as a form of partnership;
>
> And Whereas in support of such recognition it is necessary to provide in law for the orderly and equitable settlement of the affairs of the spouses upon the break up of the partnership...[737]

The property which is considered to be part of the economic partnership in Ontario is referred to in the Family Law Act as "net family property."[738] Under the Family Law Act, the term "net family property" means the value of all property, except for "excluded property," that a spouse owns on the valuation date[739] after deducting the following:

(a) the spouse's debts and other liabilities, and

(b) the value of property, other than a matrimonial home, that the spouse owned on the date of the marriage, after deducting the spouse's debts and other liabilities, calculated as of the date of the marriage.

The term "excluded property" means, inter alia, the following:

(a) property, other than a matrimonial home, that was acquired by gift or inheritance from a third party after the date of the marriage;

(b) income from property referred to in "(a)" above, if the third party expressly stated that it should be excluded from the spouse's net family property; and

(c) property that the spouses have agreed by a domestic contract is not to be included in the spouse's net family property.

Thus, the concept of net family property attempts to identify the value of property acquired during the marriage and the change in the value of property owned at the onset of the marriage. The special status of a matrimonial home given in the former Family Law Reform Act is continued by including its value in net family property regardless of whether it was acquired before or after the marriage.

(iii) Property Rights and Attribution

(a) Is there a "Transfer of Property" for the Purposes of the Attribution Rules?

Matrimonial Home

The advent of marital reform legislation precipitated a discussion among certain writers as to whether or not particular aspects of the legislation resulted in a transfer of property (i.e. the matrimonial home and net family property) from the registered owner spouse to the non-owning spouse.[740] For example, in the case of the matrimonial home,[741] subsection 21(1) of the Family Law Act (Ont.)[742] provides that no spouse may dispose of or encumber any interest in a matrimonial home unless, among other matters, the other spouse joins in the instrument or consents to the transaction. Thus, the non-registered owner spouse has a veto right over any dealings with the matrimonial home.[743] The question then becomes whether or not such veto right is sufficient to give the non-registered owner spouse an immediate interest in the matrimonial home of such a nature as to permit him or her to designate the same as his or her principal residence for tax purposes in the event of its disposition. It has been argued that such veto right granted to the non-registered owner spouse is

equivalent to an ownership right with the result that the non-registered owner spouse acquires a one-half interest in the matrimonial home upon marriage.[744]

If one accepts the view that an ownership interest in the matrimonial home is created by the enactment of the legislation,[745] the next step is to consider whether or not the creation of such interest (in the non-owning spouse) constitutes a "transfer of property" for the purposes of the attribution rules. As stated earlier, the attribution rules imply that some positive act on the part of the transferor is necessary for the rules to apply -i.e. the transferor must transfer the property and a strict transfer of property by operation of law (E.g. enactment of family law reform legislation) would not seem to meet the requirements for application of the sections. It is felt, therefore, that if the legislation does create an ownership interest in the non-owning spouse, the creation of such interest is not a transfer of property within the context of the attribution rules.[746]

The logical corollary to this argument is that, at least insofar as the Family Law Act is concerned, there is a possibility of income splitting insofar as income is derived from a matrimonial home, since each spouse has an immediate joint ownership interest in the matrimonial home and each spouse is entitled to the same incidental rights (i.e. possession, management and use) in respect of the home as is the other spouse. Upon the disposition of a matrimonial home, there may also be a possibility of capital gains splitting for the same reason, namely, the creation of an immediate joint interest in the

property.[747]

The same principle (i.e. non-application of the attribution rules) would seem to apply in respect of net family property as such property is defined in the Family Law Act.[748] Apart from cash held in a joint bank account, most family assets (E.g. boats, automobiles, paintings, jewellry) are not acquired, used or held principally for an income-producing purpose. However, such assets are those in respect of which capital gains may be realized upon disposition, in which case the gain may be split between the spouses.

This view receives tentative support from the provisions of subsection 5(3) of the Family Law Act which provides that, while the spouses are married and are not separated pursuant to a court judgment or a written separation agreement, then where there is a serious danger that one spouse may improvidently deplete his or her net family property, the other spouse may, on application to the court, have the difference between the net family property divided as if the spouses were separated and there was no reasonable prospect that they would resume cohabitation.[749] This provision seems to imply that upon the happening of a certain event (i.e. improvident depletion of one spouse's net family property), one spouse might acquire an interest in the other spouse's net family property to the extent that he or she may obtain a court-ordered division of such property. While there do not appear to be any decided cases in this respect (the legislation having come into force on January 17, 1986), it seems that the provision might grant a veto right to the other spouse (analogous to that in the case of a matrimonial home) to prevent

such prodigality and wasting of the other spouse's net family property. However, whether such a right is equivalent to one of ownership or an ownership interest in the other spouse's net family property is not as clear; to the extent, however, that one spouse could obtain a court-ordered division of net family property, there would be a transfer of property by operation of law, which would not attract attribution in respect of income derived from, or gains realized upon the subsequent disposition of the property.

With respect to excluded property, it seems that the same situation will not obtain since the spouse who is not the registered owner of the asset does not acquire any interest in the asset.

(iv) Family Law Reform and Community of Property

Further support for the proposition that the enactment of family law reform legislation permits certain income and/or capital gains splitting was found by drawing an analogy with the marital regime of community of property. It was pointed out that in Sura v. MNR,[750] the Supreme Court of Canada held that because of the nature of the community of property regime in the Province of Quebec, the taxpayer could not split income from the community property between him and his wife. The decision turned upon the rights of the spouses during the marriage, and the court concluded that because the husband had the sole right of management of the community, he alone should pay tax on the whole income derived from that property. However, where this particular characteristic did not exist, the Tax Review Board permitted the taxpayer to

split certain property income received by him with his wife.[751] Similarly, where the husband was accountable for his dealings with the property, the Sura case was distinguished and the community property was considered to be held jointly by the spouses.[752]

One of the main themes of the Ontario Family Law Act (and its predecessor, the Family Law Reform Act) is that all net family property (including the matrimonial home) is subject to the joint and equal rights of possession and management of both spouses.[753] Thus, in contradistinction to the Sura case, where the husband alone had the right to administer the property and any rights of ownership which the wife had were future rights and did not arise until the dissolution of the community, the Family Law Act seems to give the wife present and equal rights in all net family property. This characteristic of the legislation has been relied on as another basis for asserting that the spouses may be entitled to split income and/or capital gains insofar as the same are earned and derived from net family property, including the matrimonial home.[754]

(v) Domestic Contracts

The Family Law Act (Ont.) provides that spouses may enter into domestic contracts which are defined to mean marriage contracts, separation agreements or cohabitation agreements.[755] Such agreements, which may be concluded before or during marriage, can provide for the respective rights and obligations under the marriage and upon marriage breakdown,[756] including ownership in or division of property.[757] To the extent that these agreements purport to create immediate joint ownership in assets, whether in respect of net family property or excluded property, there would

appear to be a "transfer of property" (i.e. transfer of one-half of an ownership interest) from the owning spouse to the non-owning spouse within the context of the attribution rules.[758] Thus, one-half of any income subsequently derived from the transferred property and one-half of any capital gain (or capital loss) realized or incurred upon a subsequent disposition of the transferred property will be attributed back to the transferor under subsection 74.1(1) and 74.2(1) as the case may be.[759]

Property may also be transferred between spouses on marriage breakdown pursuant to a marriage contract or separation agreement.[760] The tax consequences arising on the transfer of assets in satisfaction of the division of net family property (and/or excluded property, depending on the terms of the agreement) will differ depending on whether the transfer is made prior or subsequent to separation.[761] Essentially, as noted above, property which is transferred prior to separation and also disposed of by the transferee prior to that date will be subject to income and capital gains attribution until separation takes place; property which is transferred before separation but not disposed of by the transferee until after separation may be subject to income attribution in the interval but will not be subject to capital gains attribution.

(vi) Judicial Interpretation of the Family Law Reform Act

One of the first reported cases which dealt with Part I of the former Family Law Reform Act[762] seemed to support the notion that inter-spousal transfers of property, resulting from the enactment of the legislation, would not give rise to the operation of the

attribution rules. In Silverstein v. Silverstein,[763] the court vested in the wife a one-half interest in an income-producing property (certain rental property owned by the husband) and also ordered a transfer of a one-half interest in the matrimonial home to the husband.[764] While the question of the operation of the attribution rules was not expressly dealt with in the judgment, certain comments made by Galligan J. appeared to indicate that the transfer of the rental property to the wife would not result in the attribution of capital gains back to the husband:

> ...It also seems to me to be equitable that if a spouse is to share in a non-family asset [i.e. the rental property] that such spouse should also share the burdens that go with that asset. In this case, the Midland Avenue property has no doubt appreciated in value since Valuation Day, 31st December 1971, and upon its disposition it will be subject to capital gains tax. I have found that Mrs. Silverstein is entitled to a one-half interest in that property and it seems fair to me that she should share the capital gains tax that it will attract.
>
> While dealing with that asset I should also make this comment. Over the years Mr. Silverstein has had the benefit of a capital cost allowance which will have to be recaptured on any sale of the property. At first I thought that some adjustment ought to be made in Mrs. Silverstein's favour, since she has not had the benefit of that tax advantage. However, Mr. Silverstein has made the principal payments on the mortgage since that property was purchased, and it is clear from the financial records that the principal payments which he has made are slightly in excess of any tax savings which he has had by reason of utilizing his right to take capital cost allowance over the years. I think it is appropriate, therefore, that on any sale Mrs. Silverstein will have to bear her share of the recapture of capital cost allowance taken in the past.[765]

While the foregoing comments seem to imply that no attribution of capital gains or recapture back to the husband would take place following the transfer of property to the wife, certain elements of the case itself seemingly precluded its use as authority for the proposition that particular provisions of Part I of the former

Family Law Reform Act afforded spouses the possibility of income and capital gains splitting. First, the decision was not concerned with the application of the attribution rules in the context of a taxation dispute, but rather with a court-ordered division of property following marital breakdown. Second, the insertion of subsection 74.5(3) into the Act, which essentially provides that the attribution rules cease to be effective upon separation of the spouses, has eliminated the question of who will be subject to tax in respect of the transferred property subsequent to such date: only the transferee spouse will be subject to tax in respect of the transferred property in question following separation.

The question of whether the provisions of Part I of the former Family Law Reform Act permitted any degree of income splitting between spouses appeared to be answered in the negative by the Supreme Court of Canada decision in Leatherdale v. Leatherdale.[766] In this case, the parties separated and reached a settlement in respect of the division of family assets (i.e. assets analogous to "net family property" under the new Family Law Act). The issue in dispute concerned the division of certain non-family assets (i.e. assets analogous to "excluded property" under the Family Law Act), namely stocks and a registered retirement savings plan, both of which were in the husband's name only. In holding that the wife was entitled to a certain share of the husband's non-family assets Laskin C.J.C., speaking for the majority, stated that the provisions of Part I of the Family Law Reform Act came into play only upon the dissolution or breakdown of a marriage and not during its currency. In other words, contrary to what certain

writers initially believed to be the case, the non-owning spouse acquired no specific property interest in either the family assets or the non-family assets until a division of such assets was made pursuant to a court order or a separation agreement upon marital breakdown. Thus, the system of spousal property law introduced by the former Family Law Reform Act could be termed a deferred sharing of assets, under which no possibility for income splitting was introduced.[767]

XXI. Indirect Payments

A. General

In addition to the attribution rules discussed above, the Act contains a number of general anti-avoidance provisions which have been applied in the context of income splitting. These provisions, namely subsection 56(2) and subsection 56(4), are designed to prevent the avoidance of tax on income that was actually earned, but which the taxpayer avoids receiving by causing it to be paid to a third party or parties. These provisions are not in themselves charging provisions, but must be used in conjunction with other charging provisions of the Act in order for the payments described to be income.[768] In this sense, the provisions statutorily adopt the common law doctrine of constructive receipt -i.e. the deeming of income to be that of the person who is beneficially entitled to it rather than that of the person who actually received it.[769]

B. Indirect Benefits

(i) General

Subsection 56(2) provides that:

> A payment or transfer of property made pursuant to the direction of, or with the concurrence of, a taxpayer to some other person for the benefit of the taxpayer or as a benefit that the taxpayer desired to have conferred on the other person shall be included in computing the taxpayer's income to the extent that it would be if the payment or transfer had been made to him.

The operation of subsection 56(2) seems to involve three persons: the taxpayer; the person to whom the payment is made or the property is transferred; and the person who makes the payment or transfers the property. A simple example of the application of subsection 56(2) would be where an employer, at the direction of an employee, pays some or all of the employee's remuneration to a third party. It is not open to the employee to argue that he is not taxable on this amount because he did not receive it; under subsection 56(2) the amount paid to the third party will be included in the employee's income because the amount would be income to the employee by virtue of section 5 of the Act if the employee had received it himself.[770] This contrasts with the situation where the taxpayer receives the entire income himself and then transfers part or all of such income to his spouse and/or minor children, thereby bringing the attribution rules in subsections 74.1 and 74.1(2) into play by making a direct transfer of property.

It should be noted that, unlike the attribution sections, subsection 56(2) does not provide that the amount included in the income of the taxpayer by the operation of this rule is to be excluded from the income of the recipient. Theoretically, therefore, it would seem possible for the amount in question to be included both in the income of the taxpayer, as a result of the application of the indirect payment rule, and in the income of the

recipient, because of the nature of the receipt, unless, perhaps, it may be argued that subsection 4(4) precludes the taxation of the same amount in the hands of two separate taxpayers.[771]

It would appear that subsection 56(2) does not apply to ordinary, commercial transactions, at least where the parties are dealing at arm's length. In Miller v. MNR,[772] the taxpayer assigned to a third party certain commissions which would become payable to him from his employer in his capacity as a sales agent. The Minister argued that the commissions so assigned should be included in the taxpayer's income under the former subsection 16(1)[773] (the present subsection 56(2)). In holding that subsection 16(1) did not apply to business contracts made for adequate consideration, Thurlow J. said:

> In my opinion, Section 16(1) is intended to cover cases where the taxpayer seeks to avoid receipt of what in his hands would be income by arranging to have the amount received by some other person whom he wished to benefit or by some other person for his own benefit. The scope of the subsection is not obscure for one does not speak of benefiring a person in the sense of the subsection by making a business contract with him for adequate consideration.[774]

(ii) Purpose of Subsection 56(2)

The purpose of subsection 56(2) is to deal with the diversion of income from one taxpayer to another for the benefit, generally speaking, of the person diverting the income or as benefit that that person desired to have conferred on another. The effect of the subsection (as indicated in the employer-employee example above) is to impute receipt of the diverted income to the person who directs or consents to the diversion. That person will be liable for tax on the income to the same extent that he would be

if he had actually received it himself.[775]

Subsection 56(2) has been invoked by the Minister in a number of cases. Such cases fall into four broad categories:

(a) the diversion of income or property from one taxpayer to another;[776]

(b) the interposition of a corporation between an individual and his employer, to divert what would otherwise be employment income of the individual through the corporation, in order to take advantage of any attendant tax saving;[777]

(c) the exercise of a discretion to pay dividends to the holders of one class of shares in a corporation to the exclusion of, or in an amount disproportionate to dividends paid to the holders of other classes of shares;[778] and

(d) loans or gifts made by a corporation to relatives of shareholders of the corporation.[779]

The discussion will focus primarily on the third category of cases, as these cases are closely associated with attempts to split income among family members. In this case, although certain commentators have suggested that this is an incorrect application of subsection 56(2), it appears that the courts do not agree.[780]

(iii) Requirements for Taxation under Subsection 56(2)

The requirements that must be satisfied for subsection 56(2) to apply were set forth by Cattanach J. in Fraser Companies Ltd. v. The Queen:

> For the transaction between the plaintiff and its subsidiary to be taxable in the hands of the plaintiff each essential ingredient set out in subsection 56(2) to taxability must be present.
> These ingredients are fourfold:
> (1) there must be a payment or transfer of property to a person other than the taxpayer;

> (2) the payment or transfer is pursuant to or with the concurrence of the taxpayer;
> (3) the payment or transfer must be for the taxpayer's own benefit or for the benefit of some other person on whom the taxpayer desired to have the benefit conferred; and
> (4) the payment or transfer would have been included in computing the taxpayer's income if it had been received by him instead of that other person.[781]

Although, because of their interdependence, it may be somewhat artificial to consider each requirement separately, it is a practical way of analyzing the provision in light of the jurisprudence concerning income splitting share capital structures. The following, therefore, are the four tests, together with an analysis with respect to the manner and extent to which the tests might apply in respect of the payment of dividends.

(a) There must be a Payment or Transfer of Property to a Person other than the Taxpayer

The meaning of the phrase "transfer of property" has already been discussed,[782] and although its meaning was analyzed in the context of the attribution rules, as subsection 56(2) contains no separate definition of this phrase, it is felt that the same interpretation may be applied to indirect payments. This view is supported by the words of Cattanach J. in Fraser Companies Ltd. v. The Queen where the learned judge stated:

> The words 'payment' and 'transfer' [in subsection 56(2)] are not terms of art nor do they have a technical meaning. Their meaning is that they have in common parlance.[783]

This statement implies that Cattanach J. is taking an expansive approach to the word "transfer," as he did in Murphy v. The Queen,[784] and as Thorson P. did in Fasken Estate v. MNR.[785]

With respect to the meaning of the term "payment," such word

is not defined in the Act and therefore one must look to its private law meaning. In private law, the term "payment" is defined as "the fulfilment of a promise, or the performance of an agreement;" "a discharge of an obligation or debt."[786] Thus, "payment" appears to have a narrower, more restricted meaning, referring more to the performance of a duty, promise, obligation, or discharge of a debt or liabilty, as in the case of a debtor-creditor relationship. In the case of corporate dividends, it seems fair to say that such a dividend constitutes a payment or a transfer of property.

While a payment or transfer of property in the normal sense will be made when a dividend is paid to a shareholder (whether the company is public or private), it is the company and not the directors that makes the transfer of property to the shareholder. Accordingly, even though the first requirement of subsection 56(2) may be met on the payment of a corporate dividend, the directors are merely performing a normal function of their office with respect to corporate property. The corporate property (i.e. net earnings or profits) paid or transferred in this way is not property to which the directors necessarily have any entitlement.[787]

(b) The Payment or Transfer must be Pursuant to the Direction of or with the Concurrence of the Taxpayer

The second requirement may be satisfied in either of two respects. As one possibility, the taxpayer may direct the payment or transfer, which will involve active participation by the taxpayer in the legal act necessary to accomplish the payment or transfer.[788] Alternatively, the payment or transfer may be made

with the consent or concurrence of the taxpayer, implying that the taxpayer must give at least tacit indication of his approval.

In Murphy v. The Queen,[789] Cattanach J. rejected the taxpayer's argument that he did not transfer anything to his wife because, as a beneficiary, he did not direct the trustees to allocate a portion of the trust income to his spouse. It was held that "when the plaintiff gave up his vested right in exchange for the rights under the varied trust he was well aware and must be taken to have anticipated that"[790] the trustees would exercise their discretion in favour of his spouse.[791] This presumed knowledge and intention on the part of the taxpayer was sufficient, in Cattanach J.'s view, to accomplish the transfer of income from the taxpayer to his spouse.

In the case of a dividend, one question is whether it may be considered to be a payment or transfer of property by someone other than the corporation. For example, consider the situation in which a person holds preferred shares, on which a dividend must be paid before any dividend is paid on the common shares, unless the holders of the preferred shares agree otherwise.[792] If a preferred shareholder consents to forgo his entitlement to a dividend so that more funds are available to pay dividends on the common shares, can it be said that by relinquishing his right to a dividend, the preferred shareholder has thereby "transferred property" to the common shareholders?

In a strict legal sense, it would seem that the holder of a preferred share, qua shareholder, has not transferred anything to the corporation or to the common shareholders. The decision as to

whether to declare a dividend on the common shares may be made only by the directors authorized under the articles or by-laws of the corporation.[793] However, if the approach in Murphy[794] is taken to its logical extreme, it could be argued that the preferred shareholder has transferred his right to a dividend to the common shareholders since he might have anticipated that the directors would then pay dividends to the common shareholders, notwithstanding that he did not participate in the legal act by which such dividends are paid.[795]

Since the power to declare dividends rests with the directors, if dividends are paid to the holders of one class of shares[796] to the exclusion of, or in an amount disproportionate to, dividends on the shares of any other class, anyone who holds shares of the other class and who is not a director would not ordinarily be considered as having directed the payment of the dividend. It may be argued, however, that he has concurred in the payment if he owns a sufficient number of shares to elect a majority to the board of directors, on the theory that he has the indirect power to control the payment of dividends.[797]

If a holder of shares on which the dividend is not paid does not have voting control of the corporation and is not a director, he should not be considered as having either directed or concurred in the payment of a dividend. However, if one applies the reasoning in Murphy,[798] it could be argued that such shareholder has concurred in the payment of a dividend if it could be shown that he relinquished the legal right, if any, which he had to call for an equivalent or proportionate dividend on the class of shares held by him.[799]

Subsection 56(2) has been successfully applied where directors paid or transferred corporate property to persons who were not shareholders of the company. In MNR v. Bronfman,[800] it was held that gifts made by a company to relatives of shareholders should be added to the income of the shareholders in proportion to their respective shareholdings because the shareholders had impliedly concurred with the beneficial acts in question at the company's annual general meeting.[801]

In the Bronfman case, however, no one shareholder directly controlled the company. The case may imply that if one shareholder had controlled the company, the benefit would have been imputed to the controlling shareholder.[802] It should be noted that the Bronfman case involved the transfer of corporate assets to non-shareholders at the shareholders' determination. It would seem that this is a fundamentally different situation than the case where a company's directors declare dividends from the company's earnings in accordance with the share rights provided by the corporate constitution.[803]

(c) The Payment or Transfer must be for the Taxpayer's own Benefit or for the Benefit of Some Other Person on Whom the Taxpayer Desired to Have the Benefit Conferred

Under what type of circumstances will a payment or transfer of property by one person to another constitute a "benefit" to the transferor? One situation involves the diversion of income from a person subject to a high marginal tax rate to a person subject to a significantly lower marginal rate.[804] The transferor will benefit in that the recipient of the income, assuming he or she is

a member of the transferor's family, will pay a lesser amount of tax than the transferor otherwise would, and the transferor will continue to have the use and enjoyment of the diverted income, assuming that such income remains within his family unit.[805]

A second illustration is the case where a taxpayer incorporates a company to receive what would otherwise be wages, salary, commissions or similar income.[806] If such arrangement is successful, the "employment income" will be taxed at a flat corporate rate rather than at the progressive individual rates. If the small business deduction is also available, the effective tax rate will be reduced, and there will be a benefit from deferral of tax to the extent that the corporate rate is less than the taxpayer's marginal rate.

Another example of a diverted payment or transfer of property which will benefit the taxpayer does not involve a direct reduction in taxes. In such a case, the taxpayer diverts the payment of an amount, which would have been taxable if he had received it, to pay an obligation of the taxpayer to a third party.[807] In this case, the taxpayer benefits through the use of "pre-tax" dollars to reduce his indebtedness.[808]

In each of the above cases, subsection 56(2) has been invoked as a statutory application of the doctrine of constructive receipt. This is consistent with the statement of Cattanach J. in Fraser Companies Ltd. v. The Queen to the effect that:

> The often repeated statement is that [subsection 56(2)] embodies a portion of the general concept of constructive receipt. The general rule is that a taxpayer is only taxed upon the receipt of income or when it becomes receivable by him in the legal sense. There are certain circumstances where income receivable may be caused not to be received by him and by that

> device he achieves benefits that amount to income. In those circumstances as set forth in subsection 56(2) that is income constructively received by the taxpayer. If the taxpayer had actually received the money or money's worth and passes it on he would have been taxable on that amount. Therefore he should not be permitted to avoid tax liability by the simple expedient of directing payment to a third party without having actually received the money himself.[809]

With respect to the payment of dividends, it has been suggested that a director cannot really benefit from his decision to declare and pay a dividend, even in those situations where the director exercises a discretion to pay dividends on one class of shares to the exclusion of another class. The reason given is that the declaration of dividends by directors is a normal function of their office and whoever receives the dividends does so as a consequence of owning shares in the company.[810] This is obviously a valid point if the director is not a holder of shares which are entitled to participate in the payment of a dividend; however, if the director is also a holder of participating shares, he will stand to benefit if he is able to divert the payment of a dividend on his shares to the holder of shares of another class (presumably a member(s) of his family who is subject to a lower marginal tax rate)[811] and is then able to have the use of the diverted dividend and/or any income derived from the reinvestment of such dividend.[812]

(d) Benefit that the Taxpayer Desired to Have Conferred on Another Person

Subsection 56(2) will impute the receipt of a payment or transfer of property to the transferor, not only if the transferor is considered to have received a benefit, but also if the benefit is one that the transferor desired to have conferred upon the

recipient. The jurisprudence does not limit the application of subsection 56(2) to those cases where the transferor has enjoyed the reduction of his taxes and retained the use of the diverted payment or property.

In Smith v. MNR,[813] a diverted payment was included in the taxpayer's income in circumstances where the taxpayer had no use of the diverted payment and the transaction did not result in any discharge of the taxpayer's obligation. The taxpayer owned 49 per cent of the shares of a corporation (H Co.), which operated a Ford automobile dealership. In 1980, he incorporated a new company (New Co.) to acquire the retiring shareholder's majority interest in the dealership. The taxpayer acquired 20 per cent of the share capital of New Co. and the Ford Motor Co. subscribed for the remaining 80 per cent of the shares.

New Co. acquired most of the assets of H Co. Until the closing date of the transaction, H Co. operated the business for the account of New Co., and during the period immediately preceding the closing date, the taxpayer engaged or concurred in a number of questionable transactions. These included the sale by H Co. of certain automobiles to New Co. as part of the sale of the business, as well as the sale of the same automobiles by H Co. to customers, so that H Co. was paid twice. Also, the taxpayer signed cheques drawn on the account of New Co. in payment of certain liabilities of H Co. to the Ford Credit Corporation (FCC) and other creditors.

In summarizing the facts, the Tax Court remarked that:

> There is no evidence that [the taxpayer] had personally guaranteed any of [H Co.'s] liabilities to FCC. There is

> no evidence that any of the monies deposited to [H Co.'s] bank account found their way to the [taxpayer] personally.[814]

Nevertheless, it was held that the payments and transfers of property by New Co. to H Co. were made pursuant to the direction of or with the concurrence of the taxpayer as a benefit that the taxpayer wished to confer upon H Co. Notwithstanding that there was no element of personal benefit to the taxpayer from the transaction, the amounts were included in his income pursuant to subsection 56(2) and were taxed as though they were an appropriation of New Co.'s property pursuant to paragraph 15(1)(a).

It has been suggested that before subsection 56(2) will apply to impute the receipt of a dividend to the director of a corporation, there must be some measure of personal benefit from his decision to favour the holders of one class of shares with the payment of the dividend.[815] That is, it is not sufficient merely to show that the declaration of a dividend was a benefit that the director wished to confer. This suggestion, however, is difficult to reconcile with the decision in Smith because, as noted above, Mr. Smith apparently derived no personal benefit from the payment made to H Co.

A possible distinction may be drawn between the Smith case and the cases involving the declaration of disproportionate dividends,[816] in that H Co. was not entitled to the payments and appropriations of corporate property of New Co. Therefore, if the only persons who receive dividends are those who are legally entitled to them (i.e. the shareholders of the class of shares in question), even though this occurs as a result of the directors

exercising their discretionary powers, subsection 56(2) should not apply.[817]

(e) The Payment or Transfer Would Have Been Included in Computing the Income of the Taxpayer if it Had Been Received by Him Instead of the Other Person

In Fraser Companies Ltd.,[818] Cattanach J. was of the opinion that in order to test the taxability of a diverted amount under subsection 56(2), one must ask whether the amount would have been taxable under a particular provision of the Act if the taxpayer himself had received it.

It has been argued above that a director will be taxable in respect of a "diverted" dividend only if he owns shares of the class on which the dividend was paid.[819] This argument, however, may be unduly restrictive. If a director is not a holder of any shares, it is difficult to put forward any basis on which an amount paid to the shareholders as a dividend could be included in computing the director's income. The same should hold true if a director owns shares of a class which is not entitled to participate in the company's earnings, although this argument would not follow the decision reached in the Titeley[820] case, discussed below. If, however, a director holds shares of a class which is entitled to receive dividends, and a dividend is declared on a class of shares other than that held by the director, it is more reasonable to expect that a proportionate share of the dividend should be included in the director's income.[821]

(iv) Policy of the Department

It should be noted that the Department's policy is clearly to

apply subsection 56(2) when it feels that income splitting is the main reason for separate share classes. In response to a question raised at the 1981 conference of the Canadian Tax Foundation during the "Revenue Canada Round Table," officials of the Department stated:

> Our view, with respect to the use of several classes of shares bearing a discretionary dividend to accomplish the same result as the waiver of dividends, is the same as that for waived dividends. In a closely-held corporation where the shareholders do not deal with each other at arm's length and such a structure is essentially an income splitting scheme, subsection 56(2) would be applied. The final determination of the applicability of subsection 56(2) will depend on the facts of each case.[822]

C. Cases Involving Income Splitting Share Capital Structures

The incorporation of a company by a taxpayer permits him to pay a salary to his spouse and/or children if such members of his family work in the business. The salaries paid to such persons must be reasonable in relation to the services performed for the company.[823] Moreover, the services provided must be bona fide, in the sense that they must be related to the business of the company.[824] Under these conditions, the opportunities for income splitting by diverting business income to family members by way of salaries is limited since the family member must provide actual services to the company and any portion of a salary paid in excess of what is considered to be reasonable will be disallowed as a deductible expense.

In view of these limitations, some taxpayers have sought to split income by having their wives become shareholders in the company either when the company is first incorporated or in "midstream" after the company is carrying on business and

generating sufficient income to more fully justify an income splitting arrangement.[825] This type of approach has been advocated on the basis that the non-managing spouse could subscribe for participating shares for a nominal amount,[826] which would entitle her to receive dividends at some future date.[827] As a shareholder, she would not be obligated to provide any physical services to the company in order to participate in the company's earnings along with her husband.

Unfortunately for taxpayers, the foregoing approach has met strong judicial resistance, with subsection 56(2) proving to be a formidable legislative hurdle against dividend income splitting through the use of share capital structures. Perhaps even more unfortunate has been the lack of guidance demonstrated by the courts in their interpretation of the provisions of subsection 56(2).

In the first reported case where the owner of a business permitted family members to become equity shareholders in the business, dividends subsequently paid to the family shareholders were held to be income of the owner and not of the family shareholders. In Titeley v. MNR,[828] the taxpayers were professional optometrists who carried on business in partnership. In 1969, they formed a new company, A Co., to take over that part of their practice which involved dispensing and selling optical goods. The new company and the partnership occupied the same business premises, apparently used the same staff and for all practical purposes were under the direction and control of the taxpayers.

The new company was established with two classes of common

shares. The Class A shares were described as non-participating common shares and were voting. The Class B shares were described as non-voting, participating common shares. It appears that the "non-participating" feature of the Class A shares meant that they were not entitled to any dividends at all or to participate in any surplus assets on a winding-up. All they had was voting control of the company. The Class B shares, on the other hand, were entitled to dividends and a return of capital on a winding-up. They had no voting rights.[829]

Dr. Titeley subscribed for 200 Class A shares at $0.01 each and Dr. Carvell subscribed for 100 Class A shares at the same price per share. Mrs. Titeley purchased 2,000 Class B shares from the company for $0.01 each and Mrs. Carvell acquired 1,000 Class B shares, also at $0.01 each.

In each of the years 1970-73, the company paid each of the taxpayers a management fee of $18,000. In the same years, the taxpayers exercised their voting control to declare dividends in favour of their wives totalling in the aggregate some $65,250 to Mrs. Titeley and $32,625 to Mrs. Carvell. No cash was, in fact, paid to either of the wives; rather, the company created accounts payable to them on its books and issued non-interest-bearing promissory notes in their favour. However, the wives did report the appropriate amounts for income tax purposes in the years in question. There is no indication in the report that the wives took part in the day-to-day activities of the company and a reasonable inference is that they did not.

The Minister added the dividends to the incomes of the

taxpayers for the years in question, apparently on the basis of subsection 56(2).

Mr. Frost, the Sitting Member, found that the new company was set up for sound business reasons and in fact carried on a bona fide commercial operation distinct from the taxpayers professional practice. Accordingly, he said that A Co. was not a sham and was taxable on the income earned by it. However, he said, there was still a "broader question" to be determined, viz:

> Did the appellants go to such extremes in arranging their affairs that they caused dividends to be paid to their wives which, pursuant to subsection 56(2) of the Income Tax Act, must be considered as taxable to the appellants as if they themselves had received the dividends?[830]

In a very brief judgment, Mr. Frost dismissed the taxpayers' appeal. Without referring to any authority, he said that "business practices require some degree of normality on the part of the taxpayers."[831] (This reference was apparently to the capital structure of the comoany under which the taxpayers were legally precluded from receiving a return on their investment (i.e. dividends) because of the conditions attached to the two classes of shares). Therefore, notwithstanding that A Co. carried on bona fide commercial operations, this was enough to dispel the "unnatural" effect of the terms attaching to the " A" and "B" shares.[832] "Schemes," Mr. Frost said, "cannot be entered into for the blatant avoidance of income taxes."[833] (Again, no authority is cited). Referring to the fact that the taxpayers made all the decisions and kept control of every aspect of the business, as well as retaining for their own benefit the funds which were shown on the books of the company as dividends paids to the wives,[834]

Mr. Frost concluded that the taxpayers had gone to such lengths in their affairs that they "produced an end result unacceptable for income tax purposes."[835]

Assuming that Mr. Frost was correct in his conclusion, his failure to analyze subsection 56(2) in any detail leaves certain unanswered questions. With respect to the first condition, there was, at least, a transfer of property (i.e. dividends) to the wives, although this point is debateable since the wives never had any amount unconditionally credited to their account, but rather received unsecured promissory notes which might, in fact, never be paid. However, since "property" is defined in subsection 248(1) to include, inter alia, "a right of any kind whatsoever," it is arguable that there was a transfer of property since the promissory notes carried with them the right to demand payment of their stated value from the corporation.

With respect to the second condition, it could be argued that the payment of dividends was made pursuant to the direction of, or with the concurrence of the taxpayers since the latter, qua directors, as well as majority shareholders, had direct control over the company's affairs.

As to the third condition, this raises the question of the meaning of the word "benefit" and the time at which one is to determine whether or not a benefit has been conferred. Based on the reported facts - for example, assuming a benefit was conferred on the wives by allowing them to acquire shares in the company for a nominal consideration[836] - was Mr. Frost right in concluding that the benefit was to be determined at the time the dividends were paid rather than at the time the wives subscribed for their

shares? As a practical matter, it would seem logical to wait and see what amount of dividends, if any, are declared but it could be argued that the benefit, if any, would accrue at the time the shares are subscribed for, since the legal relationships entitling the wives to dividends came into existence at that time.[837]

With regard to the fourth condition -i.e. that the payment is to be included in the taxpayer's income to the extent that it would have been so included had the payment been made to the taxpayer - in the Bronfman case[838] it was decided that the directors of a family corporation were assessible on the value of wedding gifts made to other members of the family, notwithstanding that the directors had no legal right to enforce the transfer of such property from the corporation to themselves. The test to be applied, the court said, was whether or not the payment would have been added to the taxpayer's income if made to him; not whether the taxpayer was legally entitled to enforce payment in the first instance.

The Titeley case is distinguishable from Bronfman on its facts. In Titeley, the fact was that, according to the company's share structure, the husbands could never receive any dividends on the shares owned by them. In Bronfman, however, there was no legal reason why the directors of the company could not have paid themselves salaries or bonuses equivalent to the value of the gifts, had they so desired. However, by the same token, one could argue that there was nothing in Titeley to preclude the husbands from paying to themselves additional salaries or bonuses equal to the amounts paid as dividends to their wives. In effect, one

the amounts paid as dividends to their wives. In effect, one returns to the requirement of the subsection that there be a payment which, if made to the taxpayer, would have been included in his income. In Titeley, the payment could not have legally been made to the husbands in the form in which it was made - i.e. by way of dividends.

When, however, the substance of what was done in Titeley case is fully examined, it is not very difficult to agree with the conclusion reached. The unreported facts of the case indicate that the funds in question never left the control of the taxpayers. That is, the dividends were notionally, but never in fact, paid to the taxpayers' wives and it was apparent that this was a mere accommodation in order to permit the taxpayers to repay their shareholder loans. On these facts, subsection 56(2) might be applicable on the basis that the taxpayers directed corporate funds be paid to their wives in the form of dividends for the purpose of repaying their shareholder loans. In fact, it almost seems that the payment of dividends to the wives was an artificial transaction, since no funds ever passed through their hands.[839]

In a subsequent unreported decision of the Tax Review Board, the Chairman (Dubrule, Q.C.) refused to apply subsection 56(2) to include dividends received by family members in the income of the controlling shareholder. In McConachie v. MNR,[840] the taxpayer controlled a management company and owned 100 per cent of its voting shares. A formal trust agreement was prepared for the benefit of the taxpayer's three children under which the taxpayer's wife was a trustee. A bank loan was arranged by the taxpayer to be made available to the trustee to purchase shares in

taxpayer. The company had several classes of shares, namely Class A common shares owned by the taxpayer, and a different class of preferred shares for the taxpayer's wife and children. The shares were issued to the taxpayer's wife as trustee for each of the three children. The citation does not indicate whether the shares were issued following a reorganization of capital, at the time the company was incorporated, or whether dividends could be paid to all or only some of the classes of shares. The taxpayer's wife received a $12,000 dividend personally and a dividend of $5,000 as trustee for each of the three children during the taxation year in question. The Minister assessed the taxpayer alternatively under former subsection 75(1) and subsection 56(2) in respect of the dividends paid on the children's shares.

The Chairman held that, insofar as subsection 56(2) was concerned, the subsection had no application in this case. He suggested that subsection 56(2) would apply if the taxpayer had wages owing or a dividend payable following its declaration, and subsequently directed the company to pay the amount due to him to a third party. In these circumstances, the amount directed to be paid to the third party would be taxed in the taxpayer's hands.[841]

The Chairman went on to say that the crucial aspect of subsection 56(2) is that there be a transfer of property. In his view, such a transfer occurred when the children became shareholders of the company.[842] However, the Chairman stated that this transfer did not fall within the ambit of subsection 56(2) because, if the company did not pay dividends, subsection 56(2) would not apply. In other words, the Chairman felt that the

payment or transfer contemplated by subsection 56(2) is the allotment of the company's shares and not the subsequent payment of dividends on the shares. There is a right to receive dividends only if the directors exercise their discretion and declare a dividend on the company's shares.

The Chairman also dismissed the assessment under subsection 75(1), without apparent reasons, concluding that the property had not been transferred to the taxpayer's children.

Because of its sketchy description, the McConachie case is somewhat difficult to reconcile with the decision in Titeley. However, it would seem that if either case could be said to fall squarely within the ambit of subsection 56(2) it would be McConachie because here there was an actual transfer of funds (i.e. dividends) to the taxpayer's spouse, both in her personal capacity as well as qua trustee, whereas in Titeley, the purported payment of dividends was never really effected since the money was retained by the husbands in order to repay their shareholder loans. In McConachie, the Chairman felt that there was a transfer of property at the time that the shareholders subscribed for their shares. However, his suggestion that subsection 56(2) would apply if there was a dividend payable to the taxpayer which the taxpayer diverted to another person, may be taken to mean that the payment of dividends on the class of preferred shares, without a pro rata payment of dividends on the common shares, did not necessarily result in the taxpayer conferring a benefit upon the preferred shareholders. In other words, so long as dividends were paid solely on participating preferred shares (or, if common dividends were paid, they were not diverted by the taxpayer another person)

subsection 56(2) would have no application.

This suggestion that dividends could be paid exclusively to one class of shares without bringing subsection 56(2) into play was not accepted by the Federal Court in the case of Champ v. The Queen.[843] Here, the taxpayer and his wife were the sole shareholders of a private company, W Co. The taxpayer owned two out of three outstanding shares and his wife owned the remained share. The share capital of the corporation was reorganized into two classes of shares, Class A and Class B. Subsequent to the reorganization, the taxpayer held 600 voting Class A shares and 200 non-voting Class B shares. His wife held 300 voting Class B shares and 100 non-voting Class B shares. Thus, both before and after the reorganization, the taxpayer held two-thirds of the voting power of the corporation while his wife held the remaining one-third. After the reorganization, however, each shareholder owned 100 per cent of each of the issued class of shares. The articles of association provided, inter alia, that all the classes of shares ranked equally as to participation in the corporation's earnings and capital, and that each class was entitled to such dividends as would be declared by the directors in accordance with the corporation's articles.[844]

During the years 1974-77, the company declared dividends in the amount of $75,200 payable on the Class B voting shares held by the wife. These dividends represented approximately 25 per cent of the earnings of the corporation. No dividends were declared or paid on any other class of shares.

The Minister reassessed the taxpayer under subsection 56(2)

and included in his income $50,133, being two-thirds of the dividends declared on the Class B shares. The Minister contended that because the rights and restrictions attached to the Class A and Class B shares were identical in respect of their entitlement to participate in the earnings of the company, dividends had to be declared and paid rateably on all outstanding shares.[345] Since the taxpayer owned two-thirds of the outstanding shares, he was legally entitled to receive two-thirds of any dividends paid. By purporting to declare dividends only on the Class B shares, he had effected a transfer of property to his spouse within the meaning of subsection 56(2).

The only indication of the argument advanced by the taxpayer is the following:

> It was suggested by counsel for the plaintiff that the section of the Act relied on by the Minister did not contemplate a payment of dividends to a shareholder. It was his submission that a shareholder has a proprietary right in the dividend, and since the corporation would be obligated to pay it, no tax could be attributed to anyone else.[346]

The court dismissed the taxpayer's appeal. It held that the directors of a corporation may not declare dividends selectively as between the class of shares if the articles of association or other constating documents do not so permit. As authority for its conclusion that in the absence of express preferences between different classes of shares, shareholders are entitled to be treated equally in respect of participation in profits, Rouleau J. cited Palmer's Company Law to the effect that:

> Prima facie, the rights carried by the shares rank pari passu, i.e., the shareholders participate in the benefits of membership equally. It is only when a company divides its share capital into different classes with different rights attached to them that the prima

facie presumption of equality of shares may be displaced.[847]

Having determined that the holders of the Class A and Class B shares were entitled to equal participation in the profits, Rouleau J. held that since the taxpayer was "in full control"[848] of the corporation, he personally transferred property to his wife by not declaring dividends on any of the Class A shares and two-thirds of such property was rightfully his.[849] In other words, the learned judge disregarded the fact that it is the corporation and not the shareholder which pays the dividend, and pierced the corporate veil by treating the controlling shareholder, director and corporate entity as one person.[850]

There is, perhaps, another exolanation to the conclusion reached in Champ. Under the company's articles, any dividend declared was to be paid rateably on the Class A and Class B shares. Thus, for example, if a dividend of $100 was declared, the holder of the Class B shares was entitled to receive $33 as a dividend. In fact, the Class B shareholder received $100 and so it might be said that, under corporate law, $66 was received as something other than a dividend.[851] Since the payment of $66 was an act under the control of the director, it is reasonable to regard the payment as an appropriation of corporate assets by the director as a benefit that he wished to confer on his wife. Viewed in this manner, the Champ case is analogous to the Bronfman case, since Mr. Champ, like the directors in Bronfman, made a distribution of corporate property without the requisite authority. This raises the question whether the $66 added to Mr. Champ's income as a dividend should have been added as an

appropriation of property - a more onerous treatment in view of the loss of the dividend tax credit.

Although the right to declare dividends rests generally with the discretion of the directors, once this discretion has been exercised the rights of the shareholders flow from the terms and conditions attached to the shares. As the court observed in Champ, it is only when a corporation divides its share capital into different classes with different rights attached to them that the prima facie presumption of equality of shareholder treatment is displaced. In other words, as opposed to simply designating shares by different classes, an income splitting share capital structure could be designed by creating substantive differences between the various classes of shares.[852]

Such differences could manifest themselves in different voting rights, priority as to payment of dividends, liquidation rights, redemption features, or additional participation rights. The main requirement would be to ensure that when the directors declared a dividend on one class of shares, they would not be required, by virtue of the company's articles, to pay a dividend on another class of shares. The criteria would be: If a dividend was declared in respect of one particular class of shares, could the shareholders of another class, by virtue of the company's articles, bring an action for similar treatment by arguing that their class of shares, having identical rights, was therefore entitled to identical treatment?[853]

Subsequent to the decision in Champ, it was suggested that if the constating documents of a corporation permitted disproportionate dividends on shares of different classes:

> The holders of the shares of the other class or classes [which did not receive a proportionate dividend] would not be able to bring a personal action for their equivalent dividend and the suggestion in Champ that forebearance in the exercise of this right constitutes a transfer of property would not apply.[854]

Apparently, at least one judge of the trial division of the Federal Court (Strayer J.) agrees with this suggestion. The decision in McClurg v. MNR,[855] as in Titeley and Champ, involved the imputation of a taxable benefit to a corporate director in respect of dividends paid to his wife. Unlike the Champ case, however, the relevant articles permitted the payment of dividends on one class of shares to the exclusion of the others.[856]

In McClurg, the taxpayer and a business associate, Mr. Ellis, incorporated a trucking company. The company was authorized to issue Class A common shares, which were voting, participating, and non-redeemable; Class B common shares, which were non-voting, participating on consent of the directors, and non-redeemable; and Class C preferred shares, which were non-voting, non-participating (except as authorized by special resolution), and redeemable. It was also provided that each class of shares had the right to receive dividends exclusive of other classes of shares in the company.

The taxpayer and his associate each subscribed for 400 Class A common shares and 37,500 Class C preferred shares, and their wives each subscribed for 100 Class B common shares. All common shares were issued for nominal consideration.

Mr. McClurg and Mr. Ellis were the sole directors and officers of the corporation. The taxpayer's wife apparently worked in the business from time to time during the three years in

question, although the exact nature and extent of such work is not clear from the report. However, her most important contribution in respect of the company's formation appears to have been the assistance she provided in respect of the debt financing of the company. She guaranteed a $37,500 bank loan which the taxpayer borrowed in order to invest in the company's preferred shares. She also provided security in the amount of $25,000 by granting the vendor of the business a second mortgage on the home which she owned jointly with the taxpayer. She co-signed the taxpayer's personal guarantee to the International Harvester Company (IHC) covering future indebtedness to IHC of up to $500,000. Further, she co-signed another personal guarantee to the bank with respect to the line of credit to be made available by the bank to the company. The evidence indicates that the taxpayer's wife had personal assets of $15,000 to $20,000, so that the guarantees, as Strayer J. noted, "were not empty gestures."[857]

In the years 1978 through 1980, the taxpayers' wives each received dividends of $10,000. No dividends were paid on any of the shares owned by the taxpayer or his associate but, at least insofar as the taxpayer was concerned, he withdrew, in terms of salaries and bonuses, $33,968 in 1978, $65,292 in 1979, and $57,900 in 1980. Such withdrawals were characterized by Strayer J. as being "substantial."[858]

The Minister reassessed the taxpayer for 1978, 1979, and 1980 on the basis that in each year, $8,000 of the $10,000 in dividends paid to his wife on her Class B shares should be attributed to the taxpayer under subsection 56(2). This allocation of the $10,000

was made on the basis of the number of Class A shares (400) owned by the taxpayer in relation to the number of Class B shares (100) owned by his wife. That is, the Minister felt that the dividends declared in each year should be attributed equally to all of the common shares, no matter of what class.

The basis of the Minister's contention was two-fold. First, he argued that (without citing any specific authority), according to the general principles of company law, in the absence of a provision to the contrary, dividends must be paid equally on all classes of shares. Second, he argued that since the articles of incorporation of a company form a contract between the shareholder and the company, this contract must provide for some specific entitlement (presumably, equality with all other shareholders) to dividends. The Minister then rounded off both arguments by saying that the articles of the company contravened sound principles of company law and possibly the Business Corporations Act of the Province of Saskatchewan.[859]

In the decision of the Tax Court below,[860] Goetz TCJ. upheld the assessment on the basis that the dividends received by the taxpayer's wife were excessively disproportionate to her financial contribution to the business, and that the share structure "was a channel of Northland [i.e. the company] to funnel payments of profits to the [taxpayer's] wife."[861]

In Strayer J.'s view, the central issue in the appeal was whether subsection 56(2) should be interpreted literally in its broadest possible meaning with the result that "it could require, in the context of distribution of corporate dividends, that every such dividend paid to any shareholder of a company could be

attributed to the income of the directors participating in a decision to pay a dividend."[862] The learned judge concluded that the subsection was not so broad as to lead to such a result. Rather, he adopted two qualifications from the judgment of Thurlow J. in Miller v. MNR:[863]

(a) the taxpayer must be seeking to avoid receipt of funds that would otherwise be payable to him; and

(b) the concept of a "benefit" does not include payments made for adequate consideration.

With respect to the first qualification, Strayer J. concluded, after reviewing the articles of incorporation and the rights of each class of shares to dividends (and noting that the articles specifically provided that dividends might be paid to one class of shares to the exclusion of other classes of shares), that no part of the dividend declared on the class of shares held by the taxpayer's spouse was otherwise payable to the taxpayer. Rather, he concluded that as a matter of corporate law no dividends were payable as a matter of right on the class of shares held by the taxpayer without a resolution to that effect adopted by the directors.[864] In this respect, he relied on the fact that subsection 24(3) of the Saskatchewan Business Corporations Act[865] (under which the company was incorporated) did not require that the company's articles specify the privileges of each class of shares with respect to the payment of dividends. Accordingly, he said, since the company's articles did not provide otherwise, the directors were authorized, within their absolute discretion, not only to fix the amount of dividends payable but also to determine

which among the various classes of shares would be paid dividends. On this basis, Strayer J. distinguished the decision in Champ v. The Queen[866] where, it will be recalled, the application of subsection 56(2) to a director-shareholder was upheld on the basis that the wording of the company's articles required any payment of dividends to be made rateably among all shareholders, which was not done.[867]

With respect to the second qualification, Strayer J. concluded that the dividends paid to the taxpayer's wife did not constitute a benefit within the meaning of subsection 56(2) since, on the facts of the case, it was "not possible to say that this was an artificial device with no purpose but the avoidance of taxation."[868] In this respect, Strayer J. noted that while the taxpayer and his associate did not receive any dividends, they did receive substantial incomes from the company and their shares in the company had appreciated considerably during the years covered by the assessment. Also, in contrast to the decision reached by the Tax Court,[869] Strayer J. was of the view that the personal guarantees and periodic services provided by the taxpayer's spouse were of significant assistance to the corporation. In respect of this latter point, Strayer J. distinguished the decision of the Board in the Titeley case[870] on the basis that in that case the wives received all of the dividends without taking part in the business and held all of the company's participating shares.

It is somewhat anomalous that Strayer J. felt the need to distinguish the Titeley case since Titeley was reversed on consent judgment by the Federal Court. The learned judge made no mention of that reversal, but simply distinguished the case without

overruling it.

While Strayer J.'s decision may have pierced an outer layer of the Minister's armor, it does not appear to have left a gaping hole. On the face of it, the learned judge seems to have severely limited the application of subsection 56(2) where the articles of incorporation permit the "sprinkling" of dividends among the various classes of shares at the discretion of the directors. Unfortunately, however, for taxpayers, his reasons for judgment (i.e. the financial contribution made by the wife in respect of her personal guarantees for the taxpayer's business debts; the periodic services she provided to the corporation; and the fact that the taxpayer himself was adequately remunerated for his services notwithstanding that he received no dividends) strongly suggest that both the receipt and the quantum of dividends must bear a relationship to the capital and non-capital contributions made by the shareholder to the corporation.[87]

With respect, this line of reasoning (if this is what Strayer J. is implying) ignores the fact that the shares of many private corporations (i.e. those in the initial stages of formation, which was the case in McClurg) that pay substantial dividends are issued for nominal consideration. Strayer J. seems to imply (as did Goetz TCJ. in the first instance) that a shareholder must "earn" his dividends, presumably by either making or guaranteeing a substantial investment in the company or by providing services to the corporation. It is submitted, however, that this is an inaccurate description of the nature of the relationship between a shareholder and the corporation. The shareholder's participation

(if any) in the day-to-day affairs of the corporation and the extent of his capital investment appear to have no bearing in respect of his entitlement to his dividends.[872] All that is required is that upon his subscription for shares, the shareholder contribute to the corporation an amount not less than the fair value of the share.

In further support of his decision, Strayer J. also referred to the case of The Queen v. Parsons and Vivian[873] where the issue was whether the Minister could properly ignore the interposition of management companies set up by the taxpayers and tax them personally with respect to amounts paid to such management companies by an engineering firm of which the taxpayers had previously been employees. Urie J., after restating the definition of "sham" given by Lord Diplock in the Snook case,[874] held that the management companies could not be ignored for tax purposes since they were bona fide legal realities which were not created in order to deceive any third parties (i.e. the Minister). His lordship then referred to the definition of sham stated by Estey J. in Stubart Investments Ltd. v. The Queen[875] and said that, in his view, the corporate structure set up by Messrs. Parsons and Vivian did not contain the necessary element of deceit so emphasized in such definition.

The manner in which the Parsons and Vivian case was cited by Strayer J. - that is, that the interposition of the management companies constituted a legitimate business relationship since, inter alia, all the necessary legal instruments involved were correctly completed - indicates, perhaps, that Strayer J. felt that the legal relationship (in McClurg) between the taxpayer's

wife and the company (pursuant to which she was entitled to receive dividends if, as, and when declared by the directors), was a bona fide contractual relationship between a company and its shareholder with no intention to deceive third parties -i.e. the Minister.

In the final sentence of his judgment, Strayer J. states that, in addition to the Parsons and Vivian case, he was also bound to take into account the decision of the Supreme Court in Stubart Investments Ltd.,[876] although he does not give any indication as to the manner in which the Stubart case influenced his conclusions in McClurg. Presumably, his reference to Stubart was an implicit recognition of Estey J.'s view that, in a case such as McClurg, the taxpayer may arrange his affairs so as to minimize his tax so long as such tax-minimization arrangements do not constitute a sham.

D. Comment

The principal question raised by the foregoing discussion is whether the provisions of subsection 56(2) may be applied to the payment of dividends by a corporation to its shareholders. The statutory requirements of subsection 56(2) in relation to a theoretical payment of dividends have already been discussed. In essence, there seem to be two basic approaches to the problem: (a) the corporate law position; and (b) the tax position (not always consistent with the corporate law approach) taken by the Department and partially supported by the courts.

In corporate law, the basic presumption of equality among shareholders requires, inter alia, that each share carry equal

dividend rights and that no discrimination can be made among them. In other words, unless the corporation's articles provide otherwise, the directors are restrained from acting capriciously in terms of their declaration of dividends and each shareholder must be paid rateably in respect of the number of shares which he owns.

In this regard, at least, the decision in Champ would appear to be on steady ground since, in that case, the company's articles themselves provided that all dividends would be paid according to the number of shares each individual shareholder held. Thus, when dividends were paid exclusively on Mrs. Champ's shares without any payment in respect of Mr. Champ's shares, Mr. Champ, qua director, violated the company's articles. This violation was the basis upon which Rouleau J. upheld the Minister's assessment.

But how, then, can we reconcile the Titeley decision with Champ? In Titeley, the company's articles clearly displaced the legal presumption that all shareholders are to be treated equally (which is perfectly valid since corporate law permits a company to attach different rights and conditions to its shares so long as such rights and conditions are set out in the articles) and gave only the wives the right to participate in the company's earnings. Thus, a payment of dividends to the wives only was perfectly legitimate insofar as corporate law is concerned. Perhaps, if the matter had stood there, the taxpayers might have upset the assessment (although this itself is a doubtful proposition, given Mr. Frost's fervent opposition to the entire scheme). However, although the plan was formally correct, it is submitted that it should not have been allowed to stand for the simple reason that,

whereas dividends were declared payable to the wives on the company's books, no cash ever passed into their hands and the entire transaction was merely carried out to enable the taxpayers to repay their shareholder loans.

The decision of the Federal Court - Trial Division in McClurg appears to offer some hope for taxpayers who seek to split income through share capital structures. The decision may be viewed in two respects. First, the court appears to accept that, where the articles of the company are drafted so as to permit the payment of dividends to one class of shares to the exclusion of any other class of shares, subsection 56(2) will not apply to attribute a payment of dividends to a director who declares such dividends, notwithstanding that the director is also the controlling shareholder of the company and no dividends are declared in respect of the class of shares which he personally holds.

The second aspect involves Strayer J.'s notion of the meaning of "benefit" as the term is used in subsection 56(2). In referring to the Miller[877] case (where Thurlow J. held that subsection 56(2) could not apply to contracts made for adequate consideration), the learned judge concluded that no benefit could obtain under subsection 56(2) because the taxpayer's wife had contributed to the establishment of the company through her personal guarantees and through the provision of physical services. In effect, Strayer J. is saying that the wife received no benefit because she provided adequate consideration for the dividends she received. Thus, it seems implicit that Strayer J. would have applied subsection 56(2) if he had felt that the quantum of dividends was

unreasonable or was not commensurate with the degree of consideration provided, or if the wife had provided no consideration at all. One might even speculate that his lordship was inclined to the view that, just as the payment of a salary to an employee must be "reasonable in the circumstances" in order to be fully deductible,[878] so the quantum of a dividend, in order to avoid the application of subsection 56(2), must also be reasonable, at least in respect of the shareholder's financial contribution and/or services provided to the company. If these types of conditions are attached to the payment of dividends in private, closely-held corporations, the scope for income splitting in this manner would appear to be considerably reduced.

Insofar as the tax position is concerned, strictly speaking, the payment of a dividend by a corporation, so long as the payment is made in accordance with the company's articles, should be taxable only in the hands of the shareholder by whom it is received and not in the hands of any other party. The dividend is declared to be payable by the directors qua directors, and is made by the corporation and not by the directors in their personal capacity.

The foregoing propositions are not always accepted without question, however, when the case involves shareholders of a private, closely-held corporation, who do not deal with each other at arm's length, and the share structure is essentially a vehicle for income splitting. In this situation, the disconcerting factor is the fact that the taxpayer, as director, is in the position to authorize the distribution of dividends either to himself or to his wife, or to declare large dividends on his

wife's shares alone. It is this element of choice, coupled with the tax advantages achieved through income splitting with the taxpayer's wife which offended Mr. Frost in the Titeley case. Mr. Frost had no reservations with respect to piercing the corporate veil, ignoring the distinction between a corporate entity, its directors and its shareholders, and holding that the payment of a dividend will be taken to be made at the direction of the shareholders and not by the director qua director.

In McClurg, the taxpayer obviously learned from the error made by the taxpayer in Champ by carefully drafting the company's articles so as to displace the presumption of shareholder equality. But the length to which Strayer J. went in emphasizing the fact that the husbands had taken significant salaries for their work and that the wives had made monetary contributions to the company suggests that each case of this type depends on the specific facts in question.[879]

After McClurg, a basic question that remains is whether a court will uphold an income splitting scheme where substantial dividends are paid to a spouse who makes very little or no contribution to the company other than by paying a fair value (i.e. nominal consideration) for the company's shares.[880]

Whereas, in terms of corporate law, a director may declare disproportionate dividends so long as the company's articles so permit, it is submitted that a wide-open dividend income splitting scheme may nevertheless contravene the interpretative guideline laid down by Estey J. in Stubart Investments Ltd. v. The Queen to the effect that:

> The formal validity of a transaction may not be sufficient to uphold a tax plan where the taxpayer's procedures blatantly violate the 'object and spirit' of a particular provision in the Act, even though the violation may not be sufficient to characterize as 'artificial' in the sense of subsection 245(1).[881]

In effect, if taxpayers are permitted to split income through share capital structures, the obvious intent (i.e. the "object and spirit") of the income attribution rules will be destroyed, if not seriously weakened. The attribution rules are designed to prevent income splitting through direct as well as indirect transfers of property. If taxpayers are permitted to split income through share capital structures, they will obviously succeed in accomplishing indirectly what cannot be achieved through the medium of direct transfers and loans.

E. Planning Possibilities

Following the decision of the Tax Court in McClurg (but prior to its reversal on appeal to the Federal Court - Trial Division), it appeared that it was not sufficient merely to state in the company's articles that a dividend might be declared on a particular class of shares to the exclusion of any other class, or that a proportionate dividend would not be declared on all other classes of shares. Such a discretionary dividend, it seemed, would bring subsection 56(2) into play. It was suggested, however, that there was an alternative share capital structure (termed a "dividend reserve account") which would be better able to withstand an assessment under subsection 56(2).[882] In view of the qualifications and apparent conditions which Strayer J. attached to his decision in the Federal Court decision in McClurg, and until the matter is decisively settled on appeal to a higher

court, taxpayers may wish to implement a dividend reserve account in their tax planning.

(i) Dividend Reserve Account

The Department has apparently indicated that it would not challenge a share structure that provided that if a dividend was declared on shares of one class to the exclusion of, or in a disproportionate amount on, shares of other classes, a proportionate amount would be set aside in a special account in the retained earnings of the company for eventual dividends on shares of the other classes.[883]

The "dividend reserve account" would permit the directors to exercise their discretion to pay disproportionate dividends and ensure that the holders of shares of other classes would be entitled to receive a proportionate share of the distributable earnings of the corporation at some future date, or would receive a preferential right to such a distribution on a winding-up or liquidation. The corporation's articles would provide that dividends could be declared on one or more classes of shares to the exclusion of others, but to the extent that any class of shares failed to receive its proportionate share of dividends there would be an increase in its dividend entitlement account, to be satisfied by later dividends. Such a structure would allow for timing differences in dividends on various classes of shares, without, at least in theory, permitting the payment or transfer of corporate assets to one class of shareholders at the expense of another class.

The Champ decision would not appear to negate this type of share structure as a means of income splitting through dividends,

so long as the company's articles were drafted with the requisite particulars. If, however, the rationale in McClurg is that a shareholder may not receive dividends that are "excessive" in relation to the amount of capital and/or labour he has invested in the corporation, then the mere fact that the majority shareholder will ultimately receive a proportionate dividend may not be pertinent, and the share structure may still be vulnerable to attack because it allows the directors to exercise a discretion in respect of the payment of dividends on the different classes of shares.

There is also, it seems, at least one other problem associated with the concept of a dividend reserve account and that is simply the question of whether or not the corporation will have sufficient funds at the requisite time in order to satisfy the dividend entitlement of the unpaid class of shareholders. If the corporation is allowed to pay dividends to the limits of its solvency on one class of shares, it may not be able to satisfy the entitlement of other classes, so that the controlling shareholder may again open himself to a subsection 56(2) assessment. To improve the chances for success, it is submitted that the directors should not pay dividends on any class of shares beyond the proportionate part of the corporation's ability under the relevant solvency tests to pay dividends at that time.[884] Such a restriction might, of course, diminish the extent to which the dividend reserve account could be used to split income through dividends.

F. Transfer of Income Rights

(i) General

Subsection 56(4) provides that:

> Where a taxpayer has, at any time before the end of a taxation year (whether before or after the end of 1971), transferred or assigned to a person with whom he was not dealing at arm's length the right to an amount that would, if the right thereto had not been so transferred or assigned, be included in computing his income for the taxation year because the amount would have been received or receivable by him in or in respect of the year, the amount shall be included in computing the taxpayer's income for the taxation year unless the income is from property and the taxpayer has also transferred or assigned the property.

Subsection 56(4) applies where a taxpayer has transferred or assigned[885] to a person with whom he is not dealing at arm's length,[886] the right to an amount that otherwise would have been included in computing his income because it would have been received or receivable by him in that year.[887] The subsection provides that in these circumstances the amount shall be included in computing the taxpayer's income unless the income is from property and the taxpayer has also transferred or assigned the property.

Although the apparent purpose of subsection 56(4) is to provide an obstacle to the non-arm's length switching of income, the practical utility of the provision has been questioned since it seems that the same result would be achieved by the application of subsection 56(2).[888] In fact, in many cases where reference is made to subsection 56(4), it is made along with a reference to subsection 56(2), indicating a certain overlapping application and perhaps interchangeability between the two provisions.[889]

Although subsection 56(4) requires that amounts received or receivable by the transferee or the assignee be treated as the

taxpayer's income, the subsection does not provide (as is the case with subsection 56(2)) for the deletion of such amount from the transferee's income. Thus, for example, an assignment of rental income from certain real property to someone not dealing at arm's length with the assignor would result in the income being taxed in the hands of both the assignor and the assignee. There do not appear to be any reported cases of such an occurrence although the Department does seem to recognize the possibility of double taxation in the case of a deliberate attempt to evade or avoid taxation.[890]

(ii) Exception

Subsection 56(4) appears to encompass a transfer or assignment of rights to income from all sources, whether from property, a business, an office or employment, or any other source. There is, however, one situation where the subsection is said not to apply, namely, if the income in question is from "property" and the taxpayer has also transferred or assigned the property. As already noted, "property" is defined in subsection 248(1) as including, inter alia, a "right of any kind whatsoever, a share or a chose in action." This aspect of the definition seems to result in a paradox in which, theoretically, subsection 56(4) can never apply because the income right which is transferred or assigned is, by definition, "property" which, in effect, is transferred or assigned to the other party. However, in view of the principle that a statutory provision should not be interpreted so as to produce an illogical or absurd result, it would appear that, for the exemption to apply, the property from which the income is derived must be separate and distinct from the income

right itself and be property of a kind which is capable of retention by the taxpayer after the income right is transferred or assigned.[891]

(iii) Sale

Unlike subsection 56(2), subsection 56(4) specifically refers to a "transfer." By the use of this word, the subsection is more closely akin to the attribution rules contained in subsection 74.1 et. seq. Since it has been held that a "transfer" for the purposes of the attribution rules includes a bona fide sale,[892] it seems reasonable to conclude that a sale of a right to income would not avoid the application of subsection 56(4).[893] However, in Miller v. MNR,[894] it was held that subsection 56(2) did not apply to bona fide sales in a commercial transaction. For our purposes, however, the exception contained in the Miller case would seem to be academic since transfers of rights to income to or for the benefit of a spouse or minor child of the transferor will be non-arm's length transfers which will, by definition, result in the application of subsection 56(4).[895]

It would appear that a "loan" would not fall within the ambit of subsection 56(4). In Fraser Companies Ltd. v. MNR,[896] the plaintiff, a Canadian corporation, loaned funds, interest-free, to a wholly-owned subsidiary resident in the United States. The subsidiary, in turn, loaned the funds to another company (at arm's length) and earned interest income in respect of this loan. The Minister assessed this interest income in the hands of the Canadian parent (the plaintiff) under both subsection 56(2) and subsection 56(4). Cattanach J. vacated the assessment on the

ground that a loan did not constitute a transfer of property. However, as in the case of a "sale," this result would seem to be largely superfluous for our purposes since a loan within the family unit will now be subject to income attribution by virtue of subsection 74.1(1) or subsection 74.1(2).

(iv) Capital vs. Income

Notwithstanding the very broad statutory definition of "property,"[897] the courts have nevertheless drawn a distinction between property that is a capital asset and property which merely represents an income right. In Evans v. MNR, Cartwright J. expressed the matter in the following terms:

> With the greatest respect for the contrary view entertained by the learned judge, I cannot agree that the fact that a bare right to be paid income can be sold or valued on an actuarial basis...requires or permits that right to be regarded as a capital asset. I do not think that in ordinary language a right to receive income ... would be described as a capital asset. If it were all that [a taxpayer] possessed, I would think that the natural and accurate answer to the question 'Has she any capital?'...would be 'No, but she has substantial income.'[898]

And, in Purcell v. MNR[899] it was held that a 20 per cent interest in the production from an oil property was not a capital asset but merely a right to receive possible future income.

In the context of subsection 56(4), it would seem that "property" should be given the meaning of "capital asset" rather than an "income right," as distinguished in the foregoing cases. Thus, for example, the right to receive dividends from particular corporate shares would constitute "property" within the meaning of subsection 248(1), and would be capable of an assignment or transfer as such, but it would not be the property referred to in subsection 56(4), which would be the shares themselves.[900]

In the context of income splitting, there is one reported case where subsection 56(4) was successfully invoked by the Minister in preventing a taxpayer from transferring a right to income to a family member. In Robinson v. MNR[901] the taxpayer, in a transparent attempt to avoid the application of former subsection 74(1), allegedly loaned his wife a large sum of money by way of a written demand note. In fact, there was never any direct allocation of money to the wife because the money at all times remained in the spouses' joint bank account. On the basis of such "loan," the taxpayer argued that one-half of the interest income derived from the joint account should be taxed in his wife's hands and the other half in his hands. It was held that since the money remained in the joint account and was not allocated to the wife, the conclusion to be drawn was that the taxpayer had merely assigned the right to receive the interest income to his wife in which case, by not transferring the capital sum itself, the interest income (i.e. the entire amount earned in the account) was taxable in the taxpayer's hands by virtue of subsection 56(4).

In fact, the entire transaction in Robinson appears to fall within the definition of a "sham" -i.e. "acts done or documents executed by the parties ... which are intended to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intended to create."[902]

The judgment in Robinson seems to indicate that, insofar as

subsection 56(4) is concerned, the Tax Court will apply the "capital vs. income" distinction expressed by Cartwright J. in the Evans case -i.e. the bank deposit in Robinson constituted "property" for the purposes of subsection 56(4), while the interest income derived from such deposit and sought to be transferred to the taxpayer's wife, constituted the "income right" in question.

(v) Property Income vs. Business Income

The distinction between "property income" and "business income" has already been discussed above.[903] As in subsection 74.1(1), subsection 56(4) speaks only of "income from property," thus creating the presumption that income from business is meant to be excluded. The practical implication is that a transfer or assignment of business income cannot come within the scope of subsection 56(4), even if the business itself is also transferred or assigned.

G. Conferral of Benefits

Subsections 245(2) and (3) provide as follows:

> (2) Where the result of one or more sales, exchanges, declarations of trust, or other transactions of any kind whatever is that a person confers a benefit on a taxpayer, that person shall be deemed to have made a payment to the taxpayer equal to the amount of the benefit conferred notwithstanding the form or legal effect of the transactions or that one or more persons were also parties thereto; and, whether or not there was an intention to avoid or evade taxes under this Act; the payment shall, depending upon the circumstances, be
>
> (a) included in computing the taxpayer's income for the purpose of Part I,
>
> (b) deemed to be a payment to a non-resident person to which Part III applies, or
>
> (c) deemed to be a disposition by way of gift.
>
> (3) Where it is established that a sale, exchange or other transaction was entered into by persons dealing at arm's length, bona fide and not pursuant to, or as part

> of, any other transaction and not to effect payment, in whole or in part, of an existing or future obligation, no party thereto shall be regarded, for the purposes of this section, as having conferred a benefit on a party with whom he was so dealing.

(i) Purpose of Subsection 245(2)

Subsection 245(2) is designed to enable the Minister to bring within the provisions of the Act any benefit conferred by one person on another as a result of one or more transactions of any kind, except those specified in subsection 245(3) -i.e. a transaction which is: (i) at arm's length; (ii) bona fide; (iii) not pursuant to or part of any other transaction; and (iv) not to effect payment, in whole or in part, of any other transaction. For the transaction to be exempt, it must meet all four of these conditions.

(ii) Requirements of Subsection 245(2)

Subsection 245(2) operates in two stages. The first requires a finding that a benefit has been conferred by one person on another as the result of one or more transactions, regardless of the form or legal effect of the transaction. The second stage involves a classification of the payment for tax purposes, regardless of whether there was an intention to avoid or evade taxes.

(iii) Conferral of a Benefit

Many benefits are intangible or personal, and would therefore seem inappropriate as a subject for taxation. For example, a marriage between two persons or the adoption by one person of another can be said to confer a benefit on either or both parties, but one could hardly say that such benefit should attract tax. It would therefore seem that the type of "benefit" contemplated by

subsection 245(2) would not extend to mere personal satisfactions or other non-proprietary benefits.

The term "benefit" seems to have a broader meaning than "gift." For there to be a gift, there must be a voluntary and intentional transfer of property on the part of the donor without any expectation or receipt of consideration for that property.[904] An involuntary or unintentional transfer of value from one person to another cannot be classified as a gift, although the recipient of the value may be considered as having received a benefit.[905]

The benefit must be conferred as a result of one or more "transactions," a word of broad meaning. ubsection 245(2) refers to "sales, exchanges, declarations of trust, or other transactions of any kind whatsoever," while subsection 245(3) speaks of a "sale, exchange or other transaction." All the expressions, except declaration of trust, require agreement or consent between at least two persons, and relate to a transter of property. Only a declaration of trust may involve the unilateral conferral of a benefit.

(iv) Classification of the Payment

Any benefit conferred under subsection 245(2) is deemed to be a payment to the recipient of the amount of the benefit, and such payment may be treated in one of three ways, depending on the circumstances. If the payment is of an income nature, it will be included in the income of the recipient under paragraph 245(2)(a). If the payment is of a capital nature, it may be treated as a gift under paragraph 245(2)(c). Since there is no longer any gift tax in Canada, neither the taxpayer nor the recipient will have any

gift tax to pay. However, it seems that subsection 69(1) may deem the taxpayer (i.e. donor), inter alia, to have disposed of the property at fair market value, thereby subjecting the transaction to capital gains tax. If the benefit is conferred by a Canadian resident on a non-resident, the provisions of Part XIII will apply and the benefit may be subject to witholding tax.[906]

It should be noted that subsection 245(2) will apply even where "one or more persons were also parties thereto ..." In the context of income splitting, such other person has frequently turned out to be a corporation. Thus, as in the cases decided under subsection 56(2), we are dealing with a situation where a controlling shareholder confers a benefit upon other members of his family through the medium of a corporation.

Perhaps the leading case in this area is that of MNR v. Dufresne.[907] In this case, Mr. Dufresne was the controlling shareholder in a private family-owned corporation. Until 1960, he owned 91 per cent of the issued common shares of the company, with his wife and children holding the remaining nine per cent of the shares. In that year, all the common shareholders were granted rights to acquire additional shares at $100, the par value; at the time of the granting of the rights the book value of the shares was $1,421 per share. The taxpayer and his wife refrained from exercising their rights but their children exercised their own rights in full. As a result, the children became owners of 35 per cent of the company's stock, while the taxpayer and his wife's relative shareholdings were reduced to 65 per cent.

The Minister invoked the provisions of former paragraph 137(2)(c)[908] and contended that, by not exercising his right to

acquire additional shares at par, the taxpayer had conferred an indirect benefit upon his children equal to the difference between the value of the children's shareholdings before the options were granted and the value of their shareholdings after the rights were exercised, with an allowance made for the value paid in by the children in respect of the additional shares acquired by them. The resulting figure, the Minister argued, was a benefit conferred by the taxpayer upon the children which, by virtue of former paragraph 137(2)(c), was deemed to be a disposition by way of gift.

The situation, in effect, was that because the taxpayer refrained from exercising his own rights, his share of the value of the company was greatly diminished and the shareholding value of his children increased by exactly that amount, which the Minister asserted was the benefit conferred.

The taxpayer's main defence was that, by virtue of former subparagraph 8(1)(c)(iii)[909] he had not conferred ay benefit upon his children.

Jackett P. upheld the Minister's assessment. He first said that he rejected the taxpayer's submission that subparagraph 8(1)(c)(iii) operated to invalidate the assessment. He pointed out that if it were not for this subparagraph, the subsection itself (former subsection 8(1)) would have made all the shareholders of the company liable to include in their incomes the amounts of the respective benefits, if any, conferred on them by the company through the granting of rights to buy shares at par (i.e. less than book value). Subparagraph (iii) exempted them from this

liabilty; it had no other effect, and in particular it did not have the effect of exempting the taxpayer from any gift tax that might be imposed on him, even though this liability might arise from a series of transactions of which the company's granting of subscription rights to the shareholders was one. In a footnote, the President said that in any event the benefit here in question was not conferred on the children by the "conferring" on all the shareholders of the right to acquire additional shares at par; it was the subsequent exercise of this right by the children, together with the decision of the taxpayer and his wife not to exercise it, that resulted in the benefit being conferred.

The learned President then went on to say that in his view the appeal had to be decided by answering the question of whether it had been established that the "result" of one or more "transactions" conferred a "benefit" on the children, within the meaning of those words as used in subsection 137(2). If the result of the transaction was that a benefit was conferred, it followed from the words of subsection 137(2), first that it did not matter what form the transaction took or what its legal effects were, and second that there did not have to be an intention to avoid or evade taxes.

There were three questions, said the President, which had to be answered: (1) Was a benefit conferred on each of the children in the two years; (2) if so, was it conferred by the taxpayer; and (3) if so, was the benefit the "result" of one or more "transactions?" He then proceeded to deal with these questions in reverse order.

The result of the acquisition of the shares by the children

was that they became owners of 35 per cent of the stock of the company as opposed to the nine per cent they owned before. "Certainly," the President said, "this `result' flowed from at least one transaction - that is the subscription contract - in the very special circumstances in which it was made possible for each child to enter into his or her subscription contract with the company."[910] It was therefore not necessary for him to decide, said the President, whether the other acts that took place as a necessary part of the action required to create those special circumstances were "transactions" within the meaning of the statute.

The question of whether a benefit had been conferred by the taxpayer could not be answered, said Jackett P., without taking account of "ordinary well known facts of life in the world of affairs."[911] It was true that the resolution granting the subscription rights was passed by the Board of Directors; but it seemed to him that, on a balance of probability, the taxpayer, as owner of 91 per cent of the company's shares and the head of the family, had the controlling influence in determining the course of events. The sequence of events were all pre-arranged by the taxpayer "with a view to achieving the result of increasing the children's proportions in the ownership of the stock of the company."[912] The benefit, if there was one, constituted an increase in the children's relative shareholdings at the expense of a decrease in the taxpayer's shareholdings; and if there was a benefit, it was conferred by the taxpayer.

The last question was whether a benefit had in fact been

conferred. It was clear, said Jackett P., that the preliminary proceedings and the appeal were conducted on the mutual assumption that a benefit had been conferred on the children; and since the correctness of the assumption had not been challenged by the taxpayer, the point had to be determined against him.

It is submitted that the essence of the matter lies in the footnote referred to above, in which Jackett P. said that the benefit did not lie in the granting to the children the right to buy additional shares at par, but rather in the exercise of that right by them coupled with the decision of the taxpayer and his wife not to exercise their own rights. Strictly speaking, however, it was the corporation, and not the taxpayer, which granted the children the right to purchase the shares at par; therefore, the benefit could not have been conferred by the taxpayer. The President disposed of this argument by saying that the taxpayer's controlling influence over the company's affairs enabled him to make all the arrangements which resulted in the conferral of the benefit by the dual action of the children subscribing for additional shares without their parents doing likewise.

It would seem that, based on the Dufresne case, what counts for tax purposes, insofar as subsection 245(2) is concerned, is the intention to confer a benefit. If this were not the case, one can imagine a situation where a large public company made a rights offering to all its common shareholders giving them the right to purchase the company's shares below market value. It is obviously inconceivable that all those shareholders who did not exercise their rights could be assessed for gift tax on the ground that they conferred a benefit on the other shareholders.[913]

The conclusion to be drawn, it seems, is that it is the planning and arranging of the company transactions with a view to benefiting some of the shareholders that is the determining factor. The only mention of intention in subsection 245(2) (as in the case of former subsection 137(2)) is in connection with the evasion or avoidance of taxes, which was not an issue in Dufresne; as far as conferring a benefit is concerned, the subsection merely states that where the result of certain transactions is that a person confers a benefit on another, tax liability arises. Nevertheless, it does seem implicit in Jackett P.'s judgment that the element of intention is introduced.[914]

In the subsequent case of Levine Estate v. MNR,[915] the question involved was basically the same as that in Dufresne, and it has been said that both decisions illustrate the fact that someone may make a gift to another by not doing anything.[916]

In Levine, the deceased had owned 2,000 no-par-value shares in a private company while his son owned the remaining 500 shares. The deceased received legal advice regarding tax planning and as one result the authorized capital of the company was increased from 2,500 shares to 27,500, and each shareholder was given the right to subscribe for an additional 10 shares for each share owned by him, at the price of $1 per share. The son exercised his rights in full, but his father acquired only 500 additional shares. The result was a reduction in the father's equity in the company from 80 per cent to 30 per cent with a corresponding increase in the son's equity from 20 per cent to 70 per cent. At the same time, the father agreed to sell to each of his three

daughters-in-law 800 common shares at $37.50 per share; and the son sold 1,500 of his shares to a family trust for $37.50 per share.

The Minister assessed the father for gift tax on a "gift element" of $190,000 in the transfer of the shares to his son, and $30,000 in the sale of the shares to the daughters-in-law. For reasons not stated in the report, the Minister consented to the appeal in respect of the second item, so that only the transfer to the son was in issue before the court.

The basis of the Minister's contention was that the change in the son's ownership from 20 per cent of the issued common shares to 70 per cent constituted a transfer from the father to the son. He argued that such increase in the value of the son's shares was an indirect gift under former paragraph 111(2)(b)[917] or, alternatively, an indirect transfer in the nature of a disposition by gift under paragraph 137(2)(b),[918] and so subject to gift tax under Part IV of the Act.

The taxpayer stressed three main positions: (1) the assessment could not stand because it was made on an assumption of fact which did not exist; (2) the acquisition of the shares by the son had a commercial purpose; and (3) if the acquisition did contain a gift element, it applied only to 3,500 shares and not to 5,000 shares (i.e. to the number of shares acquired by him less those shares sold to the family trust).

With respect to the first argument, Sweet D.J. disposed of it simply by referring to the notice of assessment which read, inter alia: "Value of gift element in transfer of shares of Abe Levine and Sons to Weldon."[919] This, he said, clearly indicated

the Minister's assumption of a transfer from the taxpayer to his son.

At this point, Sweet D.J. remarked that the taxpayer did not assign any shares to his son; rather it was the company that received payment for the shares issued to the son. However, his lordship felt that it was made quite clear in the Dufresne case "that when a shareholder who has effective control of a company causes, by a 'rights issue,' whereby shares can be acquired by shareholders at a price less than their actual value, equity in that company to flow from him to another shareholder, there can be a gift element or 'benefit' involved in the acquisition, by that other, of shares issued pursuant to the rights. This is so though the controlling shareholder did not assign any shares issued by the company pursuant to the rights."[920]

With respect to the taxpayer's second argument, Sweet D.J. found that the son's acquisition of the shares did not have any true commercial purpose. The learned judge did not state what such a true commercial purpose might consist of, rather he felt that the son had been adequately remunerated (i.e. in the form of salary) for the services which he provided to the company and that it was not common business practice to transfer such a large percentage of a company's issued shares simply as a reward for an employee's past services.

With regard to the taxpayer's final argument, Sweet D.J. dismissed it summarily, merely stating that, under the rights subscription, the son exercised his rights to purchase 5,000 shares and not 3,500 shares. Therefore, if the gift element

applied, it applied to 5,000 shares and not to only 3,500 shares.

In dismissing the appeal, Sweet D.J. said that he found on the evidence that the taxpayer, using the control he had in the company, had caused rights to be made available to shareholders "with the intention that [his son] would subscribe for the rights which he did and that [the taxpayer] would refrain from subscribing for all of the rights for which he might have subscribed,"[921] so that in the end the son would have considerably more shares at the expense of a decrease in his father's percentage of ownership. There was no essential difference, he said, between what was done in this case and an actual transfer of shares of the capital stock held by the taxpayer to his son.[922]

It is submitted that Sweet D.J.'s characterization of the transfer in Levine as a transfer of shares from the taxpayer to his son is consistent with the definition of "transfer" formulated by Thorson P. in Fasken Estate v. MNR[923] for the purposes of the attribution sections. In Levine, as in Dufresne, the majority shareholder, in effect, divested himself of a controlling share interest, and such controlling interest subsequently became vested in the company's minority shareholders. The means by which this result was accomplished, namely through a rights offering, was a circuitous one, but this did not make the transaction any less a transfer.

It would also seem that the transaction in question constituted a "disposition" within the scope of section 69. The present subsection 245(2) is the same as the former subsection 137(2) except that paragraph "(b)" now applies to Part XIII instead of Part III, and paragraph "(c)" now reads "deemed to be a

disposition by way of gift," whereas previously the phrase was followed by the words "to which Part IV applies," thus making it liable for gift tax. Now, however, there is no gift tax and so one might ask what is the effect of leaving this provision in the Act, minus those words? Does the provision bring the taxpayer within the ambit of subparagraph 69(1)(b)(ii)? This provision states that where a person has disposed of "anything" to any person by way of gift inter vivos, he shall be deemed to have received proceeds of disposition equal to fair market value. In Levine, as in Dufresne, there was no statutory "disposition" within the meaning of paragraph 54(c), nor were any actual proceeds of disposition received by the father, but it was found that he had conferred a benefit on his son (the children, in Dufresne), which was a gift, so that he would presumably fall within subsection 245(2). Would it not then follow that he (i.e. the father) had "disposed" of something under subparagraph 69(1)(b)(ii), so that he would be deemed to have received proceeds of disposition at fair market value? The answer would seem to be "yes."

The statutory definition of the word "disposition" in paragraph 54(c) is not exhaustive (the operative word is "includes" as opposed to "means") and so the word may logically be extended to also refer to "the parting with, alienation of, or giving up property."[924] It seems clear that the taxpayers in both Levine and Dufresne indirectly parted with or gave up property; that is, they parted with controlling interests in their respective companies through the means of a rights offering.

It should be noted that the transactions or arrangements carried out in Dufresne and Levine have not always been considered to have resulted in the conferral of a benefit within the meaning of subsection 245(2). In Marsland v. MNR[925] a husband and wife owned 94 per cent of the issued shares of a manufacturing company. In their capacity as directors, they decided to issue 350 shares to their son who, at all material times, was an employee of the company. The shares were sold to the son for $100, whereas their book value at the time was $675 per share. As a result of the issuance, the son acquired direct control of the company; in effect, his shareholding increased from six per cent to 94 per cent, while the shareholding of his parents declined from 94 per cent to six per cent.

The Minister, relying on the decision in Dufresne, contended that the parents had conferred a benefit on their son within the meaning of former paragraph 137(2)(c) equal to the difference between the share issuance price of $100 and the book value of $675, times the number of shares issued (i.e. 350).

It was held that, on the particular facts of the case, and especially in view of the fact that the son was a valuable employee to the company, any benefit which was conferred upon him was taxable under former section 85A (the present subsection 7(1)) and not under paragraph 137(2)(c).

It would appear that the Marsland case is basically indistinguishable from Dufresne or Levine. In all three cases, the director and controlling shareholder (in the case of Marsland, the husband and wife) of a private, closely-held company carried out certain transactions, in his capacity as director, the result of

which was to enable theretofore minority shareholders (with whom the director did not deal at arm's length)[926] to acquire a majority shareholding interest in the company. In Dufresne and Levine, the change in shareholding interests was achieved through a rights offering, while in Marsland such change was produced through the issuance of treasury shares at a substantial discount from book value. However, if one removes the fact of the non-exercise of rights (by the parents) in Dufresne and Levine, one is left with a situation identical to that in Marsland -i.e. a transfer of treasury shares at a substantial discount resulting in a change in shareholder control of the company.

In Marsland, the Board distinguished the Dufresne case on the basis that in Dufresne none of the taxpayer's children were employees of the company. However, the Marsland case was decided prior to the judgment of the Federal Court in Levine, where the taxpayer's son was an employee of the company. To this extent, then, the decision in Levine may be said to overrule the judgment in Marsland.

Conclusion

The concept of income splitting among family members is relatively straightforward and in theory simply means allocating an equal share of the combined family income to each of the members of the family. If this could be done and each individual was taxed on his representative share of the combined income, the perfect split would be achieved. This theory, however, encounters numerous difficulties in practice, the first of which is that under the Canadian system of taxation the family unit is not

recognized as the basis for taxation but rather, in dealing with natural persons, the Income Tax Act treats each individual as a separate unit for taxation purposes. The entire income earned by, or accruing to, that individual is required to be taxed in his hands only and cannot be aggregated with that of other members of his family.

The principal rules contained in the Act (i.e. the attribution rules) to prevent and recombine split income are found in sections 74.1 through 75.1. While, prior to May 23, 1985, it was possible to circumvent the attribution rules by having the higher-income spouse make a loan to the lower-income spouse and/or a minor child, such a loan will now attract attribution unless the borrower pays a stipulated rate of interest on the loan. Clearly, the payment of interest significantly restricts the ability of high marginal rate taxpayers to avoid tax by loaning money to family members who are subject to lower marginal rates of tax.

The amendments to the attribution rules have redefined the boundaries of the income-splitting playing field, and significantly increased the complexity and uncertainty of tax planning in this area. In fact, the daunting complexity of the rules (especially those involved in attempting to split income through a corporation), coupled with the administrative and legal costs of maintaining proper records to achieve minimal tax savings, may persuade many taxpayers that the game is no longer worth the candle. For example, Mssrs. Dart and Smith have pointed out that where one spouse has income that places him or her in the top marginal rate and the other spouse has no income at all, then where the former transfers $68,000 to the latter, the maximum tax

saving that can be achieved (depending on the province of residence) is probably about $9,500 per year. One can surely question whether this tax saving is sufficient to justify compliance with the substantial complexity which the amendments to the attribution rules have added. Although taxpayers have resorted to direct loans and transfers to achieve tax savings less than the $9,500 referred to above, the concern now will be that Revenue Canada may transfer substantial amounts of income from one spouse to another, with little or no change in ultimate tax liability but with substantial interest penalties levied against the individual to whom the income is attributed.

Income splitting between spouses still remains available in the case of a small business corporation and by way of sales for fair market value. In the former case, although the attribution rules do not apply to a transfer or loan of property by an individual to a small business corporation, care must be taken to ensure that the small business corporation shares owned by a spouse or trust for minor children are acquired with funds obtained from sources not attributed to the individual. In addition, where the small business corporation has more than one class of shareholders entitled to receive dividends, the individual may open himself up to a subsection 56(2) assessment where disproportionate dividends are paid to shareholders of other classes of shares.

With respect to minor children, a loan or gift to a trust for the benefit of a minor may avoid the attribution rules if the trust does not receive or earn income from property acquired by it

until after the child attains 18. A loan to a trust for a minor can be used to purchase shares (say of a family corporation) if the payment of dividends on the shares can be delayed until after the child reaches 18.

Where a family expects to realize total capital gains exceeding the $500,000 exemption, it may be attractive to utilize techniques to accumulate potential capital gains in the hands of children. For example, a trust can be established to hold capital assets, and preferred beneficiary elections can be used to allow realized gains to be treated as gains of the children for the purposes of the exemption. The attribution rules do not detract from this objective since capital gains realized by children of all ages are not attributed back to the parent. In order to put minors in a position to realize capital gains for purposes of the exemption, however, consideration must be given to the income attribution rules which may apply to income earned directly or indirectly from the transferred property.

In summary, there are still certain other techniques available for income splitting which may prove useful to families. Briefly (the list being illustrative and not limitative), such techniques are as follows:

(a) Gifts or loans made by non-residents to persons resident in Canada are not subject to the attribution rules;

(b) Instead of having a grandparent give the full share of his estate to his child, a portion may be allocated to a trust for his grandchildren. If the parent received his full share of the inheritance, then all income would be taxable to the parent although some of the funds may be used to pay for non-deductible

personal expenses of the grandchildren. If a trust were set up in a will for grandchildren, income earned by the trust could be taxable to the grandchildren at their lower marginal rates and could be used to pay for the grandchildens' education and other non-deductible expenses. This planning is based on the fact that the attribution rules only apply when the transferor is alive.

(c) Income earned on the investment of income from transferred property is not attributed to the transferor and for tax purposes is income of the transferee; and

(d) Where a spouse or child wishes to start a business, the individual may advance funds to finance the necessary capital expenditures. Any income earned by the spouse or child would be taxable in his or her hands only and not in the hands of the individual who advanced the funds.

APPENDIX A

LOANS or TRANSFERS TO A TRUST

The following mathematical example is taken from the technical notes of the Department of Finance. Assume that an individual makes a non-interest-bearing loan of $1,000 in a taxation year to a trust, which acquires a $1,000 bond with the proceeds. The trust has four beneficiaries who have an equal interest in the income and capital of the trust. One of the beneficiaries is the individual's spouse and another is a person who has not attained the age of 18 before the end of the year. The income of the trust for the year, prior to the claiming of any deductions for amounts paid or payable to the beneficiaries, is $240, of which $100 is interest from the bond. All of the income of the trust for the year is payable to the beneficiaries. Presumably the capital of the trust which generates the trust's income, other than income from the transferred property, was funded with pre-May 23, 1985 loans, loans from non-residents of Canada or with the accumulated income.

In this case, there are two beneficiaries who are designated persons in respect of the individual, and each of them is treated as having derived income from the loaned property. This income is then attributed to the individual for the year. The income from the loaned property in respect of each of the two designated persons is calculated as the lesser of the following two amounts.

(1) The first is the income of the person from the trust ($60 in this example).

(2) The second is the designated person's share of the trust

income from the loaned or transferred property, on the assumption that only designated persons share in this income. In this case, there are two such designated beneficiaries who share equally in the trust's income. Since the trust's income from the loaned or transferred property is $100, the share of each designated beneficiary is $50. This amount can be determined by the following formula:

$$\frac{A}{B} \times C$$

Where A = income of the designated person from the trust

= 1/4 of $240

= $60

B = income of all designated persons from the trust

= $120

C = income from the loaned or transferred property or property substituted therefor

= $100

The attributed amount in respect of each designated person in this case is the lesser of the two amounts determined, or $50 in this example.

The formula is designed to exclude from the attribution rules income not derived from transferred property. However, the first dollars paid to a designated beneficiary will attract attribution. The amount of income attributed in respect of the designated person cannot exceed the amount of that person's income from the trust. If in the foregoing example the trust was a discretionary trust and all of the income was paid to the beneficiaries who were adult children, there would be no attribution. Unlike the rules

respect to loans or transfers of property to a corporation, this rule makes reference only to the income earned by the trust in the year. It is not a running account. It may be possible to mitigate the impact of this rule in a discretionary trust by paying all of the income to beneficiaries, other than a spouse or minor child, and to provide for payments out of capital to be made to the spouse or minor child where equalization is desired.

APPENDIX B

LOANS or TRANSFERS to a NON-SMALL BUSINESS CORPORATION

The following example of how section 74.4 operates is taken from the Department of Finance technical notes.

Assume that on January 1, 1986, an individual makes an interest-free loan of $12,000 to a corporation that is not a small business corporation. The individual's spouse is the sole shareholder of the corporation. The principal amount of the loan is repaid in four equal instalments of $3,000 each with the payments being made on June 30, 1986; December 31, 1986; June 30, 1987; and December 31, 1987. The corporation pays a taxable dividend of $400 to the spouse. The prescribed rate of interest is 10 per cent. For 1986, the amount of $700 would be imputed which is calculated as two-thirds of $1,050 (6 months x $12,000 x 10%/12 + 6 months x $9,000 x 10%/12) less interest paid on the loan. The amount of dividends paid to the spouse is $400 and the lesser of these amounts or $400 is attributed to the individual and is considered not to be a dividend of the individual's spouse,

For 1987, the amount is $1,000, which consists of the imputed amounts from the previous years ($700) plus the imputed amount for 1987, which is $300. The amount of dividends paid to the spouse after the time of the loan is $800, being $400 in each of 1986 and 1987. The lesser of these two amounts ($1,000 and $800) is $800. The amount previously attributed is $400. The difference, of $400, is attributed to the individual for 1987.

For 1988, the imputed amount remains $1,000 because the loan was fully repaid before 1988. Total dividends paid to the spouse

after the time of the loan are now $1,200 and the lesser of these two amounts is $1,000. The amount previously attributed is $800. The difference, or $200, is attributed to the individual for 1988.

The following example illustrates how a capital gain realized by a spouse on a disposition of shares could be attributed. Assume that the sum of $10,000 was loaned by an individual to a corporation on an interest-free basis on January 1, 1986 and was used by the corporation to acquire an investment. A spouse used a gift from a non-resident or her own salary to acquire all of the common shares. Dividends of $500 are paid on the shares owned by the spouse in 1986 and 1987. It is assumed that the prescribed rate is 10 per cent for 1986 and 1987. Rather than sell the underlying investment, the spouse disposes of the shares on December 31, 1987 and realizes a capital gain of $2,000.

For 1986, the dividend of $500 would be attributed to the individual.

For 1987, the attributed amount would be $1,334, computed as the lesser of:

(a) $1,000 (the loan) x 2/3 x 10% = $667 plus

$1,000 (the loan) x 2/3 x 10% = (the prescribed rate) $667

= $1,334

(b) The aggregate of:

(i) $1,000 (the taxable dividends paid to the spouse) and

(ii) $2,000 (the capital gain)

= $3,000

The attributed amount would be treated as a taxable dividend of the individual. The difference between the attributed amount ($1,334) and the taxable dividends paid to the spouse ($1,000)

would be deemed not to be a capital gain of the spouse. In other words, the spouse would realize a capital gain of $2,000 - $334 = $1,666.

APPENDIX C:

BURDEN of PROOF

Burden of Proof in the Federal Court - Trial Division

Neither the Anderson Logging Co. case nor the Johnston case offered any guidance as to where the onus lay when either the Minister or the taxpayer was the appellant in the Exchequer Court (now the Federal Court - Trial Division) after an adverse decision of the Tax Appeal Board (now the Tax Court of Canada).

The question of onus on an appeal before the Exchequer Court was first considered by Thorson P. in Goldman v. MNR[927] where the learned President took the view that if an assessment had been found erroneous by the Board and the matter appealed by the Minister to the Exchequer Court, it "does not come to this court with any presumption of validity in its favour."[928] From this he reasoned that the onus was upon the Minister to establish the correctness of the assessment and not upon the taxpayer. However, in MNR v. Simpson's Ltd.,[929] the learned President amended this thinking and substantially reversed the proposition just stated. In Simpson's Ltd. he decided that since an appeal to the Exchequer Court from a decision of the Tax Appeal Board is a trial de novo of the issues of fact and law, it must follow that the onus remains where it would be were the trial that of the case in the first instance before the Board -i.e. upon the taxpayer. This is well stated where he says:

> Consequently where the Minister appeals from the decision of the Board allowing an appeal from the assessment, the fact that the Board found the assessment to be erroneous must be disregarded. To do otherwise would be tantamount to giving effect to the Board's decision which would be inconsistent with the view that the hearing of the appeal from it is a trial de

novo.[930]

From this he concluded that the onus of proving the assessment to be erroneous in fact remains on the taxpayer.

In disavowing the earlier view which he took in Goldman, Thorson P. pointed out that his remarks with respect to the burden of proof had been obiter - as the taxpayer had lost his appeal before the Board in Goldman - and was inconsistent with the concept of a trial de novo.[931]

Following the Johnston decision, both taxpayers and the Crown became much more concerned with the findings and assumptions of fact of the Minister - what Rand J. had called "the basic fact on which the taxation rested."[932] It was Cattanach J., in MNR v. Pillsbury Holdings Ltd.,[933] who first shed light on Rand J.'s limitation and attempted to explain the principle of the Johnston case in such a way as to limit to more manageable proportions the task confronting the taxpayer before the courts.

In the Pillsbury case, Cattanach J. defined several ways in which the taxpayer could question the findings or assumptions of the Minister and meet the Minister's pleading:

(a) challenge the Minister's allegation that he did assume those facts (i.e. the facts pleaded in the reply),

(b) asssume the onus of showing that one or more of the assumptions was wrong, or

(c) contend that, even if the assumptions were justified, they would not, of themselves, support the assessment.

These alternatives have been cited with concurrence in several subsequent cases.[934] With respect to alternative "(a)," what appears to be intended is that if the taxpayer can show that an

allegation of fact was not relied upon by the Minister in making the assessment, then the burden would not rest on the taxpayer to disprove that fact, since it is only "every fact found or assumed by the assessor of the Minister"[935] in making the assessment which must be presumed to exist. With respect to alternative "(c)," it appears to contemplate simply an issue of law which, so far as it concerns the application of a charging provision of the Act would, according to the rule in Partington v. A.G.,[936] require that the Minister satisfy the court of the taxpayer's liability. It seems that most taxpayers have attempted alternative "(b)."[937] In so doing, they have simply attempted to prove the facts as they exist, apart altogether from the assumptions which may or may not have been made in the Minister's assessment or his pleadings.

In the Pillsbury case, Cattanach J. added parenthetically, in an observation which has also found favour in subsequent judgments, that the Minister is not bound by the assessor's assumptions, but if he changes his stand before the courts the burden will be on him to the extent of the change:

> The Minister could, of course, as an alternative to relying on the facts he found or assumed in assessing the respondent, have alleged by his Notice of Appeal further or other facts that would support or help in supporting the assessment. If he had alleged such further or other facts, the onus would presumably been on him to establish them.[938]

Thurlow J. (as he then was) in the case of Conway Estate v. MNR[939] concurred in this reasoning, pointing out that there was nothing in the Johnston case requiring that the taxpayer disprove every basis upon which an assessment could conceivably be justified. In particular, his lordship considered that the burden

was not on the taxpayer to disprove or rebut facts or arguments raised for the first time in the Minister's reply, for he said:

> If the assumptions upon which the assessment was based have been demolished it appears that the appellants are entitled to succeed unless the facts necessary to justify the taxation under the alternative plea have also been established by the evidence. The onus of supporting the assessment under the alternative plea was accordingly not on the appellant but on the Minister.[940]

C. Alternative Assessments

It was in the case of Brewster v. The Queen[941] where the opportunity arose for the court to consider whether, for the purpose of determining the onus of proof on a taxpayer, the Minister could make assumptions in the alternative at the time of the assessment. The issue was whether certain income was income of the taxpayer or of a corporation controlled by the taxpayer to which he had transferred a nine per cent interest in a partnership. The Minister alleged that he assessed, in substance, on two alternative positions: (a) the transfer to the company of the interest in the partnership was ineffective, and (b) the company was a sham. In other words, according to Rand J.'s dictum in Johnston, the onus would have been on the taxpayer to disprove both positions. Gibson J. decided that this was wrong in view of the state of the law. As he put it:

> Pleading assumptions in the alternative is novel in view of the state of the law. In law the onus is on the taxpayer to destroy some or all of the assumptions. But it is open to the defendant to plead other facts not relied on in making the assessment, but in that event the onus is on the Minister of National Revenue to prove such other facts.
>
> It seems therefore that it is fundamentally wrong in law for...the Minister to assess or re-assess and not tell precisely the basis for such assessment or re-assessment, but instead as certain assessors often do, namely, assess or re-assess in the alternative, or

> merely record the basis as contrary to the Income Tax Act, on the premise that thereby they are 'keeping their options open,' and that they are entitled in law to do so.[942]

According to Gibson J., the Minister can have only one clear assessing position, for the purpose at least of Rand J.'s limitation in Johnston. The onus on the taxpayer does not go beyond that. Even where the Minister has, in fact, found facts which support alternative assessing positions it is, it would seem, only those facts found or assumed in respect of the main basis of the assessment which bear on a determination of the burden of proof on the taxpayer.[943]

D. No Assumptions Pleaded by the Minister

While the decisions in the Pillsbury and Brewster cases helped to clarify and further refine Rand J.'s limitation in the Johnston case in instances where the Minister's assumptions were specifically pleaded, they did not offer any guidance with respect to how that limitation was to be applied in cases where those assumptions were not pleaded. The opportunity to consider this situation arose in Tobias v. MNR,[944] a case in which the taxpayer was involved in searching for a pirate treasure rumoured to be off the shore of Nova Scotia. The main problem for the taxpayer was how to determine what the findings and assumptions of fact of the Minister were at the time of issuing the assessment, for those findings and assumptions were not pleaded. After reviewing Rand J.'s limitation in Johnston and his own decision in Pillsbury Holdings, Cattanach J. dealt with the issue in the following terms:

> Because the statement of defence does not contain specific allegations setting forth the

> assumptions on which the assessments were based...as was done in the Pillsbury Holdings case and in the Brewster case, the question then arose as to what assumptions were made by the assessors...The plaintiff is entitled to know what those assumptions were and if the plaintiff is entitled to dispute that assumptions alleged to be made were in fact made, as stated in the Pillsbury case, it follows that in the absence of specific allegations in the pleadings as to what assumptions were made by the assessors, then the plaintiff is entitled to establish what assumptions were made.[945]

In the result, Cattanach J. found that the Minister had not discharged the onus on him in respect of one of the issues and he failed on that one for that reason.[946]

E. Discharging the Onus

What is the burden of proof on the taxpayer? Primarily it is what Rand J. said it was in the Johnston case, and it is a matter of substantive law.[947] It is for the taxpayer to cast doubt on the basic fact of the assessment, even where the Minister is the plaintiff in the Federal Court.[948] Where the findings and assumptions of fact of the Minister are not pleaded or otherwise determined and put into evidence at trial, the onus answers to discharging the assessment.[949] On the other hand, where the assumptions are pleaded or otherwise determined, the onus is on the taxpayer only to the extent of the exact assumptions made by the Minister at the time of assessment. This appears to be so, whether there is a deficiency in those assumptions which result because the Minister has not assumed enough, as in the Pillsbury Holdings and Littler cases, or because the facts alleged by the Minister in his pleadings are beyond the main assessing position, as in the Brewster case.[950]

F. Standard of Proof

In evaluating the proof, there is a well-established

difference between criminal and civil proceedings. In the former case, the accused must be proven guilty beyond any reasonable doubt. In civil matters, there is a less exacting standard in which the court is called on to weigh the proof. In such types of tax disputes (the type with which we are here concerned) the court must determine the taxpayer's liability on the "balance of probability," sometimes also characterized as the "preponderance of evidence."[951] Where the taxpayer is accused of a criminal offence under the Act (E.g. tax evasion under section 239), the burden of proof is on the Crown to establish beyond a reasonable doubt that the taxpayer is guilty of such offence and that the commission of the said offence was wilful.[952]

G. United States

In the United States, the same rule has been followed that the burden of proof is on the taxpayer, although the issue has never bulked as large as a rationale for so many judgments.[953] In Helvering v. Taylor[954] it was contended on behalf of the government that the burden was on the taxpayer not only to prove that the assessment was erroneous but also to prove the correct amount of tax. The United States Supreme Court held that the burden was on the taxpayer to upset the assessment, but that there was no statutory provision requiring him also to prove what the correct amount of the tax was.[955] The result in Taylor was followed in Burka v. Commissioner[956] where it was held that the Commissioners' assessment was presumptively correct and that the burden was on the taxpayer to overcome it. It was also stated that the Commissioners' assessment did not require any supporting

evidence.

There are certain situations, however, where the Internal Revenue Code and the Tax Court Rules shift the burden of proof to the government: (a) where the government raises a new and previously unpleaded contention in its answer before the Tax Court; (b) where the government alleges fraud on the part of the taxpayer; and (c) where the government asserts "transferee liability."[957]

Except for "small tax" cases subject to subsection 7463(b) of the Internal Revenue Code,[958] Tax Court decisions may be appealed by either party to the Federal Court of Appeal on a question of fact, a question of law or a mixed question of fact and law.[959] The burden of proof remains on the taxpayer at all stages of the appeal process, unless the burden of proof shifts to the government by virtue of one or more of the three statutory exceptions mentioned above.[960] The decision of the Court of Appeal may be reviewed by the United States Supreme Court with leave therefrom.[961]

H. United Kingdom

As in Canada and the United States, the legal burden of proof lies on the taxpayer to adduce evidence showing that the assessment is incorrect;[962] so that where the taxpayer adduces no evidence on the basis of which the Commissioners[963] can reduce or vacate the assessment, they must confirm it in the amount assessed.[964] However, as in Canada and the United States, where the Crown alleges fraud on the part of the taxpayer, the onus lies on the Crown to prove such fraud.[965]

Although the initial evidential onus lies on the taxpayer,

this does not exonerate the Special Commissioners from satisfying themselves that the taxpayer is properly chargeable to tax nor the Crown from satisfying the Commissioners on this point.[966] For example, where the issue is whether activities of the taxpayer do, or do not, constitute the carrying on of business, and the taxpayer adduces facts consistent with either alternative, the onus would then shift to the Crown to satisfy the Special Commissioners that the activities constituted the carrying on of business.[967]

Either the taxpayer or the Crown may appeal from the Special Commissioners to the High Court.[968] The appeal is by way of stated case and lies only on a point of law.[969] The limits on the power of the High Court to disturb the findings of the Special Commissioners were summarized by Lord Denning in J.P. Harrison Ltd. v. Griffiths:

> ...the powers of the High Court on an appeal are very limited. The judge cannnot reverse the Commissioners on their findings of fact. He can only reverse their decision if it is erroneous in point of law. Now here the primary facts were all found by the Commissioners. They were stated in the case. They cannot be disputed. What is disputed is their conclusion from them. And it is now well-settled...that their conclusion cannot be challenged unless it was unreasonable, so unreasonable that it can be dismissed as one which could not be reasonably entertained by them. It is not sufficient that the judge would himself have come to a different conclusion.[970]

The High Court may reverse, affirm or vary the determination of the Special Commissioners or may remit the case to them or make such order as the court thinks fit.[971] From the High Court there is a further right of appeal to the Court of Appeal and thence, with leave, to the House of Lords.[972]

[1] See 3 Report of the Royal Commission on Taxation 103 (Carter Commission) (Canada 1966); Treasury Dept. (U.S.), The Tax Treatment of Family Income, reprinted in Hearings on Rev. Revisions before the House Committee on Ways and Means, 80th Cong., 1st Sess., at 846 (1947); Klein, "Familial Relationships and Economic Well-Being: The Family Unit Rules for a Negative Income Tax," 9 Harvard J. Legis 361 (1971); Bittker, "Income Tax Reform in Canada: The Report of the Royal Commission on Taxation," 35 U. Chi. L. Rev. 637-681 (1968); Groves, "Taxing the Family Unit: The Carter Commission Proposals and U.S. Practice," 22 National Tax J. 109-134 (1969); McMahon, "Expanding the Taxable Unit: The Aggregation of the Income of Children and Parents," 56 New York Law Rev. 69-144 (1981).

[2] In the United States, however, married couples have been permitted since 1948 to aggregate their income and deductions on a joint return and to pay a tax equal to twice what a single person would pay on one-half of their consolidated taxable income (paragraph 1(d) of the Internal Revenue Code). The original reason for the joint return income splitting was keyed more to the desire to equalize the treatment of married taxpayers in common law states (where income splitting was not permitted) with that of taxpayers in community property states (where income splitting was permitted) than to equalize the treatment of different married taxpayers in either type of state having the same combined income but a different distribution between the spouses. See H.R. Rep. No. 1274, 80th Cong., 2d Sess. (1948) at 241; McMahon, supra footnote 1, at 71. In the United Kingdom, the general rule is that the separate incomes of the husband and wife must be aggregated for the purposes of determining total income: Finance Act, 1970, section 36(1). This is because a woman's taxable income, insofar as it is income for a taxation year in which she is a married woman "living with her husband," is deemed for income tax purposes to be his income and not to be her income: Finance Act, section 36(2). The effect is that the husband alone is assessable on the joint income at his own marginal rate: Finance Act, section 37(1). However, in recognition of the fact that such provisions may be a disincentive to wives who might otherwise go out to work, section 23 of the Finance Act provides that where a husband and wife so elect, the wife's earnings (i.e. earned income) will be taxed separately in her hands only and will not be aggregated with that of her husband.

[3] Bittker, supra footnote 1, at 641-42.

[4] "Progressive" means that the percentage of tax increases as the taxpayer's income rises until he reaches the highest statutory marginal rate.

[5] S.C. 1970-71, c.6 as amended. All future statutory references are to sections of the Income Tax Act unless otherwise stated.

[6] The federal income tax authorities have obviously made the assumption that the progressive income tax is a desireable system

because, inter alia, progression aids in maintaining economic stability; taxes should be levied in proportion to the benefits received, which rise more rapidly than income; taxes should be levied in relation to ability to pay; and progression reduces socioeconomic inequality. However, the argument may be made that although we have a statutory progressive rate, taxes are in fact only nominally progressive due to the numerous exclusions and deductions of income items from the tax base and to the multitudinous methods that taxpayers with high incomes use to escape high rates. See McMahon, supra footnote 1, at 68-69.

[7] It should be noted that the fact that an individual may support other members of a family is recognized partly in the family-related deductions permitted under section 109. If the necessary conditions are met, deductions are permitted for spouses, children, nieces, nephews, parents, grandparents, aunts and uncles.

[8] For example, the use of corporations which are held or deemed to be "associated" under the relevant provisions of the Act, and the use of management companies or trusts to shift income to spouses and/or children in lower marginal brackets.

[9] For a mathematical analysis of the type of tax savings which may result from income splitting see Wakeling, "Techniques for Income Splitting and Estate Freezing," British Columbia Tax Conference (Toronto: Canadian Tax Foundation, 1984) 1-84, at 7-21.

[10] Carter Commission, supra footnote 1 at 122-24.

[11] A representative illustration of this theme is found in the American case of Helvering v. Clifford, [1940] 309 U.S. 331 (U.S. S. Ct.), at 335: "We have here at best a temporary reallocation of income within an intimate family group...It is hard to imagine that [the taxpayer] felt himself poorer after this trust had been executed or, if he did, that it had any rational foundation in fact."

[12] While this theory may be appealing, the justification for consolidating family income is not "tax logic," but rather the observer's perception of social realities. The Commission implicitly acknowledged this by proposing a series of limits to the inclusion of children's income in the family's consolidated tax base. First, consolidation was to be compulsory only if the children were minor or disabled. Other children, whether living with their parents or not, were excluded, except that students between 21 and 25 years of age could elect to have their income included in the family tax base. Moreover, minors over the school-leaving age could elect to be excluded if employed and living apart from their parents. Finally, regardless of a child's age, gifts and bequests received by him (which were to be included in taxable income under another Commission proposal) could be deposited in an "Income Adjustment Account," a quasi-trust device for holding the property intact until the child's departure from the family unit and taxing the accumulated income to him at that time. This

exception to consolidation was confined by the Commission to property acquired by gift or bequest in the belief that such property is more likely to be treated as sacrosanct by the parents than would be the child's personal earnings. (Carter Commission, supra footnote 1, at 123-24).

13 Proposals for Tax Reform (1969) (commonly referred to as the White Paper on Tax Reform) cited and discussed in: Grover and Iacobucci, Materials on Canadian Income Tax, 6th ed. (Toronto: De Boo, 1985) at 41-43.

14 See Dulude, Taxation of the Spouses: A Comparative Study of Canadian, American, British, French and Swedish Law (unpublished Master of Laws thesis), Institute of Comparative Law, McGill University, (Montreal, 1984) at 52.

15 Memo by Julie Loranger, then federal coordinator for the Status of Women, to the Honourable Marc Lalonde, then Minister Responsible for the Status of Women, December 21, 1976; cited in Dulude, supra footnote 14, at footnote 144.

16 1917 (Dom.) c.28, subsection 4(4).

17 As discussed in more detail below, under the attribution sections, income and/or capital gains derived from loaned or transferred property is, subject to certain rules and conditions, taxed in the hands of the lender or transferor, and not in the hands of the recipient of the property -i.e. the spouse or minor child.

18 S.C. 1948, c.52, subsection 21(1).

19 R.S.C. 1952, c.48; 1974-75-76, c.26.

20 See Fasken Estate v. MNR [1948] CTC 265 (Ex. Ct.) (discussed infra).

21 In paragraph 8 of Interpretation Bulletin IT-258R2 ("Transfer of Property to a Spouse," May 11, 1982) the Department states that it accepted that, for the purposes of former subsection 74(1), a transfer did not include a genuine loan made by a person to his spouse. While the Department did not give an all-inclusive statement as to when a loan would be considered to be "genuine," it indicated that a loan would not be considered to be genuine if there was no written and signed acknowledgement of the loan by the borrower and no agreement to repay it within a reasonable time. In addition, the "genuine" character of the loan was enhanced if there was evidence that the borrower had given security for the loan, that interest on the loan had been paid and that actual repayments had been made.

22 [1959] CTC 375 (Ex. Ct.).

23 Former subsection 22(1) provided that:

> 22(1) Where a taxpayer has, since 1930, transferred property to a person who was under 19 years of age, either directly or indirectly, by means of a trust or by any other means whatsoever, the income for a taxation year from the property or from property substituted therefor shall be deemed to be income of the taxpayer and not of the transferee unless the transferee has before the end of the year attained the age of 19 years.

[24] Certain writers suggested that Thurlow J.'s ruling in Dunkelman was statutorily reversed by the extended definition of "property" (in the 1971 Act) which was amended to read, inter alia, "unless a contrary intention is evident, money." (See Cullity, "Attribution of Income," (1972) 10 Osgoode Hall Law Journal 93-122 at 101; Hansen, "The Definition of Transfer in Sections 74 and 75 - Judicial Nonsense," (November - December, 1976) 24 Canadian Tax Journal 612-630 at 614). However, as there was never apparently any doubt that an outright gift of money constituted a "transfer of property" under the 1948 Income War Tax Act (see Fasken Estate, supra footnote 20; Blumenthal v. MNR [1950] 2 Tax ABC 354 (TAB); Meade v. MNR [1963] 34 Tax ABC 155 (TAB); Trinca v. MNR [1951] 3 Tax ABC 354 (TAB)) it seemed that the extended definition of "property" did nothing more than bring such definition in line with the judicial authorities as they stood at the time.

[25] [1968] CTC 244 (Ex. Ct.).

[26] While a taxpayer could avoid the application of the former attribution provisions by making a loan to his spouse, the Tax Appeal Board and the courts did, on occasion, refuse to acknowledge the existence of such loan if it had not been reduced to writing. For example, in both Blumenthal v. MNR, supra footnote 24 and Trinca v. MNR, supra footnote 24, the Board refused to accept the existence of an inter-spousal loan on the ground that there was no written evidence of such loan from the taxpayer to his wife; and, in Minden v. MNR, [1963] CTC 364 (Ex. Ct.), Cattanach J. held that, in the absence of any promissory note and with no evidence of any specific terms of repayment, he could not accede to the taxpayer's contention that certain sums advanced to his wife constituted a loan. In Robins v. MNR, [1963] CTC 27 (Ex. Ct.), however, the court agreed with the taxpayer that money expended by his wife to purchase furniture constituted a loan from himself to her notwithstanding that the loan agreement was strictly an oral one.

[27] [1973] 2 NZLR 19 (N. Zealand Supreme Ct.).

[28] [1940] NZLR 627 (N. Zealand C.A.).

[29] [1966] 116 CLR 1772 (High Ct. of Australia).

[30] Finance Act, 1975, subsection 20(2).

[31] Ibid., subsection 49(1).

[32] The reason for the statutory exception appears to lie in the fact that, with respect to transfers of property between spouses, there is no attribution of income derived from the transferred property. Thus, there is no reason for Parliament to levy any capital transfer tax in respect of interest-free or low-interest loans made between spouses. (See Pinson, Pinson on Revenue Law. 15th ed. (London: Sweet and Maxwell, 1984) 491-92).

[33] See Goodman, "Attribution of Income under the New Tax Rules," notes for an address given to the National Tax Centre Conference, (Toronto, January 20, 1986) at 4.

[34] See Hartkorn, "Income-Splitting - The New Rules," (November - December, 1985) 33 Canadian Tax Journal 1226-1245 at 1227.

[35] Former subsection 75(1) provided that:

> (1) Where a taxpayer has, since 1930, transferred property to a person who was under 18 years of age, either directly or indirectly, by means of a trust or by any other means whatever, any income or loss, as the case may be, for a taxation year from the property or from property substituted therefor shall, during the lifetime of the transferor while he is resident in Canada, be deemed to be the income or loss, as the case may be, of the transferor and not of the transferee, unless the transferee has, before the end of the year, attained the age of 18 years.

[36] S.C. 1986, c.6, s.38 (formerly Bill C-84).

[37] Subsection 75(2).

[38] Section 74.1.

[39] Section 74.2.

[40] Subparagraph 74.2(1)(c)(i).

[41] Subsection 74.4(2).

[42] Section 74.1; subsection 74.5(3).

[43] The new rules, which received Royal Assent on February 13, 1986, generally apply to loans made to a spouse, minor child, a trust of which the spouse or minor child is a beneficiary, and a non-small business corporation in which the spouse or a minor are shareholders.

[44] Subsection 74.5(2).

[45] Section 74.5.

[46] Section 74.3.

[47] Section 74.4 et. s.

[48] Subsection 74.5(6).

[49] Subsection 74.5(7).

[50] Subsection 74.1(3).

[51] Subsection 74.5(11).

[52] Subsection 74.1(2).

[53] Section 75.1.

[54] Section 74.2.

[55] For example, see sections 73, 74.1 et. s., 109; subsections 24(2), 40(5), 70(6), 82(3), 104(4), and 160(1); and paragraphs 109(1)(a) and (b); and 250(1)(e).

[56] In contrast, the word "spouse" under the former Ontario Gift Tax Act (S.O., 1972, c.12) was defined to include a person who established that she had, for a number of years immediately prior to the making of a gift by a donor with whom she was residing, been publicly represented by the donor as his spouse. The statute did not, however, indicate how many years a "number of years" would require. See MacGowan, "The Tax Consequences of Marriage," in Report of Proceedings of the Twenty-Sixth Tax Conference, 1974 (Toronto: Canadian Tax Foundation, 1975) 275-95.

[57] [1959] 23 Tax ABC 240 (TAB).

[58] Subsequent cases have been unanimous in their acceptance of the conclusion reached in No. 673 v. MNR. See Schapira v. MNR [1966] 40 Tax ABC 223 (TAB); Sokil v. MNR [1968] Tax ABC 337 (TAB); McPhee v. MNR [1980] CTC 2042 (TRB).

[59] See paragraph 73(1)(d), subsection 73(1.1).

[60] Regulation 6500(1).

[61] In effect, paragraph 73(1)(d) and subsection 73(1.1), inter alia, give legislative recognition to "common law" relationships where various provinces recognize them. However, as no such recognition is afforded by subsection 74.1(1), it would appear that the word "spouse" does not include a "common law" spouse for the purposes of the attribution rules. However, if a "common law" couple subsequently went through a formal marriage ceremony recognized under Canadian law, any pre-marital transfer of property (whether by marriage contract or otherwise) made between them would appear to attract attribution by virtue of the words "to a person who has since become his spouse" in subsection 74.1(1).

62 In the Province of Ontario, for example, section 52 of the Family Law Act (S.O. 1986, c.54) provides for agreements between people who are living together, but who are not legally married, to divide property between them in the event of cessation of co-habitation. Section 29 of the same statute defines "spouses" to include persons who are not married but who have lived together continuously for at least three years or have lived together in a relationship of some permanence resulting in a child. A person falling within section 29 is a prescribed person for the purposes of subsection 73(1).

63 For taxation years commencing after 1981, the extended definition provided by subsection 252(3) is relevant for the purposes of: paragraphs 56(1)(b) and(c); section 56.1; paragraphs 60(b) and (c); and section 60.1 (alimony and maintenance payments); subsection 73(1) (tax-free inter vivos transfer of capital property to a spouse); paragraph 146(16)(a) (tax-free transfer of registered retirement savings plan funds to a spouse's registered retirement savings plan upon marital breakdown).

64 Under the pre-1972 Act (R.S.C. 1952, c.148) "property" had a narrower meaning and was defined in paragraph 139 (1)(ag) to mean:

> `Property' means property of any kind whatsoever whether real or personal or corporeal or incorporeal and, without restricting the generality of the foregoing, includes a right of any kind whatsoever, a share or a chose in action.

65 [1948] CTC 265 (Ex. Ct.).

66 In In re Earnshaw-Wall, [1894] 3 Ch. 156 (Ch. D.), Chitty J., in an extensive discussion of the word "property" said (at 158):

> ... `property' is mainly used by lawyers in three senses [one of which is] ... as denoting valuable things - things which can be turned into money or assessed at money value; in other words, rights which may be exchanged for the ownership of money. It is in this last sense that the word `property' seems to be used when a man speaks of all his property. Property, then, may mean either (1) ownership or (2) an object of ownership, or (3) valuable things, according to the context.
> ... and property, as meaning valuable things, includes incorporeal as well as corporeal things. That is to say, property consists of two kinds of things, (1) tangible things in their owner's possession; (2) valuable rights of various kinds unaccompanied with the possession of anything corporeal.

In Guthrie v. Walrond, [1883] 22 Ch. D. 573 (Ch. D.), Fry J. (at 576) quoted the opinion of the Lord Chancellor in Earl of Tyrone v. Marquis of Waterford, [1860] 1 D.F. and J. 613 (at 625) to the effect that: "The word `property' (as used in this will) has a

most extensive significance." It was there held that debts due to the testator in respect of collieries in the county of Northumberland passed as property under his will. In In re Prater, [1888] 37 Ch. D. 481 (C.A.), the Lord Chancellor, in deciding that the words "my property at the Rothchilds' bank" included shares in the stock of the company, stated (at 486): "'Property' is a word of the very largest description, and looking at this will I see nothing to cut it down to 'money' so as to make it pass only on the banker's balance." See also Crossley Vaines on Personal Property, 5th ed. (London: Butterworths, 1979) at 3, where the learned author ascribes a similar broad meaning to the word "property:"

> 'Property' is a word of many meanings. It may mean a thing owned; it may mean ownership itself ... or it may even mean an interest in a thing less than ownership but nevertheless conferring certain rights, as when we speak of the "property" of a bailee in the thing bailed ... In English law, therefore, "property" comprehends tangibles and intangibles, moveables and immovables; it means a tangible thing (land or chattel) itself, or rights in respect of that thing, or rights, such as a debt, in relation to which no tangible thing exists.

67 [1836] 5 L.J.N.S. 87 at 90.

68 A "contingent right" is a right which depends for its effect upon an event which may or may not happen. Such a right is not transmissible to the party's heirs or legal representatives if he dies before it vests in possession. (See Megarry and Wade, The Law of Real Property, 4th ed. (London: Steven and Sons, 1979)) at 173.

69 [1957] 18 Tax ABC 294 (TAB).

70 It should be noted that the decision in No. 481 v. MNR was rendered under the 1952 Act where the statutory definition of "property" in paragraph 139(1)(ag) was, as indicated above, a narrower one. Under the subsequent enlarged definition of "property," the word was stated to also include: "money" (unless a contrary intention was evident); "a timber resource property;" and "work in progress of a profession." Since none of these additional phrases would seem to be applicable to the facts in No. 481 v. MNR, it seems that the decision would not have been affected by the subsequent broader definition of "property."

71 [1974] CTC 495 (FCA); appeal dismissed: [1976] CTC 296 (SCC).

72 This coincides with the definition of "property" found in Black's Law Dictionary, 5th ed. (West Publishing Co. 1979) viz., "that which belongs exclusively to one...The word is also commonly used to denote everything which is the subject of ownership, corporeal or incorporeal, tangible or intangible, visible or invisible, real or personal; everything that has an exchangeable value or which goes to make up wealth or estate."

[73] [1969] CTC 274 (Ex. Ct.); affirmed on other grounds: [1971] CTC 96 (SCC).

[74] See also The Queen v. St. John Shipbuilding and Dry Dock Co., [1980] CTC 352 (FCA), where it was held that confidential, but unpatented, technical information supplied to a Canadian company constituted "property" within the meaning of section 248(1). In concurring with the decision in the Western Electric Co. case, Thurlow C.J. seemed to imply that since, in the latter case, it was held that technical information of the same type in issue constituted "property" under the narrower pre-1972 statutory definition of the term, it certainly constituted "property" under the broader post-1971 statutory definition. Beyond this, however, the Chief Justice did not elaborate. In the United States, it appears that unpatented confidential trade secrets constitute property. See Stalker v. United States, [1965] 209 F. Supp. 30 (Michigan Distr. Ct.), where the court said (at 32): "It is established that a trade secret constitutes property." In U.S. Revenue Ruling 55-17 it is stated that: "While manufacturing know-how is of a non-patentable nature it is something that its possessor can grant to another for a consideration. The right to use such know-how is not materially different from the right to use trade marks, secret processes and formulae."

[75] See Krishna, The Taxation of Capital Gains, (Toronto: Butterworths, 1983) at 61:

> As noted above, property includes incorporeal property...Examples [of incorporeal property] include such rights as reversions, remainders, franchises, executory interests, rights of way, causes of action, and easements. In other words, incorporeal property consists of things which can neither be seen nor touched but represent rights in law.

[76] At common law, real property comprises two distinct genera, called corporeal and incorporeal hereditaments. Corporeal hereditaments are land, buildings, minerals, trees and other things which are part of or affixed to land - in other words, the physical matter over which ownership is exercised. Incorporeal hereditaments, on the other hand, are not things at all, but rights which may be exercised in relation to land. The most important incorporeal hereditaments are easements (the equivalent to servitudes under the Quebec Civil Code), profits and rentcharges. (See Megarry and Wade, supra footnote 68 at 12).

[77] A leasehold interest is an estate in real property, its distinguishing characteristic being that its maximum duration is fixed in time (E.g. a lease for 10 years).(See Megarry and Wade, supra footnote 68 at 43-47, for a discussion of the different categories of leasehold interests at common law).

[78] See also Regulation 1100(14) where a "rental property" is defined to include certain leasehold interests in real property. In summary, the term "real property" is not one frequently used in

the Act, the more common reference being to land or, in the case of buildings or other structures attached to land, depreciable property of a prescribed class.

[79] See Ward's Tax Law and Planning (Toronto: Carswell) (looseleaf) vol. 1, paragraph 40.2[c].

[80] Krishna, supra footnote 75, at 1-26.

[81] The general authority for the deduction of capital cost allowance is contained in paragraph 20(1)(a) and the mechanics of the deduction are set out in Parts XI and XVII of the Regulations.

[82] See MNR v. Wardean Drilling Ltd., [1969] CTC 265 (Ex. Ct.), where Cattanach J. was of the opinion that depreciable property is acquired when title to the property has passed, or when the purchaser has all the incidents of title, such as possession, use and risk, even though legal title may remain with the vendor as security for the purchase price.

[83] "Eligible capital property" includes property such as goodwill, customer lists, trademarks, franchise, licence (including one granted by a government authority) and incorporation expenses. (See Interpretation Bulletin IT-432, "Meaning of Capital Expendtures," August 10, 1983, paragraphs 5-33, for a list of other expenditures considered to be eligible capital expenditures). When a taxpayer acquires an eligible capital expenditure, one-half of the cost of such expenditure falls into a depreciable asset class, "cumulative eligible capital," as defined in paragraph 14(5)(a). This class is depreciated at the rate of 10 per cent per annum computed on a diminishing balance basis as provided in paragraph 20(1)(b). Where such property is sold by the taxpayer, one-half of the net proceeds become an "eligible capital amount" within the meaning of subsection 14(1); this amount is credited to the cumulative eligible capital pool (unless an election is made under subsection 14(6)) and if such proceeds exceed the unamortized balance in the pool at the end of the taxation year, the excess is included in income by virtue of subsection 14(1). Where a taxpayer ceases to carry on a particular business, section 24 allows him to deduct the balance in the cumulative eligible capital pool in respect of the business in the year in which he ceases to carry it on. This deduction is not available, however, if the business is transferred to the taxpayer's spouse or a corporation controlled by him. Instead, the balance in the cumulative eligible capital pool is transferred to the spouse or corporation: subsection 24(2) and Interpretation Bulletin IT-313R, "Eligible Capital Property - Ceasing to Carry on Business," (October 10, 1978, paragraph 70). See also Krishna, supra footnote 75, at 20-21.

[84] [1948] CTC 265 (Ex. Ct.) at 279. See also St. Aubyn v. Attorney-General [1952] A.C. 53 (HL); Dunkelman v. MNR, supra footnote 22, at 386 (approving the definition in Fasken Estate for the 1952 Act); and compare Campbell v. MNR, [1963] 32 Tax ABC 203 (TAB), where the Assistant Chairman expressly restricted its

meaning to the "passing of ownership." See Sachs v. The Queen [1980] CTC 358 (FCA) per Thurlow C.J. at 361-62.

85 See Hansen, supra footnote 24, at 614.

86 See Bethune v. MNR [1958] CTC 89 (Ex. Ct.) (husband taking title to real property in the name of his wife); Blumenthal v. MNR, supra footnote 24 (husband becoming owner of shares in a personal corporation as a direct result of wife's financial contribution to the corporation); Trinca v. MNR, supra footnote 24 (outright gift of cash); German v. MNR [1957] CTC 291 (Ex. Ct.) (payment to wife by purchaser of real property owned by husband).

87 Fasken Estate v. MNR, supra footnote 65 (wife becoming entitled to the right to receive certain interest income upon an oral declaration of trust in her favour); Murphy v. The Queen [1980] CTC 386 (FCTD) (wife becoming entitled to trust income as a result of a variation of trust agreement).

88 It should be noted that, by virtue of subparagraph 69(1)(b)(ii), the transferor, in a non-arm's length transfer of property (spouses are deemed not to deal with each other at arm's length by virtue of paragraphs 251(1)(a) and 251(2)(a)) is deemed to dispose of the property for proceeds of disposition equal to the fair market value of the property and the transferee is deemed to have acquired the property at fair market value. Thus, in a transfer of property which has appreciated in value since its acquisition, the transferor will realize a capital gain and/or recapture of capital cost allowance where applicable. However, in the case of an inter vivos transfer of capital property between spouses (or former spouses), subsection 73(1) provides for a "rollover" -i.e. a deferral of recognition of gains (or recapture of capital cost allowance: subsection 73(2)) which would otherwise be occasioned at such time. If the conditions precedent in subsection 73(1) are met (i.e. both the transferor and his spouse (or former spouse) are resident in Canada at the time of the transfer) the rollover is automatic unless the transferor elects under the same subsection not to have its provisions apply. If no election is made, then any capital gain (or capital loss) will only be realized when the transferee subsequently disposes of the property. If an election is made, and such election generates a capital loss to the transferor, such loss is considered to be a superficial loss by virtue of subparagraph 54(i)(i). In other words, the Act, in at least this case, seems to accept both spouses as a single unit by allowing capital property transfers between them to go initially tax-free while preserving the inherent potential tax liability for accrued gains or losses.

89 [1963] 32 Tax ABC 203 (TAB).

90 [1957] CTC 291 (Ex. Ct.).

91 As required by the Dower Act, R.S.A. 1948, c.12.

92 Supra footnote 90, at 294.

93 See Fasken Estate v. MNR, supra footnote 65; Connell v. MNR [1946] CTC 306 (Ex. Ct.).

94 [1952] CTC 104 (Ex. Ct.).

95 As to the meaning of "Substituted Property" within the context of the attribution rules, see infra at 94.

96 32(2) Where a husband transfers property to his wife, or vice versa, the husband or wife, as the case may be, shall nevertheless be liable to be taxed on the income derived from such property or from property substituted therefor as if such transfer had not been made.

97 See, for example, Beam and Laiken, Federal Income Taxation in Canada, 4th ed. (Toronto: CCH Ltd, 1985) 143-45; Canada Tax Service (Toronto: DeBoo) (looseleaf) vol. 3, paragraph 74-106; Cullity, supra footnote 24, at 101; Hansen, supra footnote 53 at 613-15; Harris, Canadian Income Taxation, 2d ed. (Toronto: Butterworths, 1981) 353-57; Lynch, "Income Splitting among Family Members," Report of Proceedings of the Thirty-Second Tax Conference, 1980 (Toronto: Canadian Tax Foundation, 1981) 752-773 at 758; Income Taxation in Canada, (Toronto: Prentice-Hall) (looseleaf) vol. 4, paragraph 50,252; vol. 5 paragraph 79,060; Scace, The Income Tax Law of Canada, 6th ed.(Toronto: Carswell, 1985) 297-99; Ward's Tax Law and Planning, supra footnote 79, paragraphs 11.3[a]-11.6[a] at paragraph 11.3[b]. Of course, such an assertion must be accompanied by the caveat that a Tax Court is not bound by any opinion expressed by an author and will rarely refer to such opinion as support for its judgment.

98 Subsection 74.5(1) is applicable to transfers or sales of property made after May 22, 1985.

99 Paragraph 74.5(1)(c).

100 Subsection 110.6(3).

101 The prescribed rate of interest is found in Regulation 4300. The rate is adjusted quarterly to reflect changes in the Bank of Canada rate.

102 Subparagraph 74.5(1)(b)(i).

103 Subparagraphs 74.5(1)(b)(ii) and (iii). It should be noted that if this stipulation (i.e. that interest payable on indebtedness be paid no later than 30 days after the end of the particular year) is not met in each succeeding year, the entitlement to the commercial sale exception will be lost in that particular year and all subsequent years, even if the interest is paid on a timely basis in such subsequent years. This stipulation has been deservedly criticized as being unduly onerous. This is because, for example, taxpayers who report their interest income

on an accrual basis and therefore will have included the interest in their income, will not meet the test if the interest is not actually received. This could be a pitfall for taxpayers who might carry out sales of property during the course of the year between family members on the assumption that no attribution will apply, only to find out in the subsequent year, when professional advisers are consulted, that the exception will never be available because interest was not actually paid by January 30 of the taxation year in question. (See Dart and Smith, "Estate Planning: A New Era," (January - February, 1986) 34 Canadian Tax Journal 1-48 at 16; Ulmer, "Family Members as Shareholders of a Small Business Corporation," notes for an address given to the National Tax Centre Conference (Toronto, January 20, 1986) at 33.

104 Supra footnote 90.

105 Subsection 74.5(1) does not state what occurs if the consideration given for the transferred property is less than the fair market value thereof. In such a case, presumably there would be attribution of income and/or capital gains which would be determined in the same proportion that the shortfall of the consideration is to the fair market value of the transferred property.

106 Hartkorn, supra footnote 34, at 1241.

107 Paragraph 54(g).

108 Paragraph 40(2)(b).

109 Hartkorn, supra footnote 34 at 1241; Ulmer, supra footnote 103, at 28-29; see also CCH, Tax Profile, vol. 1, no. 20, (February 11, 1986) 155-57 at 156.

110 S.C. 1986, c.6.

111 A loan has been defined to mean: "a contract which consists of delivery by one party and receipt by another party of money on agreement, express or implied, to repay money with or without interest." (Parsons v. Fox [1979] 179 Ga. 605 (Georgia C.A.)).

112 Subsections 74.1(1) and 74.1(2).

113 Subsection 74.2(1).

114 Subsection 74.3(1).

115 Subsection 74.2(2).

116 Under the original proposals contained in the Federal Budget of May 23, 1985, the "grandfathering" provisions indicated that term loans (i.e. loans repayable on a particular date) would be grandfathered until the earlier of December 31, 1985, or the date the loan was repaid, while demand loans outstanding on May 23, 1985, would have to be paid back before January 1, 1988, in order

to avoid attribution. Under the actual legislation, however, this distinction was removed and all loans must be repaid prior to January 1, 1988, to avoid attribution. The apparent reason for this change was that the Finance Department felt that taxpayers were converting demand loans into long-term loans after Budget Day. (See Drache, The Canadian Taxpayer, December 17, 1985, at 189).

[117] Subsection 251(1) provides that:

> (1) For the purposes of this Act,
> (a) related persons shall be deemed not to deal with each other at arm's length; and
> (b) it is a question of fact whether persons not related to each other were at a particular time dealing with each other at arm's length.

Thus, there are, for the purposes of subsection 252(1), two groups of individuals not dealing at arm's length: (i) "related persons" - subsection 251(2) et. s.; and (ii) persons not dealing at arm's length based on a factual determination. The result is that persons (or groups of persons - paragraph 251(4)(a) et. s.) will be held to be dealing at arm's length unless they are found to be in a non-arm's length relationship. For the purpose of determining a rate of interest that would have been agreed upon between arm's length persons under similar circumstances, the test appears to be whether an independent judge, viewing the matter objectively, would have reached the same or similar conclusion as the parties themselves did. (See Couzin, "Of Arm's Length, and Not Dealing Thereat," (May - June, 1978) 26 Canadian Tax Journal 271-286 at 277).

[118] Supra footnote 103; Hartkorn, supra footnote 34, at 1230.

[119] See McDonnell, "Income Splitting and the New Attribution Rules," Report Bulletin No. 466, (Prentice-Hall; March 13, 1986) at 5-6.

[120] The provisions of subsection 50(1) should be read in conjunction with those of subparagraph 40(2)(g)(ii) which deem to be nil all losses arising from the disposition of debts other than debts acquired for the purpose of gaining or producing income from business or property, or as consideration for the disposition, at arm's length, of capital property. Since the lender, in this case, has charged interest on the loan, his loss would not appear to be nil as he would be considered to be earning income from property. As well, the fact that the transaction is not at arm's length would not be material in view of the disjunctive nature of the exceptions contained in subparagraph 40(2)(g)(ii). (See Sanscoucy v. MNR [1980] CTC 2312 (TRB) (capital loss not deemed to be nil by subparagraph 40(2)(g)(ii) since the taxpayer incurred expenses to produce the income in question). (See also MacGowan, supra footnote 56, at 293).

[121] Subsection 80(1) applies when a taxpayer's debt or other

obligation to pay an amount is settled or extinguished without any payment in fact having been made or by payment of an amount less than the principal amount of the debt or obligation. The resulting gain is not treated as a capital gain, but must be applied to reduce certain losses of the taxpayer or the adjusted cost base to him of certain capital property (or where applicable, the capital cost to him of certain depreciable property). Generally speaking, a debt or other obligation will be considered to be settled or extinguished when no further legal liability of any sort, by the debtor to the creditor, remains. (See Canada Tax Service, supra footnote 96, vol. 3, paragraph 80-101).

122 When interest rates decline, interest payments on corporate indebtedness are likewise reduced, resulting in higher profits and, other things equal, stronger corporate balance sheets. (Witness the unprecedented 600 point rise in the Dow Jones Industrial Average from September, 1985, to June, 1986, as interest rates in the United States declined to their lowest levels since 1978). With respect to bonds, their price relationship with interest rates is also an inverse one -i.e. as interest rates decline, bond prices (especially those of long-term bonds) rise.

123 A "specified person" is defined in subsection 74.5(8) as follows:

> (8) For the purposes of subsections (6) and (7), "specified person," with respect to an individual, means
> (a) a person who is or who has become the spouse of the individual;
> (b) a person who is under 18 years of age; or
> (c) a corporation, other than a small business corporation, the shareholders of which include a person described in paragraph (a) or (b), a trust in which such a person is beneficially interested, a partnership of which such a person is a member or another corporation, other than a small business corporation, of which such a person is a specified shareholder.

124 This crossover transfer illustrates the necessity for the second test in subsection 74.5(6) -i.e. a transfer which is conditional on a similar arrangement being made for the benefit of a specified person. That is, the first requirement of subsection 74.5(6) (i.e. a transfer from the individual to the intermediary and thence to a specified person) could easily be overcome, for instance, by A transferring the shares to B, with B's wife then transferring different shares of the same value back to A's wife. This transaction would apparently not be caught by paragraph 74.5(6)(a) (since this paragraph involves a tracking of the transferred property, which tracking would be upset by B's wife transferring different shares to A's wife), but would apparently be caught by paragraph 74.5(6)(b), since this paragraph does not require any tracking of property but simply that the initial transfer be conditional on a similar arrangement being made for the benefit of a specified person. (See Bernstein, Family Tax

Planning After 1985, (Toronto: CCH, 1986) at 24).

125 Hartkorn, supra footnote 34, at 1231-32.

126 In some cases where an individual borrows a sum of money from a bank, the loan interest is not paid currently, but is merely capitalized and added to the amount of the loan during the first few years of its term. In this situation, the loan will no longer be exempt from attribution, notwithstanding that a proper interest rate is charged by the bank. It is difficult to see what tax policy underlies the attribution of income in these circumstances. (See Goodman, supra footnote 33, at 14-15).

127 [1964] CTC 252 (Ex. Ct.).

128 Supra footnote 18.

129 In O'Brien v. MNR, [1957] Tax ABC 189 (TAB), the taxpayer financed the purchase of two farms by her husband, not by direct financing, but by arranging for bank loans to her husband to be secured by her own personal assets. The Assistant Chairman upheld the attribution to the taxpayer of income from property substituted for the farms. With respect to the taxpayer's claim that she had not transferred any property, the Assistant Chairman agreed that technically this was correct, but that since it was the asset owned by her which enabled the husband to acquire the farms, the ultimate effect was the same as if the taxpayer had actually transferred the property herself. The enactment of subsection 74.5(7) seems to indicate that prior to May 23, 1985, Parliament felt that the Wertman case (and not the O'Brien case) represented the state of the law in respect of a loan guarantee made by one spouse for the benefit of the other spouse.

130 The rule with respect to loan guarantees may also have been enacted to protect against guarantees being arranged with a view to the borrower deliberately defaulting so that the guarantor will be called upon to honour the guarantee. (See Ulmer, supra footnote 103, at 47).

131 See Goodman, supra footnote 33, at 15.

132 See infra at footnote 173.

133 See Bernstein, supra footnote 124, at 25-26.

134 See Hartkorn, supra footnote 34, at 1232.

135 Ibid. at 1233.

136 Ibid.

137 Ibid.

138 It is interesting to speculate how far the reaches of subsection 74.1(3) extend. Consider the situation where one spouse

transfers cash to the other spouse and the latter uses the cash to pay down a mortgage on certain real property. It is clear that the mortgagor's equity in the property is increased, and it is equally clear that there was a transfer of property, the cash. It would also seem that the transaction might fall within the wording of paragraph 74.1(3)(b), being a transfer of property used "to reduce an amount payable for other property." However, is there a substituted property? Perhaps not, because although there has been an increase in the transferee spouse's equity in the property, this spouse has always owned the property. (See Katz, "Income Splitting: The Labyrinth of Attribution," British Columbia Tax Conference, 1980 (Toronto: Canadian Tax Foundation, 1981) 293-329 at 303). See also Rafael v. MNR, [1978] CTC 2398 (TRB), where the husband paid the mortgage payments on certain real property (i.e. the family residence) which was beneficially owned by the wife. It was held that such payments did not constitute a transfer of property from husband to wife since the beneficial interest in the property had always been vested in the wife from the date the property was purchased.

139 See Wakeling, supra footnote 9, at 65.

140 Ibid. at 66. It is not clear exactly why his latter strategy was adopted to split income since the same result could be achieved, without the intervention of a third party (i.e. the bank), by the husband simply loaning the wife the cash to purchase the shares. Since a loan was not considered to be a transfer of property for the purposes of the attribution rules, any income and/or capital gains derived from the shares would be taxed in the wife's hands only.

141 Subsection 73(1). Although the wife may pay the husband for the shares, since no election is made not to have subsection 73(1) apply, the provisions of subsection 74.5(1) will not apply and therefore the attribution rules will apply accordingly.

142 Hartkorn, supra footnote 34, at 1234-35.

143 Supra footnote 20.

144 See Hansen, supra footnote 24, at 630-31; Cullity, supra footnote 24, at 98-99.

145 Cullity, supra footnote 24, at 97; Hansen, supra footnote 24, at 626-27.

146 At common law, an interest in property may be either vested or contingent. A "vested interest" may be either "vested in interest" or "vested in possession." An interest is "vested in possession" when it gives the right of present enjoyment; whereas an interest is "vested in interest" when it gives a present right or title to a thing, which carries with it an existing right of alienation, even though the right to possession or enjoyment may be postponed to some uncertain time in the future. By contrast, a "contingent interest" gives no present interest whatsoever, but

depends for its effect on an event which may or may not happen. (See Megarry and Wade, supra footnote 68, at 173-74).

147 A "defeasible interest" is a present interest which is subject to being defeated or revoked upon the happening of a future event or the performance of a condition subsequent or by a conditional limitation. Normally, a beneficiary who is vested defeasibly is entitled to intermediate income; one whose interest is contingent is not, unless a statute has conferred it on him. And until the contingency is satisfied, the contingently interested beneficiary has only a mere hope, a possibility, that he will get anything. (Megarry and Wade, supra footnote 68; Waters, "Trusts Law and Tax Law: A Growing Conflict," (1981) University of Western Ontario Law Review, 111-139 at 124).

148 See the discussion under subheading, "Statutory Definition of Property."

149 Cullity, supra footnote 24, at 97-98; Hansen, supra footnote 24, at 620.

150 [1980] CTC 358 (FCA).

151 The term "preferred beneficiary" is defined in paragraph 108(1)(g) to mean: (i) the settlor of the trust; (ii) the settlor's spouse or former spouse; or (iii) a child, grandchild or great grandchild of the settlor or of the settlor's spouse. Subsection 104(14) provides that a trust and a preferred beneficiary may jointly elect in respect of a taxation year that all or such part of the trust's accumulating income as is designated in the election may be included in the beneficiary's income for the year of the election and excluded from the income of any beneficiary of the trust (not necessarily the beneficiary making the election) for a subsequent year in which it is paid. By virtue of subsection 104(12), any amount elected and designated under subsection 104(14) may be deducted in computing the income of the trust for the year. (See Bernstein and Hanson, "The Taxation of Accumulating Income of Personal Trusts," (November - December, 1980) 28 Canadian Tax Journal 715-750 at 720-28).

152 See Dunkelman v. MNR, supra footnote 22; Meade v. MNR, supra footnote 24; Sachs v. The Queen, supra footnote 150.

153 Murphy v. The Queen [1980] CTC 386 (FCTD); Meade v. MNR, supra footnote 24. In Murphy, the taxpayer's spouse had no capital interest in the trust but merely a right to receive distributions of income if the trustees deemed it appropriate. The court recognizd that there could be no attribution unless the taxpayer had transferred income-producing property to his spouse and concluded that such a transfer had been made but did not succeed in identifying the "property" with any clarity.

154 Sachs v. The Queen, supra footnote 150.

155 Subsection 74.5(9) reads as follows:

(9) Where a taxpayer has loaned or transferred property, either directly or indirectly, by means of a trust or by any other means whatever, to a trust in which another taxpayer is beneficially interested, the taxpayer shall, for the purposes of this section and sections 74.1 to 74.4, be deemed to have loaned or transferred the property, as the case may be, to or for the benefit of the other taxpayer.

156 Subsection 74.5(10) reads as follows:

(10) For the purposes of this section and sections 74.1 to 74.4, a taxpayer is beneficially interested in a trust if the taxpayer has any right (whether immediate or future, whether absolute or contingent or whether conditional on or subject to the exercise of a discretionary power by any person or persons) to receive any of the income or capital of the trust either directly from the trust or indirectly through one or more other trusts.

157 See Cullity, "Trusts and the New Attribution Rules," notes for an address given to the National Tax Centre Conference, (Toronto, January 20, 1986) at 6.

158 [1964] CTC 469 (Ex. Ct.).

159 Subsection 122(1) provides that the tax rate for an inter vivos trust is 34 per cent of its taxable income for the year.

160 A "designated person" is defined in subsection 74.3(2) as follows:

(2) For the purposes of subsection (1), "designated person," in respect of an individual, means a person
(a) who is the individual's spouse; or
(b) who is under 18 years of age.

161 Ibid.

162 Supra footnote 156.

163 Subsection 104(21).

164 For a mathematical illustration of the operation of subsection 74.3(1), see Appendix "A."

165 E.g. subsection 104(19) (taxable dividends); subsection 104(21) (taxable capital gains); subsection 104(21.1) (taxable capital gains from Canadian securities).

166 Subsection 104(19).

167 Hartkorn, supra footnote 34, at 1238.

[168] Cullity, supra footnote 157, at 7.

[169] Ibid. at 8.

[170] See McDonnell, "The New Attribution Rules - Part Two," in Report Bulletin No. 469 (Prentice-Hall: March 20, 1986) at 10-11.

[171] Ibid.

[172] See Canada, Department of Finance, Notice of Ways and Means Motion to amend the Income Tax Act, tabled in the House of Commons on May 9, 1985.

[173] A "small business corporation" is defined in subsection 248(1) to mean a Canadian-controlled private corporation all or substantially all of the assets of which are:
(a) used in an active business carried on in Canada by the company or by a corporation that the company controls;
(b) shares, debt or security instruments of other small business corporations that are connected with the company within the meaning of subsection 186(4) (under these rules, for example, B Co. is connected to A Co. if A Co. controls B Co. or if A Co. beneficially owns, at that time, more than 10 per cent of the issued shares of B Co. having full voting rights under all circumstances and such shares represent greater than 10 per cent of the fair market value of all the issued share capital of B Co.); or
(c) any combination of assets described in the points above.
(See Traves, "The Small Business Corporation and Testamentary Planning - There's Nothing Small About It," (July - August, 1982) 30 Canadian Tax Journal 588-603).
The reasons why Parliament drafted the corporate attribution rules in subsection 74.4(2) so as to apply only to non-small business corporations were apparently two-fold: (i) it accepted the proposition that there is no attribution of income where the transferred (or loaned) property is used to earn business income, and (ii) in any event, it felt that subsection 56(2) could be effectively employed to prevent income splitting through small business corporations.

[174] Subsections 74.4(2) and (3) apply to transfers or loans made to a non-small business corporation after November 21, 1985.

[175] A "designated shareholder" is defined in subsection 74.4(1) as follows:

> (1) "designated shareholder" of a subject corporation in respect of an individual means a shareholder of the subject corporation that is
> (a) a person who is the individual's spouse,
> (b) a person who is under 18 years of age,
> (c) a partnership of which a person described in paragraph (a) or (b) is a member
> (d) a trust in which a person described in paragraph (a)

or (b) is beneficially interested, or
(e) a corporation (other than a small business corporation) of which a person described in paragraph (a) or (b) above is a specified shareholder.

176 Subsection 82(2) provides, inter alia, that, for the purposes of sections 74 to 75, a taxable dividend received by the individual from the subject corporation will retain its character for these purposes -i.e. it will be subject to the gross-up and tax credit mechanism.

177 Subsection 74.4(2) to subsection 74.4(5).

178 For a mathematical illustration of the operation of subsection 74.4(3), see Appendix "B."

179 Paragraph 74.4(3)(b).

180 A "gift over" is a gift to a particular individual for life, and from and after his decease, the property goes to another. It is equivalent to the concept of a "substitution" in the civil law whereby a testator names a second legatee who is to take the bequest either on failure of the original legatee or after him. (Black's Law Dictionary, 5th ed.).

181 Subsection 74.5(10).

182 See the definition of "designated benefit" in subsection 74.4(1) (and in particular clause (c)(ii)(B) with respect to the computation of a designated benefit in the case of a transfer of property) and clause 74.4(3)(a)(i)(B). (See Ulmer, supra footnote 103, at 34).

183 Subparagraph 74.4(3)(a)(i).

184 Subparagraph 74.4(3)(a)(ii).

185 It has been pointed out that this conclusion is not as clear as it could be. Hartkorn, (supra footnote 34, at 1238) considers that clause 74.4(3)(a)(ii)(B) does not actually achieve this result. Dart and Smith (supra footnote 103, at 13), on the other hand, conclude that this result is achieved, but in a clumsy manner. This divergence of opinion apparently stems from the failure of the legislation to refer specifically to interest on the loan; instead one is expected to interpret the term "excluded consideration" to include the interest which the individual receives from a subject corporation when he loans money to that corporation. This interpretation does appear to be consistent with the definition of "excluded consideration" in subsection 74.4(1), but is perhaps unexpected because the term "excluded consideration" is initially introduced in the context of transfers of property to a corporation and not loans to a corporation. (See Ulmer, supra footnote 103, at footnote 46).

186 See the definition of "designated benefit" in subsection

74.4(1), at clauses (c)(i) and (ii).

187 Ibid., clause (c)(ii)(A).

188 Ibid., clause (b).

189 Clauses 74.4(3)(ii)(A) and (B).

190 Subsection 74.4(4).

191 Paragraph 74.4(4)(a).

192 Paragraph 74.4(4)(b).

193 Hartkorn, supra footnote 34, at 1240; Ulmer, supra footnote 103, at 37.

194 Dart and Smith, supra footnote 103, at 14-16.

195 Ibid. at 17.

196 Supra footnote 173.

197 Ulmer, supra footnote 103, at 39.

198 It should be noted that the fact that a private corporation may otherwise qualify as a small business corporation within the meaning of subsection 248(1) does not automatically mean that the taxpayer will be able to effectively split income with other family members through the corporation. Where, for example, disproportionate dividends are paid to family members who are shareholders of the corporation, the taxpayer may open himself up to a subsection 56(2) assessment; and, where the taxpayer pays salaries to family members which are considered to be unreasonable in the circumstances, the effect of section 67 may be to disallow the salaries as a deductible expense for the company. (See the discussion under heading "Indirect Payments").

199 Hartkorn, supra footnote 34, at 1240.

200 Paragraph 87(2)(j.7).

201 Paragraph 88(1)(e.2).

202 See Crawford, "The New Income Attribution Rules for Non-Small Business Corporations," notes for an address given to the National Tax Centre Conference, (Toronto: January 20, 1986) at 6-7.

203 Subsection 74.1(2).

204 Subsection 74.4(5).

205 Subsection 74.5(6).

206 Subsection 74.5(7).

207 Subsection 74.5(11).

208 S.C. 1986, c.6.

209 Ibid.

210 Ibid.

211 Subsection 104(12).

212 Hartkorn, supra footnote 34, at 1242.

213 Paragraph 74.5(2)(c); Ulmer, supra footnote 103, at 43-4.

214 Subsection 74.1(3).

215 Hartkorn, supra footnote 34, at 1242.

216 Subsection 74.4(2).

217 S.C. 1986, c.6.

218 Income Tax Act 1948, subsection 21(1).

219 Supra footnote 22, at 384.

220 [1951] 1 All ER 76 (HL).

221 Finance Act, 1938, c.46.

222 (1) Any capital sum paid directly or indirectly in any relevant year of assessment by the trustees of a settlement to which this section applies to the settlor shall - (a) to the extent to which the amount of that sum falls within the amount of income available up to the end of that year, be treated for all the purposes of the Income Tax Acts as the income of the settlor for that year...

223 (5)...in this section - (a) the expression 'capital sum' means - (i) any sum paid by way of loan or repayment of a loan; and (ii) any other sum paid otherwise than as income, being a sum which is not paid for full consideration in money or money's worth.

224 Supra footnote 220, at 81.

225 Ibid., at 82.

226 Ward's Tax Law and Planning, supra footnote 79, vol. 1, paragraph 11.3[d].

227 See Dunkelman v. MNR, supra footnote 22, per Thurlow J. at 380.

228 R.S.C. 1927, c.97.

229 Fasken Estate v. MNR, supra footnote 65.

230 Supra footnote 22.

231 Supra footnote 23.

232 Supra footnote 22, at 380.

233 Supra footnote 65.

234 Supra footnote 90.

235 See also Naiberg v. MNR, [1966] Tax ABC 492 (TAB), which involved a scheme whereby each of the three taxpayers transferred shares of a private company to the wife of one of the other taxpayers in consideration for the wife assuming an obligation to pay the value of the shares to her husband. It was held that each husband had indirectly transferred his shares to his wife. Among the grounds on which the decision was based was the fact that upon completion of all the transfers the same number of shares remained "in the family."

236 [1980] CTC 386 (FCTD).

237 See the discussion under heading "The Requirement of Vesting."

238 In Murphy v. The Queen, supra footnote 236, it was clear that the taxpayer had a vested one-half interest in the income under the trust prior to the variation of the trust.

239 Supra footnote 127.

240 See Lynch, supra footnote 97, at 759; McKenzie, "Recent Developments in Income Splitting," Prairie Provinces Tax Conference, 1981 (Toronto: Canadian Tax Foundation, 1982) 415-453 at 426.

241 [1979] CTC 2320 (TRB).

242 A similar conclusion was reached in Luck v. MNR, [1980] CTC 2614 (TRB), where the taxpayer purchased a farm with his wife as tenants in common. When the taxpayer subsequently sold the farm some years later, he sought to split his mortgage interest income with his wife. It was held that the taxpayer could not split such income with his wife since that there was no evidence that she had contributed in any substantial way towards the purchase of the farm. Again, the Board intimated that the taxpayer would have succeeded if the farm had been purchased on the basis of a joint contribution by the spouses.

243 A lease is a contractual arrangement, either formal or informal, that defines the relationship between owners and

occupiers of real property. At common law, a lease is "a conveyance by which a person having an estate in hereditaments transfers a portion of his interest to another, usually in consideration of a certain periodical rent or other recompense, and it imports that exclusive possession is given of the premises conveyed." (Garland Manufacturing Co. v. Northumberland Paper Co. [1899] 31 OR 40 (Ont. C.A.)). In the Province of Quebec, article 1600 of the Civil Code provides that: "The lease of things is a contract by which the lessor binds himself towards the lessee to grant him the enjoyment of a thing during a certain time, for a consideration, the rent." This definition implies that, under Quebec law, unlike at common law, a lease of real property does not constitute a "transfer." Mignault is of the same opinion: "L'article [1600] stipule que le louage des choses accorde la jouissance d'une chose pendant un certain temps...En cela, le louage des choses diffère du bail a rente, de l'emphytéose et de certains baux de l'ancien droit...qui tous transtéraient un droit dans la propriété même de la chose, et non pas seulement la jouissance de cette chose... En vertu de l'article [1600], les baux a loyer ne transfèrent qu'une aliénation de la jouissance de cette même propriété." (Mignault, Droit civil canadien, tome 9, (Montreal: C. Theoret ed., 1935) 21-23.

244 A leasehold interest is an estate in realty held under a lease for a fixed term of years. While, in general, all interests in land are considered to be real property, a leasehold interest is an exception to this rule and is classified as personal property. (Megarry and Wade, supra footnote 68, at 10). However, for the purposes of the Act, subsection 248(4) provides that an "interest in real property" includes a leasehold interest.

245 In Stubart Investments Ltd. v. The Queen, [1984] CTC 294 (SCC), a case which involved an intercorporate transfer of assets in order to take advantage of a loss carryforward, Estey J., in specifically rejecting the proposition that a transaction could be disregarded for tax purposes solely on the basis that it was entered into by a taxpayer without a bona fide business purpose, stated that (at 313) the formal validity of a transaction may nevertheless be insufficient "... where the 'object and spirit' of the allowance or benefit provision is defeated by procedures blatantly adopted by the taxpayer to synthesize a loss, delay or other tax saving device..." Thus, in our example, the sublease of property to the taxpayer's wife would, it seems, be a procedure designed by the taxpayer as a tax saving (i.e. income splitting) device and might therefore violate the 'object and spirit' of the attribution provisions. (Quaere: What degree of tax saving would constitute a "blatant" (as opposed to, say, a "moderate") violation of the 'object and spirit' of the attribution provisions?).

246 See the discussion under heading "Transfers to Trusts."

247 Supra footnote 146.

248 See Cullity, supra footnote 24; Hansen, supra footnote 24, at

627-28.

249 Re Baden's Trust Deed [1971] A.C. 424 (HL); Gartside v. IRC [1968] A.C. 553 (HL); IRC v. Holmden [1968] A.C. 685 (HL). It should be noted, however, that while the discussions in these cases are to some extent generally applicable, they did not arise in the context of anti-avoidance and attribution sections which may involve different considerations.

250 [1980] CTC 358 (FCA).

251 Subsection 104(14) and Regulation 2800 set out a scheme under which the trustees of a trust and the preferred beneficiaries (supra footnote 148) may elect with respect to the "accumulating income" of the trust. ("Accumulating income" is defined in paragraph 108(1)(a) as being the trust's income for that year before deduction of amounts subject to preferred beneficiary elections -i.e. it is the trust's income after deduction of the amounts payable to beneficiaries). The effect of the election is that the designated portion of the accumulated income is regarded as having been received by the preferred beneficiary and is therefore deducted by the trust in computing its income for tax purposes. The amount so designated is included in the tax return of the preferred beneficiary for tax purposes, although no amount of income is in fact distributed to him. (See "Income Splitting - Attribution Rules," in "Current Cases," (September - October, 1980) 28 Canadian Tax Journal 618).

252 Supra footnote 250, at 360.

253 Supra footnote 147.

254 Supra footnote 22.

255 Supra footnote 65.

256 See Bernstein and Hanson, supra footnote 151, at 745-49; Fuke, "Current Developments in Estate Planning," Prairie Provinces Tax Conference, 1981 (Toronto: Canadian Tax Foundation, 1982) at 399 et. s.

257 [1980] CTC 386 (FCTD).

258 Ibid. at 396.

259 See McDonnell in "Current Cases," feature, (November - December, 1980) 28 Canadian Tax Journal 783-88 at 784.

260 It is true, he said, that in the Sachs case the property transferred to the discretionary trust was shares, a chose in action, whereas in the instant case the property was "an intangible or incorporeal right, a much more nebulous type of property but it was property nevertheless." (Supra footnote 257, at 394).

261 Ibid. at 395.

262 Under a purely discretionary trust, the trustee no obligation whatsoever to distribute income and/or capital to the beneficiaries thereof. In any particular year, he is required only to consider whether or not some or all of the trust income should be distributed to a particular beneficiary. If his decision not to distribute any property is an honest and objective one, he has no action against him for breach of trust. (See Waters, Law of Trusts in Canada (Toronto: Carswell, 1984) at 766-77).

263 Paragraph 104(15)(c) deals with the case of a fully discretionary trust (such as the one in Sachs) under which the only beneficiaries are children of the settlor. The paragraph directs that the portion of the accumulating income of any particular beneficiary is to be determined in prescribed manner. Regulation 2800(3) provides rules that set limits on the amount that may be regarded as the shares of any particular beneficiary. Where all the beneficiaries are minor children and the settlor and/or his spouse is not entitled to share in the accumulating income, the regulation provides that the accumulating income of the trust is to be notionally divided equally between the minor beneficiaries for purposes of the preferred beneficiary election. (McDonnell, supra 259, at 618).

264 Subsections 104(2); 104(6); Pichosky v. MNR, supra footnote 158.

265 Black's Law Dictionary, 5th ed.; See MacGowan, supra footnote 56, at 288-89.

266 See Bernstein, "Marriage - A Tax Shelter?" 21 McGill Law Journal, (1975) 631-655 at 636. In the Province of Quebec, gifts included in a marriage contract are valid by virtue of article 1257 of the Civil Code subject to the proviso that the clause containing such gifts is not contrary to public order or good morals (article 1258). See, for example, Molson v. MNR [1938-39] CTC 12 (Ex. Ct.); aff'd [1938] SCR 213 (SCC) (antenuptial gift of corporate securities by husband to wife with wife to receive all dividends therefrom until the husband's death); Connell v. MNR [1946] CTC 303 (Ex. Ct.) (antenuptial gift of corporate shares by husband to wife). In the common law Provinces, antenuptial gifts in the formal (i.e. contractual) sense have largely been replaced by the more customary and informal "wedding gift." See MacGowan, supra footnote 56, at 288.

267 While marriage contracts and settlements have lost most of their allure in the common law Provinces, one practitioner suggests two situations where a marriage contract should be seriously considered at the outset of the marriage or before its actual celebration. The first situation is marriage between young people who do not possess substantial incomes or assets, but whose prospects indicate that one or both will in future possess substantial incomes or assets - for example, through inheritance or receiving shares in a family corporation. Since the advent of

family law reform legislation has significantly changed the rights and obligations of the spouses (basically giving each spouse a one-half interest in the assets of the other spouse (see the discussion under heading "Attribution and Family Law")), it is no longer only the very rich who must contemplate antenuptial agreements or marriage settlements, and this is reinforced by the extremely high incidence of divorce in recent years. The second situation where an antenuptial agreement or marriage settlement is important is that in which two persons marry in the later years of their lives, following the death of a former spouse. Both parties may have sufficient assets and income to maintain themselves, and they prefer, for personal reasons, to keep such wealth separate and independent from each other and not comingled. This situation requires careful documentation if the assets of each party are to be used in accordance with his or her respective wishes. (See Hull, "Estate Planning for the Stable and Unstable Marriage and for Nonmarital Cohabitation," Report of Proceedings of the Thirty-Third Tax Conference, 1980 (Toronto: Canadian Tax Foundation, 1981)) 993-1003 at 996-97.

268 In the Province of Quebec, marriage takes effect from the date of the celebration of the marriage notwithstanding any stipulation to the contrary: Article 1261 CC. Thus, it is from this date that the attribution rules will commence to operate with respect to pre-marital transfers of property. It should also be noted that where a pre-marital transfer of property is made (i.e. before the parties are spouses) without any consideration or at less than fair market value, the rules with respect to transfers for inadequate consideration contained in subsection 69(1) will come into effect, for while the parties would not be deemed not to be dealing at arm's length under paragraph 251(1)(a) and paragraph 251(2)(a), they would appear, because of the nature of their relationship, not to be dealing at arm's length on a de facto basis pursuant to paragraph 251(1)(b). (See Couzin, supra footnote 117).

269 R.S.C. 1948, c.52, subsection 21(1).

270 Supra footnote 96.

271 Supra footnote 266.

272 (1917) Dom. c.28, subsection 4(4).

273 Supra footnote 266; see the opinion of Cannon J. at 225; per Duff C.J.C. at 218.

274 [1946] CTC 303 (Ex. Ct.).

275 See also Dobell v. MNR, [1950] CTC 379 (Ex. Ct.), where it was held that a transfer of property made under a pre-marital contract did not attract attribution under former subsection 32(2) since the transfer was made before the Income War Tax Act (1917) came into force. This was so, notwithstanding that a portion of the gift was physically transferred to the donee after the marriage

had taken place.

276 See Houghton v. MNR, [1956] 15 Tax ABC 246 (TAB), where the Chairman (Monet Q.C.) held that, under the Quebec Civil Code, a gift in a marriage contract takes effect at the time the contract is signed.

277 Ibid.

278 The Board did not explain the basis of the taxpayer's argument that there were two separate gifts, but it seems that the first gift of $10,000 was simply the original antenuptial gift, while the second gift of $13,000 represented the fair market value of the property in 1951 less the value of the original antenuptial gift.

279 Where a taxpayer agrees to transfer capital property to his future spouse pursuant to a marriage contract entered into after 1972, the result seems clear, even where delivery of the property takes place several years after the deed is signed. Since the parties would not be married at the time the deed is signed, the automatic rollover under subsection 73(1) would not apply. However, it seems that because of the inherent nature of the relationship, the parties would not be dealing at arm's length by virtue of paragraph 251(1)(b) (upon marriage they would be statutorily deemed not to be dealing at arm's length by virtue of paragraphs 251(1)(a) and (2)(a)) and therefore by virtue of subsection 69(1) the taxpayer would be deemed to dispose of the property for proceeds of disposition equal to the fair market value of the property and the transferee would be deemed to acquire the property at fair market value. If the property has appreciated in value since its acquisition, the transferor will incur a capital gain and/or recapture of capital cost allowance where applicable. Where the transferee subsequently disposes of the property after delivery, the adjusted cost base will be equal to the fair market value at the time of effective transfer -i.e. the date of the marriage contract. If the property has declined in value and will result in a capital loss attributable to the transferor, care should be taken to ensure that the deed is signed more than 31 days prior to the marriage in order to avoid the superficial loss rules contained in subsection 54(1) and subparagraph 40(2)(g)(i).

280 We are here not dealing with antenuptial gifts given by one of the spouses directly to the other but rather with gifts (cash and/or other personal property or real property) given to the spouses by friends or relatives (i.e. third parties).

281 [1960] 1 All ER 653 (C.A.).

282 See also Hichens v. Hichens, [1945] 1 All ER 451 (C.A.), per Lord Goddard (at 453): "...it is often very difficult to decide questions of property between husband and wife according to their strict rights. The matter very often comes up with respect to wedding presents, which in one sense are given to both spouses,

and very often you have to solve the matter by saying that if a present is given by a friend of the wife or a relation of the wife the property should be given to the wife, and that it should be given to the husband if it was a present by a relation or friend of the husband."

283 [1950] L.T. Jo. 108 (Chan. Ct.).

284 There do not appear to be any reported Canadian cases which have specifically considered the question of ownership of wedding gifts received from third parties.

285 [1953] 124 NYS (2d Series) 517 (NY Municipal Ct.).

286 The same conclusion was reached in the earlier case of Falk v. Falk, [1947] 103 NYS (2d Series) 1036 (NY Supreme Ct.), where it was held that a wedding gift of $10,000 given by the wife's parents became the joint property of both spouses. It was also held, as a logical corollary, that certain real property which the spouses subsequently purchased with such money also became jointly owned. See, however, Ilgenfritz v. Ilgenfritz, [1952] 49 Mo. App. 127 (Mo. Ct. App.), where it was held that wedding gifts given to the wife by her friends and relatives became her own personal property and that there was no legal presumption of joint ownership with respect to wedding gifts. The authority of this case, however, would seem to be impaired by reason of its reliance upon the particular terms of the Missouri statute in question.

287 With all due respect to the English justices, it is submitted that the American position (i.e. existence of a presumption of joint ownership of wedding gifts) reflects a more realistic assessment of current marital trends. This is the age of "50-50" marriages, and it is accurate to say that while marriage may have been a one-headed relationship in the past, it is undoubtedly today a partnership of equals. If, however, one supports the English position then, as Professor Dussault points out (infra footnote 303), the intention of the donor should be evidenced by appropriate documentation in the case where wedding gifts involve substantial value. Although the donor will be primarily motivated by his relationship with the donees, he should take into account the present and anticipated tax position of the parties to the marriage.

288 The question of whether two properties are identical (within the meaning of section 47) is discussed below at 134.

289 Canada Tax Service, supra footnote 97, at paragraph 54-150.

290 See MacGowan, supra footnote 56, at 284. The operation of the superficial loss provisions therefore requires the taxpayer and his spouse to maintain a close watch on each other's investments and to have full knowledge of their respective acquisitions and dispositions of capital property.

291 For the sake of simplicity, we will assume that the parties

have stipulated in their marriage contract that the antenuptial gift will take effect from the date of the solemnization of the marriage.

292 For an analysis of the relationship between marital regimes in the Province of Quebec and the attribution rules, see Cuddihy, "L'application des Lois Fiscales aux Régimes Matrimoniaux," 82 La Revue du Notariat, (January-February, 1980) 241-271.

293 Articles 1260 and 1268 CC.

294 Article 1265 CC. For a detailed discussion of certain tax consequences following a variation of the marital regime see Jolin, "Tax Aspects of Matrimonial Regimes in Quebec," Report of Proceedings of the Thirty-First Tax Conference, 1979 (Toronto: Canadian Tax Foundation 1980) 277-315. Where the parties enter into a marriage contract after July 1, 1970, they may elect to be governed by the regime of separation of property, partnership of acquests or community of property -i.e. any of the three marital regimes. In their marriage contract, the parties are free to stipulate all kinds of agreements concerning their respective rights and obligations in the marriage, subject to the condition that no covenant shall be contrary to public order and good morals (articles 1257, 1258 CC).

295 Article 1266e CC. The main distinguishing characteristics of the three types of marital regimes are described below under the heading "Attribution and Family Law."

296 Subsections 74.1(1) and 74.2(1).

297 Article 406 CC.

298 Article 1266d(2) CC.

299 Article 1266p CC.

300 Such a "droit de suite" (i.e. the right of a creditor to pursue the debtor's property into the hands of third parties for the enforcement of his claim) exists by virtue of section 160 under which the transferor and transferee are jointly and severally bound to pay certain taxes owed by the transferor at the time of the transfer up to the value of the property transferred. As well, the transferee is solidarily bound to pay taxes owed by the transferor in respect of attributed income. See the discussion under heading "Tax Liability on Property not Transferred at Arm's Length."

301 Article 1297 CC: "The wife has the administration and free disposal of her private property..."

302 Article 1275 CC.

303 Article 1272(1) CC.

304 [1962] 62 DTC 1005 (SCC).

305 He alone can dispose of this income, he alone has the unrestricted enjoyment of this income, and nothing can leave the common fund unless it results from the expression of his wish. He receives on his own account, and not at all as agent or fiduciary for the benefit of his wife. (Ibid. at 1007)

306 Ibid. at 1008.

307 Cuddihy, supra footnote 292, at 246. The paramountcy, in this case, of subsection 74.1(1) appears to be based on the principle that a specific provision of a statute will override a rule or judgment of general application.

308 Prior to 1969, it was the husband alone, as sole administrator of the community, who could freely dispose of such property; the right of the wife with respect to the community property did not crystallize until the dissolution of the marriage (article 1338 CC). After 1969, the husband's right to freely dispose of community property was fettered by an amendment to article 1292 CC. Although the husband remained the sole administrator, he is now required to obtain the prior concurrence of his wife in order to validly make a gift inter vivos of community property or to alienate any immoveable property belonging to the community.

309 See Dussault, "The Taxation of the Spouses - A Quebec Perspective," Report of Proceedings of the Twenty-Sixth Tax Conference 1974 (Toronto: Canadian Tax Foundation 1975) 339-358 at 347.

310 That the husband and wife are co-owners of the property of the community, cannot, it seems to me, be doubted by the jurists. In spite of the hesitations that certain authors have entertained, I believe that it is now universally conceded that this in fact is the rule by which we must be governed. (Supra footnote 304, at 1008).

311 See Dussault, supra footnote 309, at 346; Bernstein, supra footnote 266, at 634.

312 It should be noted that the Sura case did not deal with the taxation of capital gains resulting from the disposition of community property, but only with income derived from community property.

313 [1954] CTC 50 (Ex. Ct.).

314 See Interpretation Bulletin IT-258R2, paragraph 11.

315 For a mathematical illustration of such income splitting see Wakeling, supra footnote 9.

316 See Stratton v. MNR, [1966] CTC 637 (Ex. Ct.), where the taxpayer transferred his one-half interest in certain farm property to his wife. It was held that former subsection 21(1) (now subsection 74.1(1)) had a one-way effect -i.e. the subsection only applied to the attribution of income back to the transferor but did not allow for the attribution of any losses incurred by the transferee in respect of the transferred property. To the same effect, see Martens v. MNR [1964] 35 Tax ABC 9 (TAB).

317 Supra footnote 127, at 259.

318 [1971] Tax ABC 247 (TAB).

319 The basis of the decision appears to be simply that the Act cannot be applied in an extra-territorial manner to transactions conducted by the taxpayer while he was not a Canadian resident.

320 In the result therefore I am of the opinion that whatever interest the appellant's wife had in the funds in the Swiss banks must for the purposes of this case be regarded as property transferred to her by the appellant within the meaning of subsection 21(1)... (Supra footnote 127, at 260).

321 [1986] 1 CTC 114 (FCTD).

322 Ibid. at 119.

323 Since there is no section of the Act which taxes a non-resident in respect of income earned or gains realized outside Canada (subsection 2(1) and section 114 tax worldwide income of an individual who is resident in Canada for all or part of the year respectively; subsection 2(3) and section 115 tax the income and certain gains realized by a non-resident who is employed or carries on business in Canada, or who disposes of certain taxable Canadian property) it would seem that, according to the principle that there is no taxation unless the Act specifically provides for it, such income or gains would not be taxable. (See Cumyn, A Non-Resident's Guide to Canadian Taxation, (Toronto: De Boo, 1977) at 1-13).

324 Supra footnote 321, at 119-20.

325 Supra footnote 323.

326 See Government of India v. Taylor, [1955] A.C. 491 (HL), where it was held that a foreign state was precluded from suing in English courts for taxes due under the laws of that state since the courts of one state do not permit judgments for foreign taxes to be enforced.

327 See B.C. Electric Railway Co. Ltd. v. The King, [1946] CTC 224 (J.C.P.C.), where it was held that it was within the legislative competence of Parliament to require that Canadian resident companies withold tax on the payment of dividends to non-

residents.

328 Income Taxation in Canada (Prentice-Hall), supra footnote 97, vol. 4 paragraph 79,071. What seems to be agreed upon is that the words "while he is resident in Canada" in subsection 74.1(1) indicate that attribution will cease in the event that the individual severs his Canadian residence. See Katz, supra footnote 138, at 299; McKenzie, supra footnote 240, at 429.

329 Ibid. See also Canada Tax Service, supra footnote 97, at paragraph 74-111. The Department is of the same opinion: Interpretation Bulletin IT-258R2, paragraph 13(b).

330 The words "that relates to the period in the year throughout which the individual is resident in Canada" in subsection 74.1(1) make it clear that attribution is contingent only upon the individual (and not his spouse) being a Canadian resident.

331 While it has been argued that Canada's tax treaties will not assist a resident Canadian taxpayer where he is subject to attribution in respect of transfers made to a non-resident (see McKenzie, supra footnote 240, at 429), in fact the opposite appears to be the case. In Fletcher v. MNR, [1977] CTC 2256 (TRB), the taxpayer, a Canadian resident, made gifts of corporate shares to his nieces in the United Kingdom in trust for their minor children. When dividends were subsequently paid on the shares, the Minister invoked former subsection 75(1) and added their value to the taxpayer's income. The taxpayer argued that under article 9(3) (the present article X(1)) of the Canada - United Kingdom tax treaty, the tax on dividends should not exceed 15 per cent of the gross amount thereof. The Board agreed with the taxpayer that the limitation under the treaty should prevail and ruled in his favour. This decision is on sound footing since it accords with the principle of treaty paramountcy -i.e. in Canada, tax treaty provisions override domestic law, past and future. See Hunter-Douglas v. The Queen [1979] CTC 424 (FCTD); Associates Corp. of North America v. The Queen [1980] CTC 80 (FCTD).

332 A possible consequence of the application of the foregoing principle would be double taxation on the same income where the recipient spouse is a non-resident who derives attributed income from Canadian source investments -i.e. one tax levied under Part I which is payable by the individual and a second tax imposed on the recipient under Part XIII (witholding tax). To alleviate this possibility of double taxation, subsection 212(12) specifically exempts the non-resident from Part XIII tax.

333 Subsection 48(1).

334 See Katz, supra footnote 138, at 299.

335 The apparent rationale for the addition of subsection 73(1.1) (added to the Act by S.C. 1977-78, c.32) was that tax-paying spouses should not be subject to adverse tax consequences as a result of legislative enactments over which they have little

direct control and which were brought into force for reasons unrelated to income tax treatment. For example, the former Ontario Family Law Reform Act (S.O. 1980, c.152) introduced a new system of property law for spouses under which, basically, the spouses became entitled to the division of all family assets into equal shares upon marriage breakdown regardless of the actual ownership of the assets. Prior to the enactment of such legislation, upon a marital breakdown, transfers of, say, capital property, in settlement of a spouse's claim for equal division of the family assets, could give rise to capital gains consequences by operation of law, without any voluntary disposition of the property. Thus, subsection 73(1.1) was added to provide certain relief (i.e. a tax-free rollover) where the parties are ordered by a court to effect certain transfers which would otherwise give rise to adverse tax consequences. In such a situation, it was recognized that there is not the element of tax avoidance which is sought to be addressed by, for example, the attribution rules. (See Eng, "Tax Consequences of Provincial Family Law Reform Legislation," (September - October 1978) 26 Canadian Tax Journal 554-574).

336 See Ward's Tax Law and Planning, supra footnote 79, vol. III, paragraph 11.3[b]. In Gathercole v. Smith, [1881] 17 Ch. D. 3 (C.A.), however, the English Court of Appeal was of the opinion that the word "transfer" does include a transfer of property which takes place by operation of law. In this case, the issue was whether or not the pension granted to a retiring public official was "transferable at law or in equity." Per James L.J. at 7:

> Now 'transfer' is one of the widest terms that can be used. It appears to me that very word was used by the Legislature not only to prevent the incumbent from assigning himself, but for preventing any transfer by operation of law in invitum - not only to prevent a voluntary dealing by an incumbent with an annuity...but to prevent the annuity from being otherwise transferred.

Per Lush L.J. at 9:

> The word 'transferable,' I agree with Lord Justice James, is a word of the widest import and includes every means by which the property may be passed from one person to another.

Even if one does accept the proposition that the attribution rules apply to transfers by operation of law, it is arguable that such a proposition is limited to transfers of capital property since subsection 73(1) is itself expressly restricted to transfers of capital property.

337 [1955] 13 Tax ABC 379 (TAB).

338 Ibid. at 382. It should be noted that the decision in Reese to the effect that a Canadian resident could invoke the laws of his matrimonial domicile in order to effectively split his income was

not folllowed in later cases where the issue arose. In Bedford v. MNR, [1969] 29 Tax ABC 397 (TAB), it was held that a taxpayer resident in Canada, although domiciled in the United States, could not invoke the property laws of his conjugal domicile in order to split his United States' source income with his spouse. The rationale for the decision was based on that enunciated in the case of Sura v. MNR, supra footnote 304, namely that the Act taxes the person and not his property. In the Sura case, the taxpayer argued that because of the community of property laws in the Province of Quebec, he should be entitled to pay tax on only one-half of his income and his wife on the other one-half. The Supreme Court held that tax is imposed on the person and not on the property; that the tax is imposed on the legal beneficiary of the income from a source; that the Quebec community of property laws did not render the wife the beneficial owner of the income but gave her only a future right on division of the property. Accordingly, the ownership of the property giving rise to such income in the hands of the person being taxed is irrelevant. See also: Skelton v. MNR, [1956] 14 Tax ABC 413 (TAB), where a United States' resident carrying on business in Canada was unsuccessful in his contention that one-half of such Canadian business income should be taxed in his wife's hands on the basis that, under the State of Idaho laws, he was married in community of property; Pope v. MNR [1960] 25 Tax ABC 22 (TAB); and No. 676 v. MNR [1960] 25 Tax ABC 95 (TAB), where the Board, in both cases, followed the decision in Sura and held that income falling into a legal regime of community of property was taxable solely in the hands of the husband.

339 Supra footnote 127.

340 By virtue of article 1268 et. s. of the Quebec Civil Code all moveable property owned by the spouses before the marriage automatically falls into the community on the day of the celebration of the marriage. (Except in the limited circumstances provided for by article 1275 CC, immoveable property does not enter into the community). If this is the case then, unless one interprets Thurlow J.'s decision (i.e. that the pre-nuptial contract had the effect of transferring the property in question from husband to wife) as confining attribution to the income from property acquired prior to the marriage, his lordship's opinion clearly requires some modification of the notion that a transfer involves the divesting of proprietary rights which were formerly vested in the transferor.

341 Subection 248(1).

342 In fact, it appears that the property disposed of by the taxpayer and the property acquired by the spouse or minor child need not be identical. All that is necessary is that the transferee acquire some property right as a direct result of a disposition of property by the transferor. See Fasken Estate v. MNR, supra footnote 65; Murphy v. The Queen, supra footnote 257.

343 [1951] 3 Tax ABC 280 (TAB).

344 See also Trinca v. MNR, supra footnote 24, where it was held that business income which was derived from transferred property was subject to attribution but only on that proportion of the business income that the amounts transferred by the transferor bore to the total cost of purchasing and commencing the transferee's business.

345 [1963] CTC 364 (Ex. Ct.).

346 Cullity, supra footnote 24, at 103; London, "Taxation of the Family United," Report of Proceedings of the Twenty-Sixth Tax Conference, 1974 (Toronto: Canadian Tax Foundation 1975) 297-317 at 310.

347 See Goodman v. MNR, supra footnote 343; Trinca v. MNR, supra footnote 24; MNR v. Minden, supra footnote 345.

348 Supra footnote 26.

349 Supra footnote 22.

350 Ibid. at 391.

351 [1979] CTC 389 (FCA).

352 Ibid. at 391.

353 This is a clear application of the maxim inclusio unius est exclusio alterius. While it may have been noted that the judicial opinions which support this proposition (i.e. Noel J. in Robins, Urie J. in Lackie) are obiter dicta, there is some additional reassurance provided by Interpretation Bulletin IT-258R2, paragraph 10, and Interpretation Bulletin IT-260R, paragraph 8, which state that, in the Department's view, the attribution rules do not apply to business income derived from transferred property.

354 For a critical analysis of the distinction between income from business and income from property see Couzin, "Business and Property Income," in Current Developments in Measuring Business Income for Tax Purposes, Corporate Management Tax Conference, 1981 (Toronto: Canadian Tax Foundation 1982) 41-71. See also Ward's Tax Law and Planning, supra footnote 79, vol. II, paragraphs 40.1 - 40.3[b]; Grover and Iacobucci, Materials on Canadian Income Tax, 6th ed. (Toronto: DeBoo, 1985) 230-260.

355 Perhaps it is prudent to preface the remarks contained in this section with the proposition that income from business and income from property are "not mutually exclusive but blend completely" (per Thurlow J. in Wertman v. MNR, supra footnote 127, at 262). In particular, where there is a statutory reference to income from a business, then the mere fact that the type or character of revenue is one which naturally arises from the utilization of property

does not exhaust the issue. This point was expressed by Thurlow J. in Wertman (at 266):

> That the rentals are primarily or entirely receipts from property may be a factor of great importance but it is not necessarily conclusive for the question in a case such as the present one is not so much what the income is derived from but whether the income can be fairly described as income from a business within the meaning of that term as used in the Act. Moreover, cases are I think readily conceivable where particular income may be accurately described as income from property and just as accurately as income from a business.

356 It should be noted that while the statutory definition of "property" is very broad, it is nevertheless exhaustive (the word there is "means"); on the other hand, the definition of "business" is merely inclusive. This normally means that the word "business" must bear both its normal meaning and the extended statutory meaning, and one cannot restrict the former because of the latter. (See, for example, The Queen v. Compagnie Immobilière BCN Ltée [1979] CTC 71 (SCC) at 76).

357 [1948] CTC 189 (Ex. Ct.).

358 [1881] 4 T.C. 422 (C.A.) at 423, 425. The Canadian courts appear to have adopted the same view. See The Queen v. Rockmore Investments Ltd., [1976] CTC 291 (FCA), per Jackett C.J. at 293:

> Apart from [subsection 248(1)], I know of no special considerations to be taken into account from a legal point of view in deciding whether an activity or situation constitutes the carrying on of business for the purposes of Part I of the Income Tax Act. Subject thereto, as I understand it, each problem that arises as to whether a business is or was being carried on must be solved as a question of fact having regard to the circumstances of the particular case.

359 Drawing the line between the two sources does not mean determining what income has which source, but rather perceiving when income from property passes into the commercial sphere and becomes income from a business. Or, looking at it in a different perspective: "If income from property has any meaning at all, it can only mean the production of revenue from the use of such property which produces such income without the active and extensive business-like intervention of its owner or someone on his behalf." (Per Noel J. in Hollinger v. MNR [1972] CTC 592 (FCTD) at 600). See also Weintraub v. MNR [1975] CTC 112 (FCTD). And in the same spirit: "...the contrast in paragraph 3(a) of the Act between 'business' and 'property' as sources of income makes it clear, I think, that a line must be drawn for the purposes of the Act, between mere investment in property...for the acquisition of income from that property and an activity or activities that constitute 'an adventure or concern in the nature of trade' or a

'trade' in the sense of those expressions in section 248." (Per Jackett C.J. in Rockmore Investments at 293). Thus, where the income arises from a property to which there has been applied "the active and business-like intervention of its owner," there may be said to be a business source.

360 [1972] CTC 592 (FCTD) at 599-600.

361 It has been held that the income of a partnership may be either income from business or income from property for purposes of the Act, notwithstanding that a partnership is defined in the Partnership Acts of the commmon law Provinces (and in article 1830 of the Quebec Civil Code) to be the relationship subsisting between persons carrying on a business in common with a view to profit. See Mandel v. The Queen [1976] CTC 545 (FCTD); (this issue was not raised on further appeal).

362 The taxation of income from rental property has been the subject of several articles. See, for example, Johnston, "Leasing," Corporate Management Tax Conference 1973 (Toronto: Canadian Tax Foundation 1974) 107-23; Appleby, "Income Tax Considerations for Landlord and Tenant" in Shopping Centre Leases (Agincourt, Ont: Canada Law Book 1976) 131-62; Marlow, "Income from Rental Real Estate," Corporate Management Tax Conference, 1977 (Toronto: Canadian Tax Foundation 1978) 105-23; Ostfield, "Income Tax Considerations of Leasing: An Update," in Income Tax Aspects of Corporate Financing, Corporate Management Tax Conference, 1980 (Toronto: Canadian Tax Foundation 1981) 229-77; series of papers in the panel "Choice of Methods for Holding and Developing Real Estate," in Report of Proceedings of the Thirty-First Tax Conference, 1979 (Toronto: Canadian Tax Foundation, 1980) 637-750; Richardson, "Holding Real Estate for the Production of Income," Corporate Management Tax Conference, 1982 (Toronto, Canadian Tax Foundation, 1983) 3-58.

363 The term "real property," as used in this section, would include any real estate acquired for the purpose of earning income in the form of rentals. It would include residential accomodations such as houses or multilevel apartment complexes, as well as commercial real estate such as office buildings, shopping centres, industrial buildings, factories and manufacturing plants.

364 It is interesting to note that under the Income War Tax Act (R.S.C. 1927, c.97) it was unnecessary for the court to decide whether rental income received from the letting of real property constituted business income or property income. This was because under subparagraph 2(1)(m) of this Act "earned income" was defined to include, inter alia, "business income," and it specifically excluded "income derived by way of rents or royalties;" under subparagraph 2(1)(n), "investment income" was defined to include any income which was not included in "earned income." Thus, rental income was statutorily defined to be "investment income" and could not, by definition, constitute business income. See Demers v. MNR [1950] 2 Tax ABC 387 (TAB); Sebilleau v. MNR [1950] 2 Tax ABC 245 (TAB).

365 Reference may be made to certain personal corporation cases where the Tax Appeal Board appeared simply to take it for granted that real estate rental income constituted property income and not business income. See, for example, Von Westphalen v. MNR [1964] 35 Tax ABC 29; Glaspie v. MNR [1963] 33 Tax ABC 274; and Manson v. MNR [1952] 7 Tax ABC 298, where it was held that real estate rentals had to be considered as property income on the basis that very little effort was expended by the landlord to earn the income in question. See also Van Der Voort v. MNR [1958] 21 Tax ABC 28; No. 136 v. MNR [1953] 9 Tax ABC 366; and Peery Estate v. MNR [1952] 6 Tax ABC 311. See, however, Ginsberg v. MNR, [1953] 9 Tax ABC 321, and Rubinstein v. MNR, [1962] 28 Tax ABC 348, where it was held that real estate rentals earned by an individual constituted business income since the rent was derived from office buildings and other commercial (i.e. non-residential) establishments.

366 The size or number of units being rented, the extent to which their management or supervision occupies the owner's time, whether the property is rented bare or partially furnished are not factors to be taken into account in determining if the operation is a business. (See Ravasi v. MNR [1979] CTC 2808 (TRB)). Also, the annual gross income derived from the property as well as whether the property is managed by an agent instead of the owner himself is not relevant in the characterization of the rental income. (See Baginski v. MNR [1978] CTC 2679 (TRB)).

367 [1965] CTC 478 (Ex. Ct.) at 485. In Wertman v. MNR, supra footnote 127, Thurlow J., after citing with approval the opinion of O'Connor J. in Martin v. MNR, supra footnote 357, to the effect that, prima facie, the perception of rent by a property owner does not constitute the carrying on of business, said (at 267):

> There may well be cases wherein the extent of the various services provided by the landlord under the terms of the leasing contract is such that the rental paid by the tenant can be regarded as in a substantial measure a payment for such services as well as for the use of the property and the interrelation of the use of the premises with the use of such services may be so extensive that the whole sum paid could readily be regared not as mere rental of property but as true receipts of a business of providing apartments and services to tenants...The nature of the services provided in my opinion also has a bearing on the question, such as maid service and linen and laundry service, being more indicative of a business operation...

368 See The Queen v. Canadian-American Loan Investment Ltd. [1974] CTC 101 (FCTD).

369 In Burri v. The Queen, [1985] 2 CTC 42 (FCTD), the question was whether the income earned by two corporations from the rental

of apartment buildings was "Canadian investment income" within the meaning of what is now subparagraph 129(4)(a)(ii) or whether the rentals constituted income from an active business. Strayer J., in holding that the rentals constituted Canadian investment income, stated that the tests for distinguishing between business income and property income put forward in Wertman (supra footnote 127), and in Walsh and Micay (supra footnote 367) (i.e. the nature and extent of the services provided by the landlord) applied equally as well to rentals received by a corporate landlord. (See also Spence Building Ltd. v. MNR [1977] CTC 2104 (TRB); J.A. Leroux Inc. v. MNR [1979] CTC 3051 (TRB); and Cross Country Development Corp. v. MNR [1981] CTC 2558 (TRB), where, in each case, rental income was found to be income from property.

370 See CIR v. Korean Syndicate Ltd., [1921] 12 T.C. 181 (C.A.), per Lord Sterndale a 196; see also Anderson Logging Co. v. The King, [1924] SCR 45 (SCC) per Duff J. at 56. In Burri v. The Queen, (supra footnote 369), however, Strayer J. questioned the validity of the presumption that a corporation's profits should be characterized as business income as opposed to property income, and even went as far as to deny the existence of the presumption altogether. The learned judge held that, in any event, if such presumption did exist it was clearly rebuttable and, in the instant case, it was rebutted by the limited nature of the services provided to the tenants as well as the breadth of the company's objects of incorporation which provided, inter alia, that the company was empowered to "sell, lease, exchange or mortgage ... the lands or any of the buildings [owned by it]."

371 See Richardson, supra footnote 362, at 7.

372 See The Queen v. Rockmore Investments Ltd. [1976] CTC 291 (FCA); The Queen v. Cadboro Bay Holdings Ltd. [1977] CTC 186 (FCTD).

373 Richardson, supra footnote 362, at 7.

374 Ibid. But see Burri v. The Queen, supra footnote 369, for a contrary opinion. It is submitted that if one looks at the substance of the transaction (i.e. the receipt of rental income from the leasing of real property) as opposed to its form, there is essentially no difference in the situation where an individual leases real property as opposed to the situation where a corporation is used to lease the same type of property. Thus, Strayer J.'s clear recognition of a corporation's ability to have income from property even in pursuit of objects mentioned in its memorandum of association may be the correct position to take.

375 Crossley Vaines, supra footnote 66, at 4-5.

376 Subsection 248(4) specifically excludes a mortgage from being an interest in real property; therefore, for the purposes of the Act, it must be classified as personal property.

377 Crossley Vaines, supra footnote 66, at 9-11. The list is not

exhaustive but illustrative.

378 Paragraphs 12(1)(j), (k). See the dicta of Noel J. in Hollinger v. MNR, supra footnote 360, at 599-600. In The Queen v. Canada Southern Railway, [1986] 1 CTC 284 (FCA), the taxpayer, a Canadian railway company, leased its railroad property to an American railway company at a rental sufficient for the taxpayer to pay annual dividends of $3 per share on its stock. Subsequently the American company subleased the facilities to its parent which had become the controlling shareholder of the taxpayer. The issue was whether the dividends credited by the taxpayer in 1972 and 1973 to the American company could "reasonably be attributed to the business carried on in Canada" by the latter so as to qualify for the exemption from non-resident tax under Regulation 805(1). It was held that the dividends paid to the American company constituted income from property on the ground that the source of the dividends was the shares and not the railway business carried on by the American company in Canada. The court referred to The Queen v. Marsh and McLennan Ltd. ([1983] CTC 231 (FCA) discussed below) and stated that the test to be applied was not whether the dividends were used in the business but whether the shares consituted a fund which itself was "employed and risked in the business." On the facts, the shares were not employed and risked in the business. It was also relevant, said the court, that the American company was not in the business of dealing in shares.

379 Paragraph 12(1)(c). See Hollinger v. MNR, ibid.

380 Krishna, supra footnote 75, at 69-70.

381 While, generally, an individual who deals in shares as an ordinary investor will have his profit treated as capital gains and not business income (see Irrigation Industries Ltd. v. MNR [1962] CTC 215 (SCC)), cases may arise where the taxpayer's professional status or his course of conduct indicates that his purchase and sale of shares is the carrying on of business or otherwise an adventure in the nature of trade. For example, where the transactions are carried out by securities dealers or stock promoters, the courts have generally concluded that the taxpayer is engaged in a business venture, rather than an ordinary investment (see Whittall v. MNR [1967] CTC 394 (SCC); Robertson v. MNR [1962] CTC 550 (Ex. Ct.); aff'd [1964] CTC 113 (SCC)). Where the taxpayer engages in the buying and selling of speculative securities or where he trades frequently and turns over shares quickly, the resulting income may be held to be business income (see Bossin v. The Queen [1976] CTC 358 (FCTD)); see also Interpretation Bulletin IT-479R, "Transactions in Securities," February 29, 1984, where the Department lists the various factors it will consider in determining whether the taxpayer's course of conduct indicates that his purchase and sale of securities is the carrying on of business or otherwise an adventure in the nature of trade.

382 [1983] CTC 231 (FCA).

383 The relevant portions of paragraph 129(4)(a) as it read in 1976 are as follows:

> 'Canadian investment income' of a corporation for a taxation year means the amount, if any, by which the aggregate of ...
> (ii) all amounts each of which is the corporation's income for the year from a source in Canada that is a property (other than a property used or held by the corporation in the year in the course of carrying on a business) ...
> (iii) all amounts each of which is the corporation's income for the year ... from a source in Canada that is a business other than an active business ... exceeds the aggregate of amounts ...

384 See McLean, "Current Cases," feature (July - August, 1983) 31 Canadian Tax Journal at 670-76.

385 See Krishna, "Essays and Comments," in Canadian Current Tax, (August, 1984) vol. 1, No. 8 (Toronto: Butterworths) C37-C42.

386 [1984] CTC 319 (FCA).

387 Ibid. at 327-28 (per Ryan J.).

388 See Income Taxation in Canada (Prentice-Hall), supra footnote 97, vol. 1, paragraph 16,269:

> If a taxpayer uses or holds property as an integral part of a business he carries on, income generated from that property is considered to be income rom the taxpayer's business, notwithstanding that such income may consist of interest, dividends, rents, royalties, or other types of income which might, in other circumstances, constitute income from property.

389 With respect to mortgages and other debt obligations, the courts have held that transactions in respect thereof may give rise to business income (no attribution) or capital gains (subject to attribution). In Cohen v. MNR, [1957] CTC 251 (Ex. Ct.), it was held that an individual who purchased a number of short-term mortgages and held them to maturity realized a capital gain because he was acting as an ordinary investor. However, in MNR v. Spencer, [1961] CTC 109 (Ex. Ct.), Thorson P. disagreed with the Cohen case and held that the acquisition of first, second and third mortgages, all of which were short-term, gave rise to business income, being an adventure in the nature of trade. See also Wood v. MNR [1969] CTC 57 (SCC) (thirteen mortgages acquired over nine years gave rise to capital gains). See also Interpretation Bulletin IT-114, "Discounts, Premiums and Bonuses on Debt Obligations," August 3, 1973, paragraphs 13-16, where the Department lists the factors it will take into account in determining whether transactions in debt obligations give rise to business income or capital gains. Where the transferee's trading

is held to give rise to business income, it is felt that, as in the case of dividends, interest income received by the transferee during the course of such trading will be characterized as business income on the basis that it pertains to or is incidental to the main source of (business) income.

390 The Act describes a capital gain as a gain that arises from a disposition of capital property to the extent that the gain is not otherwise included in computing income under section 3: paragraph 39(1)(a). A "capital property" is defined as property the disposition of which gives rise to a capital gain: paragraph 54(b). Thus, the Act tells us that a capital gain or (loss) arises from a disposition of capital property, and a capital property is property the disposition of which gives rise to a capital gain (or loss). The net effect of this "definition" is that if a taxpayer's gain is determined to be income from a source other than a capital gain, then it is included in the taxpayer's income as income from that source and is not included as a capital gain. Similarly, to the extent that a taxpayer's loss is deductible in computing his income as a loss from an office, employment, business or property, it is not a capital loss. The separation of capital gains from other sources of income is reinforced by subsection 9(3), which provides, inter alia, that "income from a property" does not include any capital gain from the disposition of that property, and "loss from a property" does not include any capital loss from the disposition of that property. (See Krishna, supra footnote 75, at 3-4).

391 Subparagraphs 74.2(1)(a)(i) and (ii).

392 Paragraph 74.2(1)(b).

393 Subaragraphs 74.2(1)(c)(i) and (ii). "Listed personal property" refers to the types of property described in paragraph 54(e) such as paintings, sculptures, jewellry, rare books, stamps and coins. For the purposes of subsection 74.2(1), the taxable net gain from such property is determined as if the recipient had never owned listed personal property other than that received from the individual.

394 Paragraph 74.2(1)(d).

395 Paragraph 74.2(1)(e).

396 See the discussion under heading "Transfer by Operation of Law."

397 The "tax-free zone" of the transferor, if any, in respect of the transferred depreciable property will be assumed by the transferee under subsections 20(1) and 20(1.1) of the Income Tax Application Rules (ITAR), 1971. For this to apply, the depreciable property must have been owned by the transferor (or a non-arm's length predecessor in title) on December 31, 1971, and its original capital cost must be less than the fair market value of the property on December 31, 1971.

398 The "tax-free zone" of the transferor, if any, in respect of the transferred property will be assumed by the transferee under subsection 26(5) of the ITAR, 1971. For this to apply, the transferor (or a non-arm's length predecessor in title) must have owned the property on June 18, 1971.

399 As provided by subsection 73(1), the only qualifying condition for the rollover treatment is that both the transferor and his spouse must be resident in Canada at the time of the transfer.

400 See Skerrett, ("Inter-Spousal Transfers and Family Farm Transfers - Where Are We on 1 January 1974?" in Report of Proceedings of the Twenty-Fifth Tax Conference, 1973 (Toronto: Canadian Tax Foundation, 1974) 260-301 at 269 et. s.) for an example of where recapture might occur upon a transfer of depreciable property between spouses.

401 Subsection 73(2) deems the capital cost to the transferee, in circumstances where the cost to the transferee as deemed by subsection 73(1) is less than the capital cost of the transferred property to the transferor, to be equal to the capital cost to the transferor. The excess of the deemed cost, as established by subsection 73(1), over the deemed capital cost as established by subsection 73(2), is deemed to be capital cost allowance deducted by the transferee in years prior to the year of the transfer.

402 Subparagraph 69(1)(b)(i).

403 Paragraph 69(1)(a).

404 Subparagraph 69(1)(b)(ii).

405 Paragraph 69(1)(c). Ward's Tax Law and Planning, supra footnote 79, paragraph 11.5[b]. Where an election is made not to have the rollover treatment apply, and a loss arises which would otherwise qualify as a capital loss under paragraph 40(1)(b), it appears that such a loss would be a "superficial loss" within the meaning of subparagraph 54(i)(i) and, accordingly, not usable by the transferor (subparagraph 40(2)(g)(ii)), although it would be added in computing the adjusted cost base to the transferee of the transferred property (paragraph 53(1)(f)). (See Skerrett, supra footnote 400, at 266-67).

406 Ward's Tax Law and Planning, supra footnote 79, at paragraph 11.5[c].

407 Interpretation Bulletin IT-258R2, paragraph 11.

408 Subsection 74.5(3).

409 "Identical property" for the purposes of subsection 47(1), paragraph 54(i), and ITAR 26(8) are properties which are the same in all material respects, so that a prospective buyer would not have a preference for one as opposed to another (Interpretation

IT-78R, "Identical Properties," October 19, 1984, paragraph 1). Whether property acquired by a taxpayer is "identical property" already owned by him is a question of fact. Corporate shares of the same class and of the same kind are identical property, notwithstanding that they may be physically identifiable as separate properties -i.e. different share certificates with different serial numbers does not mean that the shares are not identical. In contrast, lots or parcels of land can never be identical property even if they are adjoining lots of the same size and quality -i.e. each plot of land is unique. (See Krishna, supra footnote 75, at 125-26).

410 ITAR 26(8)(d), (e).

411 ITAR 26(8).

412 See Skerrett, supra footnote 400, at 270.

413 With respect to capital gains (and capital losses) realized in respect of a disposition of capital property, subsection 9(3) provides that such gains (or losses) cannot, for the purposes of the Act, be considered to be income (or loss) from a property.

414 See The Queen v. Arnos [1982] CTC 12 (FCA); MNR v. Bessemer Trust [1973] CTC 186 (FCA). See also Rainy Lake Hotel Co. Ltd. v. MNR, [1961] 26 Tax ABC 293 (TAB), where the Chairman (Snyder Q.C.) was of the opinion that recapture is treated as income of the same nature as the income against which the capital cost allowance deduction was take .

415 See subsection 13(3) which provides, inter alia, that where an individual disposes of depreciable property which was used for the purpose of earning business income, any recapture recovered will also be treated as business income for tax purposes.

416 For a discussion of the lifetime capital gains exemption see: Dart and Smith, supra footnote 103, at 22-28; Lawlor, "The New $500,000 Capital Gains Exemption," (January - February, 1986) 34 Canadian Tax Journal 81-109; Goodman and Tobias, "The Proposed Capital Gains Exemption," (July - August 1985) 33 Canadian Tax Journal 721 -728.

417 Section 110.6 et. s.. Subsection 110.6(3) provides that:

> (3) In computing the taxable income for a taxation year of an individual (other than a trust) who was resident in Canada throughout the year, there may be deducted such amount as he may claim not exceeding the least of
>
> (a) the amount, if any, by which $250,000 exceeds the aggregate of all amounts each of which is an amount deducted by the individual under this section in computing his taxable income for a preceding taxation year,
> (b) the amount, if any, by which his cumulative gains

limit at the end of the year exceeds the amount deducted under subsection (2) in computing his taxable income for the year; and
(c) the amount, if any, by which his annual gains limit for the year exceeds the amount deducted under subsection (2) in computing his taxable income for the year.

418 Subsection 110.6(12).

419 Subsections 110.6(2) to 110.6(4). Except in the case of qualified farm property, the maximum deduction is $10,000 for 1985, $25,000 for 1986, $50,000 for 1987, $100,000 for 1988, $150,000 for 1989 and $250,000 for 1990 and thereafter.

420 Subsection 110.6(4).

421 Subsection 110.6(1).

422 Allowable business investment losses for a year automatically reduce income for the year under paragraph 3(d). Any undeducted portion for a year becomes a non-capital loss for the year (paragraph 111(8)(b)), which can be carried back three years or forward seven years and deducted under paragraph 111(1)(a) in computing taxable income in those years. Non-capital losses claimed do not reduce the capital gains exemption.

423 Subparagraph 40(1)(a)(iii).

424 Dart and Smith, supra footnote 103, at 23, footnote 43.

425 Subsection 110.6(1).

426 Subsection 110.6(13) provides that taxable capital gains (net of allowable capital losses) for a period during which an individual was not resident in Canada are not counted.

427 For 1985, allowable capital losses (net of taxable capital gains) from dispositions of property made between January 1, 1985 and May 22, 1985, can be deducted by an individual under paragraph 3(e) against $2,000 of other income. Taxable capital gains (net of allowable losses) from dispositions made after May 22, 1985, reduce this deduction.

428 Ibid. It should be noted that capital losses for 1985 (except the portion that falls into the pre-1986 capital loss balance) and subsequent years cannot be carried back to 1984 and preceding years to reduce $2,000 of other income. As well, for 1985, a deduction under paragraph 3(e) reduces the $2,000 capital loss offset under paragraph 111(1)(b). (See Dart and Smith, supra footnote 103, at 25).

429 Paragraph 111(8)(b.2). Specifically, the pre-1986 capital loss balance is the amount by which the total of (i) the lesser of the net capital loss for 1985 and the net allowable capital losses

from January 1, 1985, to May 22, 1985, that could not be deducted against $2,000 of other income in 1985, reduced by the 1985 net capital losses carried back to a previous year, and (ii) the undeducted net capital losses from 1984 and previous years, exceeds the capital gains exemptions deducted in previous taxation years. (See Dart and Smith, supra footnote 103, at 95).

430 The distinction between capital gains and business income has unquestionably become one of the most extensively litigated areas in Canadian tax law. This being so, it is clearly beyond the scope of this paper to analyze the distinction in great detail, rather the concern will be to highlight the basic jurisprudential tests and guidelines which have emerged from the litigation. For more detailed discussion see: Chernoff, "The Application of the Doctrine of Secondary Intention since the Regal Heights Case," (1966) 2 University of British Columbia Law Review, 542-561; Colley, "Capital Gains Tax - A Perspective," (1981), 14:2 Chartered Accountant Magazine, 63-76; Cumyn, "The Taxation of Capital Gains," (Chap. 4), A Non-Resident's Guide to Canadian Taxation (Toronto: Richard DeBoo, 1977) 36-62; Grover and Iacobucci, supra footnote 354, at 471-582; Little, "Is the Secondary Intention Doctrine Dead?" (October 1976), 10:5 Certified Chartered Accountant Magazine, 34-46; Messere et. al., "Capital Gains Tax Review: A Panel," Report of Proceedings of the Thirty-Second Tax Conference, 1979 (Toronto: Canadian Tax Foundation 1980) 320-359; Krishna, supra footnote 75, at 1-26; Ward, "The Case against Capital Taxes," (1980) 2 Canadian Taxation, 31-44; Income Taxation in Canada (Prentice-Hall), "Business Income and Capital Gains," supra footnote 97, paragraph 16,551 et. s.; Ward's Tax Law and Planning, "Distinction between Income from Business and Capital Gains," supra footnote 79, paragraph 40.4 et. s.

431 The Act makes no attempt to define the criteria which distinguish capital gains from ordinary business income. Instead, subsection 39(1) excludes from the calculation of capital gains and capital losses, gains and losses from the disposition of property that would have been included in the taxpayer's income as income from a business or property in the absence of the provisions of the Act dealing with the taxation of capital gains and losses. Therefore, if an amount is otherwise included in income, it is not considered to be a capital gain. Subsection 9(3), in turn, provides that "income from property" does not include any capital gain from the disposition of property.

432 [1904] 5 T.C. 159 (SCE) at 165-66.

433 The importance of a particular factor in a given case will depend upon the nature of the property disposed of and other surrounding circumstances. For example, an intention to resell at a profit has generally been considered more important in cases involving the disposition of real estate than in cases involving the disposition of securities. Also, in many cases, the expanded definition of "business" in subsection 248(1), which includes an isolated transaction of a trading nature, has been used to label an isolated disposition as a trading transaction and to tax any

resulting gain as business income.

434 See Becker v. The Queen, [1983] CTC 11 (FCA), where the Federal Court of Appeal said that the question of whether the taxpayer was realizing an investment as opposed to trading turned on the taxpayer's intention. See also Reicher v. The Queen [1975] CTC 659 (FCA); Warnford Court (Can.) Ltd. v. MNR [1964] CTC 175 (Ex. Ct.).

435 See Leaside Realty v. MNR [1986] 1 CTC 2024 (TCC).

436 See Regal Heights v. MNR, [1960] CTC 384 (SCC), where a gain resulting upon the sale of vacant land was held to be business income from an adventure in the nature of trade on the ground that the taxpayer intended, at the time of acquisition, to resell the land at a profit in the event that a planned shopping centre development fell through.

437 [1962] CTC 215 (SCC).

438 Ibid., per Martland J. at 233:

> The only test which was applied in the present case was whether the appellant entered into the transaction with the intention of disposing of the shares at a profit so soon as there was a reasonable opportunity of so doing. Is that a sufficient test for determining whether or not the transaction constitutes an adventure in the nature of trade? I do not think that, standing alone, it is sufficient.

His lordship went on to say that shares were rarely purchased without some consideration of a possible future sale if they appreciated in value.

439 See Income Taxation in Canada (Prentice-Hall), supra footnote 97, vol. 1 at paragraph 16,661; Ward's Tax Law and Planning, supra footnote 79, at paragraph 40.6[a].

440 [1956] CTC 189 (Ex. Ct.) at 211-12. See Interpretation Bulletin IT-459, "Adventure or Concern in the Nature of Trade," September 8, 1980, paragraph 12, which summarizes the case law with respect to intention: (a) an intention to sell at a profit does not in itself establish an adventure in the nature of trade - taxpayers making a true investment will invariably contemplate selling in the event that circumstances arise which make it financially more beneficial to sell the investment than to continue to hold it; (b) where other factors indicate trading, an established or inferred intention to resell at the first opportunity constitutes corroborative evidence; and (c) the lack of an intention to sell at a profit does not preclude a transaction from being an adventure in the nature of trade.

441 See Moluch v. MNR, [1966] CTC 712 (Ex. Ct.), where the court concluded that, although the taxpayer had not acquired a

particular property with the intention of reselling it at a profit, he had subsequently engaged in a business transaction when, years later, he proceeded to subdivide the property and sell it in lots. See also Cohen v. The Queen [1980] CTC 318 (FCA); Hughes v. The Queen [1984] CTC 101 (FCTD).

442 [1979] CTC 51 (FCA).

443 Ibid., at 55.

444 The doctrine of secondary intention was first enunciated in Bayridge Estates Ltd v. MNR [1959] CTC 158 (Ex. Ct.) and Fogel v. MNR [1959] CTC 2277 (Ex. Ct.). In both cases land was purchased with the intention of building revenue-producing property thereon. When these intentions were frustrated, the land was sold at a profit. It was held that the taxpayers had a secondary intention to resell the land at a profit if their primary investment intentions could not be carried out, and accordingly the profits were taxed as business income from adventures in the nature of trade.

445 [1960] CTC 384 (SCC). In this case, an incorporated partnership acquired vacant land for the purpose of building a shopping centre thereon. The shopping centre plan fell through and the land was sold at a profit. The Supreme Court held that the profit constituted business income from an adventure in the nature of trade on the ground that the shareholders of the taxpayer company intended, when they acquired the property, to sell it at a profit if they were unable to carry out their primary aim of establishing the shopping centre. The disposition was therefore a "speculative venture" and not the realization of a gain from the "sale of long-held bona fide capital assets" (per Judson J. at 390).

446 [1963] CTC 130 at 135; aff'd [1964] CTC 372 (SCC).

447 [1965] CTC 150 (Ex. Ct.) at 159. See also Hazeldean Farm Co. v. MNR [1966] CTC 607 (Ex. Ct.); Sherman v. MNR [1973] CTC 192 (FCTD); Power v. The Queen [1975] CTC 580 (FCTD); Progress Management Co. v. The Queen [1975] CTC 244 (FCTD).

448 [1978] CTC 378 (FCA).

449

> ... the only evidence relied on in support of [the conclusion that the taxpayer had a secondary intention to trade] is, in essence, that the appellant had in mind, in making the purchase, the prospect of inflation in land values. However, in my view, the choice, as an investment, of an income-producing property (such as developed real property) with a prospect of increased capital value to offset chronic depreciation in the value of money, as opposed to, for example, a choice of bonds designed to produce a fixed amount on maturity, is not evidence of a purchase for re-sale amounting to the launching of a adventure or concern in the nature of

> trade. I do not read the evidence ... as being open to an inference that a prospect of resale at a profit was a motivating reason for the purchase and I do not accept the finding of fact [by the trial judge] as amounting to more than a finding that the investment was in a profit-producing property that would increase in value and that circumstances in the future might dictate a change in investments. (Ibid., at 380).

450 While Regal Heights involved the disposition of vacant land, Hiwako Investments involved residential apartment buildings which were sold for a profit less than one year after their acquisition.

451 Supra footnote 437, at 221. It will be noted that Martland J.'s statement is virtuallly irreconcilable with the doctrine of secondary intention as formulated in the Regal Heights case. Again, this conflict may, perhaps, be resolved on the basis of the subject matter of the transaction. Thus, in Irrigation Industries, Martland J. distinguished Regal Heights on the ground that the latter case dealt with vacant land, which was not capable of producing income, and not with shares, which by their very nature constitute an investment.

452 Reicher v. The Queen, supra footnote 434.

453 Ibid; per LeDain J. at 664:

> The issue on this appeal is whether at the time they acquired the property the appellants...had a secondary intention, as an operating motivation for such acquisition, to sell the property at a profit should a suitable opportunity present itself.

See also Hiwako Investments Ltd. v. The Queen, supra footnote 448; Kit-Win Holdings (1973) Ltd. v. The Queen [1981] CTC 43 (FCTD).

454 Dickson v. The Queen [1977] CTC 64 (FCA).

455 Hiwako Investments Ltd. v. The Queen, supra footnote 448.

456 Regal Heights Ltd. v. MNR, supra footnote 445; Bayridge Estates Ltd. v. MNR, supra footnote 444; Fogel v. MNR, supra footnote 444.

457 Income Taxation in Canada (Prentice-Hall), supra footnote 97, paragraph 16,565.

458 [1963] CTC 484 (Ex. Ct.).

459 Supra footnote 435.

460 [1964] CTC 175 (Ex. Ct.).

461 [1927] 13 T.C. 251 (C.A.) at 263.

462 [1917-27] CTC 343 (Ex. Ct.).

463 See also Noak v. MNR, [1954] CTC 6 (SCC), where the taxpayer entered into 53 transactions of purchase and sale of real estate over an eight-year period. It was held that the number of transactions and the proximity of sales to purchases indicated that the taxpayer was carrying on a business and not merely realizing or changing investments.

464 See Irrigation Industries Ltd. v. MNR, supra footnote 437.

465 For the 1985 and subsequent taxation years, paragraph 125(7)(a) defines an "active business carried on by a corporation" (for the purposes of the small business deduction in subsection 125(1)) to include "an adventure in the nature of trade." This may well be taken to emphasize that an isolated transaction may result in business income.

466 [1956] CTC 189 (Ex. Ct.).

467 See CIR v. Reinhold [1953] 34 T.C. 389 (C.A.); CIR v. Livingston [1926] 11 T.C. 538 (HL).

468 Thorson P.'s guidelines with respect to what constitutes an adventure in the nature of trade were cited with approval by the Supreme Court of Canada in Irrigation Industries Ltd v. MNR, supra footnote 437.

469 Most of the cases which have placed little or no significance on the transaction being an isolated occurrence involve commodities where, in the words of Lord Russell (in CIR v. Reinhold, supra footnote 467), "the commodity itself stamps the transaction as a trading venture, and the profit or gains are plainly income liable to tax." The reasoning here is that since the nature of the property is such that it could not produce income to the taxpayer, the only purpose for the acquisition must have been the subsequent sale of the property. See IRC v. Fraser [1942] 24 T.C. 498 (SCS) (purchase and sale of whisky); Rutledge v. IRC [1929] 14 T.C. 490 (SCS) (purchase and sale of toilet paper). In effect, the intention to resell can be found from the very nature of the commodity itself.

470 Most of the "related business" cases involve builders and other land developers, as well as real estate agents, who realized profits on real estate which they claimed to have acquired as investments. Because such individuals make their living from real estate-related activities, the onus on them to prove that they hold land in a pure investment capacity is greater than it would be if they were not in the real estate business. See Kennedy v. MNR, [1952] CTC 59 (Ex. Ct.), where the taxpayer, a house builder by trade, purchased a block of land which was later expropriated by the government at a price which resulted in a profit. It was held that since his purchase of land was closely associated with his business operations it should not be considered as an isolated transaction separate from the business normally carried on by him.

See also No. 13 v. MNR [1951] 3 Tax ABC 397 (TAB); Williscroft v. MNR [1952] 7 Tax ABC 118 (TAB).

471 [1949] CTC 196 (SCC) at 201.

472 [1952] CTC 371 (Ex. Ct.); aff'd [1954] CTC 24 (SCC).

473 See also Osler, Hammond and Nanton Ltd. v. MNR [1961] CTC 462 (Ex. Ct.); aff'd [1963] CTC 164 (SCC); McDonough v. MNR [1949] CTC 213 (Ex. Ct.) (profit received upon the successful promotion of a mining venture held to be business income on the ground that the taxpayer had engaged in the mining and prospecting business over a period of several years).

474 See Montreal Trust Co. v. MNR [1962] CTC 418 (Ex. Ct.) (profit earned on disposition of oil and gas interest held to be capital gain notwithstanding that the taxpayer was in the oil drilling business); S and S Properties Ltd. v. The Queen [1978] CTC 412 (FCTD); The Queen v. Greenington Group Ltd. [1979] CTC 31 (FCTD); Montfort Lakes Estates Inc. v. The Queen [1980] CTC 27 (FCTD) (taxpayer held to be a trader with respect to part of a piece of land and an investor with respect to another part).

475 The more unrelated the transaction is to the taxpayer's ordinary or previous business, the more influenced the court will be to conclude that the transaction constitutes the realization of an investment. See Irrigation Industries Ltd v. MNR, supra footnote 437.

476 See Irrigation Industries Ltd v. MNR, supra footnote 437; Cohen v. MNR [1957] CTC 251 (Ex. Ct.) (debt obligations).

477 See CIR v. Livingston, supra footnote 467; Rutledge v. CIR, supra footnote 469; CIR v. Fraser, supra footnote 469; MNR v. Taylor, supra footnote 440.

478 Most of the "vacant land" cases have dealt with situations where the taxpayer's avowed intention was to create an income-producing investment but in fact the property was disposed of before any actual development took place or income was earned. These cases were the basis for the secondary intention theory through which the courts attempted to justify taxing the disposition of vacant land as a speculative venture on the basis that, although the resale of the vacant land was not the primary intention of the taxpayer at the time of acquisition, it was at least a very real possibility. See Hillsdale Shopping Centre Ltd. v. MNR [1981] CTC 322 (FCA); South Shore Estates v. The Queen [1981] CTC 252 (FCTD); Horvath v. The Queen [1980] CTC 467 (FCTD); Torduff Ltd. v. MNR [1972] CTC 295 (FCTD); Wilderton Shopping Centre Inc. v. MNR [1972] CTC 319 (FCTD).

479 [1926] 11 T.C. 538 (HL) at 542.

480 See also Irrigation Industries Ltd. v. MNR, supra footnote 437, where Martland J. stated (at 222):

> The only operations of the appellant in the present case were the purchase of 4,000 treasury shares directly from Brunswick and their subsequent sale, presumably through brokers. This is not the sort of trading which would be carried on ordinarily by those engaged in the business of trading in securities.

481 See Moluch v. MNR, supra footnote 441.

482 Income Taxation in Canada (Prentice-Hall), supra footnote 97, at paragraph 16,567.

483 A number of articles have dealt with the provisions pertaining to the principal residence exemption, by discussing definitions and their interpretation, describing the calculations and noting the effect of a change in the use of property. For example, see McGregor, "Principal Residence: Some Problems," (March-April 1973), 21 Canadian Tax Journal 116-26; Freedman, "The Homeowner," Report of Proceedings of the Twenty-Fifth Tax Conference, 1973 (Toronto: Canadian Tax Foundation, 1974) 224-31; Schnek, "Employee Relocation," (January-February 1981), 29 Canadian Tax Journal 71-82; Strother, "Income Tax Implications of Personal-Use Real Estate," Corporate Management Tax Conference 1982 (Toronto: Canadian Tax Foundation 1983) 59-75; Beam and Laiken, "The Principal Residence Designation Decision: The New Complexity," (May-June 1984) 32 Canadian Tax Journal 572-87.

484 Subsection 46(1). "Personal-use property" is a defined term (paragraph 54(f)) and generally includes property used primarily for the personal use or enjoyment of the taxpayer, such as automobiles, boats and jewellry.

485 Paragraphs 40(2)(b) and (c). Nor is an individual allowed a capital loss on the disposition of a principal residence: subparagraph 40(2)(g)(iii).

486 Paragraph 54(g) defines the term "principal residence." It should be noted that prior to 1982, married couples could arrange their affairs so that one spouse had sole ownership of the family home while the other spouse had sole ownership of the family's vacation property. Properly structured, a married couple could then claim two principal residences and exempt from tax the complete gain on both residences. This income tax treatment was made possible by the Department's interpretation that the term "ordinarily inhabited" (as used in the definition of principal residence in subparagraph 54(g)(i)) included seasonal occupation of a recreational property, such as a cottage or ski chalet. However, as a result of an amendment (passed on March 30, 1983) to the definition of principal residence in paragraph 54(g), a family unit (i.e. the taxpayer, his spouse (other than a spouse from whom he was separated throughout the year pursuant to a judicial separation or written separation agreement) and unmarried children under 18 years of age) may treat only one housing property as its principal residence for a taxation year after 1981. For taxation

years prior to 1982, it is still possible to protect fully gains on two housing properties within a family unit unless both were owned by the same person. This amendment does not change the method of calculating the exempt portion of the capital gain calculated under paragraph 40(2)(b) on the disposition of a principal residence purchased after 1981, but merely limits the application of this exemption to one housing property within a family unit. (See Krishna, supra footnote 75, at 137-38; Beam and Laiken, supra footnote 483 at 572-73). With the introduction of the $500,000 lifetime capital gains exemption, the rule that a family unit may (after 1981) treat only one housing property as its principal residence for a taxation year will not effectively prevent the disposition of a second residence from being tax-free if the capital gain realized in respect of such disposition falls within the individual taxpayer's lifetime capital gains exemption. Moreover, any gain realized upon the disposition of the first principal residence (in the family unit), to the extent that such gain falls within the principal residence exemption and is therefore not taxable, will not serve to reduce the taxpayer's cumulative capital gains exemption to date. But although the disposition of the second principal residence may be tax-free, the amount of the gain which would otherwise be taxable will serve to reduce the taxpayer's lifetime capital gains exemption.

487 Section 45.

488 See Interpretation Bulletin IT-120R3, ("Principal Residence," February 16, 1984, paragraph 5). While most principal residences are located in Canada and are owned by individuals resident in Canada, in some cases a residence not located in Canada may qualify as a principal residence. Whether or not a particular residence so qualifies will depend on the facts of each case. Where a taxpayer owns a residence outside Canada at a time when the taxpayer became resident in Canada, subsection 48(3) will normally apply to deem the taxpayer to have acquired the residence at that time at its fair market value. If, prior to becoming resident in Canada, the taxpayer has rented the residence to a tenant, the property will not qualify as a principal residence. On the other hand, if the property was not rented until after the taxpayer became resident in Canada, it could qualify but only if the taxpayer, the taxpayer's spouse or child ordinarily inhabited it after the taxpayer became a resident, and the other provisions of the law are met. (See IT-120R3, paragraph 40).

489 See p. 23 for the definition of a "leasehold interest." Subsection 248(4) provides that, for the purposes of the Act, a leasehold interest is considered to be real property.

490 See Income Taxation in Canada (Prentice-Hall), supra footnote 97, vol. 2, at paragraph 24,755. The purpose of characterizing the share rather than the corresponding accomodation as a principal residence is that the housing unit will continue to be owned by the corporation and it is the share that will be sold when the taxpayer wishes to dispose of his living accomodation.

491 See Strother, supra footnote 483, at 60. Mere physical possession, such as the right of a tenant or licensee, will not constitute ownership. See Interpretation Bulletin IT-437, ("Ownership of a Dwelling," September 10, 1979, paragraph 2).

492 Although as between themselves joint tenants have separate rights, as against everyone else they are in the position of a single owner. A joint tenancy has two principal features, the right of survivorship and the "four unities." The right of survivorship means that on the death of one of the joint tenants, his interest in the property passes to the other joint tenant and this process continues until there is but one survivor who then holds the property as sole owner. The right of survivorship takes precedence over any disposition made by a joint tenant's will. With respect to the four unities, they consist of: (a) unity of possession -i.e. each co-owner is as much entitled to possession of any part of the property as the other; (b) unity of interest - i.e. the interest of each joint tenant is the same in extent, nature and duration; (c) unity of title -i.e. each joint tenant must claim his title to the property under the same document; and (d) unity of time -i.e. the interest of each tenant must vest at the same time. (Megarry and Wade, supra footnote 68, at 391-96).

493 A tenancy in common differs greatly from a joint tenancy and has three main distinguishing characteristics: (a) the tenants hold in undivided shares -i.e. each tenant has a distinct share in property which has not been divided among the co-tenants; (b) there is no right of survivorship, meaning that the size of each tenant's share is fixed once and for all and is not affected by the death of one of the co-tenants; and (c) only the unity of possession is essential -i.e. the unity of interest may be absent and the tenants may hold unequal interests. (Megarry and Wade, supra footnote 68, at 396-407).

494 See articles 441(b) to 442(p) of the Quebec Civil Code.

495 Income Taxation in Canada (Prentice-Hall), supra footnote 97, vol. 2, at paragraph 24,757; Canada Tax Service, supra footnote 97, at paragraph 54-124. An exception exists where a taxpayer transfers his principal residence to his spouse or to a spouse trust. See infra at 163-64.

496 Ibid.

497 Subparagraph 54(g)(i).

498 In Thomson v. MNR, [1946] CTC 51 (SCC), Rand J. stated (at 64):

> The expression 'ordinarily resident' carries a restricted signification, and although the first impression seems to be that of preponderance in time, the decisions in the English Act reject that view. It is held to mean resident in the course of the customary mode of life of the person concerned, and it is

> contrasted with special or occasional or casual residence. The general mode of life is, therefore, relevant to a question of its application.

And, in the same decision, Kellock J. said (at 67-68):

> 'Ordinarily' is defined as 'in conformmity with rule or established custom or practice,' 'as a matter of regular practice or occurrence,' 'in the ordinary or usual course of events,' 'usually,' 'commonly,' 'as is normal or usual.'

Thus, it would seem possible that for the purposes of paragraph 54(g), a taxpayer may be considered to ordinarily inhabit greater than one residence, if each such residence was inhabited by him in the ordinary and habitual course of his life. However, as indicated above, only one property may be designated as a taxpayer's principal residence in any particular year.

499 A taxpayer must actually live in a residence for some period of time for it to qualify as his principal residence. Mere intention to inhabit without actual occupancy will not suffice: Haber v. The Queen [1982] CTC 405 (FCTD). See also May v. The Queen, [1982] CTC 66 (FCTD), where Gibson J., in a very brief judgment, also implied that a taxpayer had to physically occupy a residence (no time period indicated) in order for it to be considered a principal residence.

500 Interpretation Bulletin IT-120R3, paragraph 9.

501 Ibid.

502 Subsection 45(1).

503 Another exception to the rule that a principal residence must be ordinarily inhabited by the taxpayer or his spouse (or former spouse) or dependent child is to be found in section 54.1, which provides that where a taxpayer has moved from his ordinary residence as a consequence of the relocation of his or her spouse's place of employment while employed by the same employer, he may not in certain circumstances lose the right to continue to treat the residence as his principal residence. If the requirements of section 54.1 are met, any year in which the taxpayer does not ordinarily inhabit his property will not be counted in the four-year limitation -i.e. the four-year limitation imposed by subparagraph 54(g)(iv) will not apply.

504 Subparagraph 54(g)(iii) and Regulation 2301.

505 The Department's position is that the designation need not be filed unless a taxable capital gain arises on the disposition after deducting the exempt portion of the gain or unless the taxpayer wishes to file the designation in respect of property disposed of to his spouse or to a spouse trust (IT-120R3, paragraph 10). It is submitted, however, that notwithstanding the

Department's position, the taxpayer should be advised to designate any exempt gain since the Minister is not bound by statements made in an Interpretation Bulletin, such Bulletin not having any force of law, but being merely an opinion.

506 In determining whether the taxpayer has discharged this onus of proof, the courts will consider such factors as the size and character of the housing unit, the use of the excess land, the location of the residence on the lot, whether residential lots are required by law to exceed one acre, whether the land can be severed into two or more viable portions and the zoning of the property at the time of the sale. See Income Taxation in Canada (Prentice-Hall), supra footnote 97, vol. 2 at paragraph 24,763.

507 See Madsen v. MNR, [1981] CTC 2131 (TRB), where it was held that: (a) property in excess of one acre must be shown by a taxpayer to be necessary for both use and enjoyment, the former involving an objective determination and the latter a subjective one; and (b) the land in excess of one acre must contribute to the use and enjoyment by the taxpayer of the property as a residence. It would appear that any commercial or other non-residential use of the property would not qualify it for inclusion as part of the principal residence. See also The Queen v. Yates, [1983] CTC 105 (FCTD), where it was held that: (a) if municipal or provincial laws require residential lots to be in excess of one acre, the entire parcel of land so required will constitute the principal residence; (b) if part of the land contiguous to a principal residence is sold in a separate transaction (in this case, pursuant to a threat of expropriation), the portion sold may constitute (depending on the facts in question) part of the principal residence; and, (c) (contrary to the Madsen decision), the rental of a portion of the land contiguous to the principal residence does not necessarily disqualify it as part of the taxpayer's principal residence. (The Department has accepted view "(b)" above but only in cases where a portion of a principal residence is disposed of by the granting of an easement (i.e. a right of way) or the expropriation of a portion of the land that forms part of the principal residence: IT-120R3, paragraphs 13 and 15). See also Cox v. MNR [1985] 1 CTC 2393 (TCC); Rode v. MNR [1985] 1 CTC 2324 (TCC) (in both cases, held; a stringent test of "necessity" is applicable; such test is: Has the taxpayer established on a balance of probability that without the excess area of land subjacent and immediately contiguous to the housing unit, he could not practicably have used and enjoyed the unit as a residence?); James v. MNR [1985] 2 CTC 2001 (TCC) (land in excess of one acre held not to be necessary for the taxpayer's use and enjoyment notwithstanding that it would have been uneconomical for him to subdivide the lot on which his house stood); Michael v. MNR [1985] 2 CTC 2122 (TCC) (land in excess of one acre held to be necessary for the taxpayer's use and enjoyment since the local zoning by-laws prohibited the severance of the property); but see Watson v. MNR [1985] 1 CTC 2270 (TCC) (excess land held not to qualify for the principal residence exemption notwithstanding that the property could not be subdivided under provincial law).

[508] See the discussion under heading "Capital Gains vs. Business Income."

[509] See, for example, Schlamp v. The Queen, [1982] CTC 304 (FCTD), where the taxpayer, after initially using each of three houses as his personal residence, subsequently sold each of them at a profit over a period of four to five years. It was held that, notwithstanding that he had actually resided in each of the houses for different periods of time, the taxpayer at all material times had the intention to sell his houses for a profit. The court attached great weight to the fact that the taxpayer was in the business of constructing homes for a profit and because of this background, it found that there was a very heavy onus on him to demonstrate that the profits were not ordinary business income. See also Rode v. MNR [1977] CTC 2365 (TRB); Welton v. MNR [1978] CTC 3153 (TRB); May and Hecht v. MNR [1980] CTC 2457 (TRB); Hollo v. MNR [1978] CTC 2617 (TRB); Haber v. The Queen [1982] CTC 405 (FCTD). In all of the foregoing cases, the test is whether the intention of the person at the time the residence was acquired was to resell it at a profit and, to this end, the court may invoke the doctrine of secondary intention.

[510] See Strother, supra footnote 483, at 64, for a mathematical example of where the entire gain on the disposition of a principal residence would be exempt.

[511] Ibid.

[512] As indicated above, if a taxpayer ceases to occupy his residence for a period each year as part of his customary and ordinary pattern of behaviour, the residence should be considered to be ordinarily inhabited by him during his absence. If a taxpayer does not reside in a dwelling at any time during a year, it would appear that he will not be considered to have ordinarily inhabited the residence for that year. Paragraph 9 of Interpretation Bulletin IT-120R3 seems to require some period of occupation of the residence during any year for which it is to qualify as a principal residence. See also Haber v. The Queen, supra footnote 509. In Ennist v. MNR, [1985] 2 CTC 2398 (TCC), the taxpayer, after taking title to a condominium unit, spent one night only in the unit before moving to another city to work. When he resold the unit he realized a profit of $30,000. It was held that the profit was not exempt from tax since the taxpayer had not "ordinarily inhabited" the unit so as to qualify it as a principal residence. It was suggested by the Tax Court that to "inhabit" a housing unit implied a sense of permanency, in addition to a period of actual physical occupation.

[513] Subsection 45 (3) is applicable to property that a taxpayer starts to use as his principal residence after 1981 and it allows him to elect out of the rule in paragraph 45(1)(a). Subsection 45(4) also provides that the election under subsection 45(3) cannot be made if capital cost allowance is claimed on the property for any taxation year ending after 1984 by the taxpayer or his spouse or a trust in favour of his spouse. The recapture of

capital cost allowance claimed on a property by a taxpayer for a taxation year ending before 1985 will not be affected by an election under subsection 45(3) by the taxpayer in respect of the property.

514 Subparagraph 54(g)(iv).

515 Subsection 45(2). That is, the taxpayer will not be subject to a deemed disposition at fair market value and a deemed reacquisition at the same fair market value upon the change in use.

516 During the period covered by the election, the taxpayer must report all income from the property and may deduct all applicable expenses except capital cost allowance in respect of the property. The denial of the ability to claim capital cost allowance is a necessary implication from the wording of subsection 45(2), which provides that while an election is in force, the taxpayer is deemed not to have commenced to use the property for the purposes of gaining or producing income, and Regulation 1102(1)(c) which provides that capital cost allowance may only be taken against depreciable property which is used for the purpose of gaining or producing income. (See Strother, supra footnote 483, at 68; Beam and Laiken, supra footnote 483, at 583). Interpretation Bulletin IT-120R3, paragraph 32, states that any claim for capital cost allowance will automatically rescind an election under subsection 45(2).

517 A taxpayer who does not make an election when he changes use or, having elected, rescinds the election prior to the expiration of the four-year period, cannot avoid the deemed disposition and related tax consequences: Woods v. MNR [1978] CTC 2802 (TRB).

518 Interpretation Bulletin IT-120R3, paragraph 36. If, however, the taxpayer does claim capital cost allowance on the portion of the residence used for earning income, a change in use of the residence will be considered to have occurred in the year, and that portion of the residence will be deemed to have been disposed of at its fair market value at that time. (IT-120R3, paragraph 38).

519 See the discussion under heading "Inter Vivos Spousal Transfer of Property."

520 An inter vivos trust that is created for the exclusive benefit of a spouse (commonly referred to as a "spouse trust") has two basic statutory requirements: (a) the spouse (i.e. the beneficiary spouse) must be entitled to receive all the income of the trust that arises before his or her death; and (b) no person other than the beneficiary spouse may be entitled to receive or otherwise obtain the use of any of the income or capital of the trust before the beneficiary spouse's death: subparagraphs 73(1)(c)(i) and (ii); with respect to testamentary spouse trusts, see subparagraphs 70(6)(b)(i) and (ii).

521 Paragraph 40(4)(a).

522 Paragraph 40(b)(ii).

523 Paragraph 40(4)(c). Where the transferee is a spouse trust, subsection 40(5) requires that the property be ordinarily inhabited by the beneficiary spouse and that any designation of the principal residence on its ultimate disposition may be made by the trust and the beneficiary spouse in order to preserve the status of the principal residence as such.

524 Where a principal residence is the subject of an inter vivos transfer, the transferor must actually designate the property as his principal residence for the relevant years in order to qualify it as his principal residence for those years: subparagraph 40(4)(b)(ii). If he does not make this designation, the spouse (or spouse trust) will be deemed to have owned the property during those years but will not be deemed to have owned it as a principal residence. Where the transferor does make the designation, and the transferee already owns a property which would satisfy the requirements of a principal residence if it were disposed of at some point in time, the transferee is not precluded from designating the property already owned as a principal residence for any of the years for which the transferred property is deemed under subsection 40(4) to be the principal residence of the transferee. Subsection 40(4) does not deem the transferee to have designated the transferred property as the transferee's principal residence and therefore there is no obstacle to the transferee designating the property already owned as a principal residence for those same years. (See Income Taxation in Canada (Prentice-Hall), supra footnote 97, vol. 2 at paragraph 24,769; Krishna, supra footnote 75, at 142-43). An amendment to subsection 40(4), effective to transfers of a principal residence after May 9, 1985, extends the scope of the subsection to apply to a property that was depreciable property of the transferor (such as rental property) before it was transferred to his spouse or spouse trust. As a result, the formula in paragraph 40(2)(b) will not exempt capital gains on a property for the period while it was used to earn rental income before the property was transferred to a spouse or spouse trust who subsequently used it as a principal residence.

525 In all three cases, it is assumed that the transfer has been effected pursuant to a subsection 73(1) rollover without recognition of any capital gain by the transferor. Subsection 40(4) will then ensure the continuation of principal residence status in the hands of the transferee. If the transferor elects not to have the subsection 73(1) rollover apply, the transfer may give rise to a capital gain, but such gain will be reduced or eliminated by subsection 40(2). If the transfer results in a loss, such loss is deemed to be nil: subparagraph 40(2)(g)(iii).

526 Subparagraph 40(2)(g)(iii). Whether or not there is an amount attributed pursuant to subsection 74.2(1), where the proceeds of disposition are used by the transferee to purchase other property, part or all of any income or capital gain realized from that

substituted property may be attributed to the transferor: (Interpretation Bulletin IT-366R, "Principal Residence - Transfer to a Spouse," May 4, 1984, paragraph 10).

527 See the discussion under heading "Only Income from Property is Subject to Attribution."

528 Paragraph 45(1)(a).

529 Subsection 74.2(1). See Interpretation Bulletin IT-366R, paragraph 10. Such gain may also, of course, be eliminated if it falls within the transferor's lifetime cumulative capital gains exemption: section 110.6.

530 None of the authors or looseleaf services appear to have directly canvassed this issue, although it is obvious, as Strother points out (supra footnote 483, at 66-67), that the taxpayer must report all income received from the property during the period that a subsection 45(2) election is in force. If such income (i.e. property income) is received by the transferee in respect of previously transferred property, it follows that subsection 74.1(1) will come into play. It should be noted, however, that since the transferee may deduct all applicable expenses (except capital cost allowance) in respect of the transferred property, to this extent the amount attributed to the transferor may be reduced or eliminated.

531 By virtue of paragraph 146(5)(a), where a taxpayer is employed in the year and as a consequence of the employment is or may become entitled to benefits under a pension plan, or contributed an amount in the year to a deferred profit sharing plan, or is a beneficiary of a deferred profit sharing plan instituted by his employer, the amount which may be deducted in computing his income in respect of contributions to a registered retirement savings plan may not exceed (i) the lesser of $3,500 and 20 per cent of the annuitant's "earned income" (defined in paragraph 146(1)(c)) for the taxation year, less (ii) the amount deducted under paragraph 8(1)(m) in computing the annuitant's income for the year. In all other cases, the deduction is limited to the lesser of $5,500 and 20 per cent of the annuitant's earned income for the taxation year: paragraph 146(5)(b).

532 Under paragraph 60(i), a taxpayer who is an annuitant (paragraph 146(1)(a) defines the term "annuitant") under a registered retirement savings plan or becomes an annuitant within 60 days after the end of the year, may deduct the aggregate of amounts each of which is the amount of any premium (paragraph 146(1)(f) defines "premium") paid by him under the plan during the year, or within 60 days after the end of the year, to the extent that it was not deducted in computing his income for a previous year or designated under paragraphs 60(j), (j.1) or (l): subsection 146(5). Contributions made beyond the 60-day period will ordinarily not be considered to be contributions for the prior year unless unusual circumstances have intervened. (See Egan v. MNR [1980] CTC 2882 (TRB)) (taxpayer still entitled to a

deduction for spousal registered retirement savings plan notwithstanding that his cheque was received by the trustee after the deadline since the original cheque had been mailed before the deadline and was lost in the mail). The 60-day rule was introduced to allow a certain amount of flexibility and enable the annuitant to calculate and pay to the registered retirement savings plan issuer the maximum amount deductible by him. This is particularly relevant for self-employed persons who have fluctuating incomes or whose incomes can only be established with certainty after the end of a taxation year. (See Income Taxation in Canada (Prentice-Hall), supra footnote 97, vol. 4, paragraph 41,559).

533 Subsection 146(4).

534 Where the taxpayer withdraws funds from a registered retirement savings plan prior to maturity (other than a refund of an over-contribution of premiums pursuant to subparagraph 146(2)(a)(i)) the Department considers such withdrawal to constitute a deregistration of the plan requiring the inclusion in the taxpayer's income of an amount (by virtue of paragraph 146(12)(b)) equal to the fair market value of the plan's property immediately before the date of deregistration: See Intepretation Bulletin IT-415R, "Deregistration of Registered Retirement Savings Plan," December 31, 1979, paragraph 4. Practically, however, a partial withdrawal can be accomplished by transferring a portion of the funds in a plan to a second plan (such transfer may be accomplished without tax consequences pursuant to subsection 146(16)) and retaining in the original plan the funds to be withdrawn. Following the transfer, the funds remaining in the first plan are withdrawn, effectively deregistering the plan. The amount withdrawn must then be included in the income of the taxpayer pursuant to paragraph 146(12)(b).

535 Subsection 146(14). While contributions made prior to the year in which the application for registration is accepted are not deductible under the provisions of the Act, the Department's practice, as outlined in Information Circular No. 77-18 (October 24, 1977), is to allow such contributions if the application for registration has been made before July 1 of that year.

536 Paragraph 146(1)(j).

537 Paragraph 146(2)(b).

538 See Scace, supra footnote 97, at 540-43.

539 Subsection 146(5.1).

540 Ibid. As is the case with the deduction provided under subsection 146(5), the taxpayer may contribute to his spouse's registered retirement savings plan within 60 days after the end of the taxation year.

541 If the wife has "earned income" she may also contribute to her own plan up to the maximum she is permitted under subsection

146(5) regardless of the amount contributed by her husband.

542 It appears that subsection 74(6) was inadvertently repealed and that the provision will be reinstated. (Drache, The Canadian Taxpayer, December 17, 1985, at 177).

543 The attribution of withdrawals to the contributing taxpayer does not apply: (a) if the taxpayer dies in the year of withdrawal; (b) if either the taxpayer or his spouse is a non-resident of Canada at the time of withdrawal; or (c) to a withdrawal from an "amended plan" to which paragraph 146(12)(a) applied before May 26, 1976: subsection 146(8.7).

544 In Hargrove v. MNR, [1979] CTC 2212 (TRB), the taxpayer took out a registered retirement savings plan for his wife and made a contribution to her plan in order to reduce his income for the year. However, one month later he cancelled the plan and withdrew the entire contribution. The Minister disallowed the deduction of the contribution claimed by the taxpayer under subsection 146(5.1). The Board upheld the Minister's disallowance of the deduction of the contribution on the ground that such deduction constituted an artificial reduction of income within the meaning of subsection 245(1) since the taxpayer always intended to cancel the plan shortly after he opened it. One question raised by this decision is the extent to which it may be applied beyond the two-year period contemplated by subsection 146(8.3) where the taxpayer's admitted intention in contributing to and then dissolving his spouse's registered retirement savings plan is simply to achieve short-term income splitting. While the Hargrove decision may not be applicable to this extent, it would seem that if a taxpayer, over an extended period of time, was consistently engaged in contributing payments to his spouse's registered retirement savings plan and then collapsing such registered retirement savings plan after the third year following each of the last contributions, such a scheme might be considered an artificial reduction of income under subsection 245(1).

545 Section 110.2.

546 See Wakeling, supra footnote 9, at 25-26.

547 See Tax Profile, (February 11, 1986), vol. 1, No. 20, at 157. In Smith v. MNR, [1966] 41 Tax ABC 338 (TAB), the taxpayer received during the years in question, a certain number of family allowance cheques. Upon receipt, the cheques were deposited in an account in the joint names of the taxpayer and his wife. When the Minister added to the taxpayer's income the interest received in respect of the cheques, the taxpayer contested the assessment on the ground that the interest income belonged to his child and not to him. It was held, inter alia, that once the cheques were deposited in the taxpayer's bank account, they became intermingled with his other personal deposits and thereby lost their individual identity. As a result, the interest income was taxable in his and his wife's hands only. This case illustrates, therefore, the importance of maintaining proper records with respect to family

allowance payments (as well as other payments - E.g. payments or gifts from a non-resident) and ensuring that such payments are clearly segregated from the parents' personal assets.

548 For an analysis of the tax consequences of separation and divorce see Sheppard, "Taxation of the Family United: Divorce - Canadian Style," Report of Proceedings of the Twenty - Sixth Tax Conference, 1974 (Toronto: Canadian Tax Foundation 1975) 316-339; Arnold, "Income Tax Consequences of Separation and Divorce," Report of Proceedings of the Twenty-Ninth Tax Conference 1977 (Toronto: Canadian Tax Foundation 1978) 193-214.

549 December 11, 1979.

550 By dissolution of the marriage we are referring to one of the spouses obtaining a decree absolute of divorce, at which point the marriage is dissolved and the parties are no longer "spouses" for tax purposes. See Bradley v. Minister of Finance [1974] 5 WWR 347 (BCCA); Interpretation Bulletin IT-258R2, paragraph 13(3), states that "...the date the transferee ceases to be his spouse is the date a divorce becomes final."

551 There is a large body of jurisprudence (and doctrine) related to the tax consequences of alimony and maintenance (within the context of paragraph 60(b) et. s.) wherein the meaning of the terms "decree, order or judgment of a competent tribunal or written separation agreement" has been analyzed. Essentially, the requirement of a court order or a written separation agreement has been construed very strictly by the courts. Nothing less than a court order or a formal or legally written document will satisfy the requirement. See, for example, Richter v. MNR, [1977] CTC 2261 (TRB), where it was held that even where it is clear that a court order will be obtained or a written agreement executed, alimony payments made prior to the effective date of the order or agreement will not be deductible since they are not made "pursuant to" the order or agreement, even if the order or agreement provides retroactively for the payments. The extent to which the Department is willing to go in its literal interpretation of these requirements is shown by Brooks v. MNR, [1977] CTC 2048 (TRB), where it argued that a payment, made after the date of a court order but before the order was entered, was not deductible. See also Horkins v. MNR [1976] CTC 52 (FCTD) (payment made under the Ontario Rules of Practice not deductible since there was no court order). (Contra: Collins v. MNR [1976] CTC 2048 (TRB) (an agreement, drawn by a third party and signed by the parties held to be a valid written separation agreement despite the fact that it did not provide for the parties to live separate and apart). Since there does not appear to be any reason why the phrase "decree, order..." etc. would be interpreted differently with respect to the attribution rules, it seems that the same strict interpretation would be applied to the provisions of paragraph 74.5(3)(a).

552 It should be noted that since the exemption from capital gains attribution is contingent upon a joint election being made by both

spouses, if one of the spouses refuses to join in making the election, the effect of the requirement of the election will be nullified. This is not an illogical scenario, especially if the break-up is an acrimonious one. In this situation, such an election, it would seem, would best be handled by the parties' respective legal counsel as part of the overall settlement. To a certain extent, the requirement of the election would provide some leverage for counsel in reaching a settlement, depending upon whom the accrued gains in question would be attributed to. For example, if the capital gains would be otherwise attributed to the husband, he could initially refuse to accede to his wife's demand for specific sums of alimony or maintenance, but then agree to pay such sums on the condition that she joined in filing the election.

553 Subsection 74.5(5).

554 Subsection 74.5(4).

555 The provision that the attribution rules cease to be effective upon separation was apparently passed as a response to certain unfairness which resulted from their cessation only upon divorce. For example, if an income-producing property was awarded to a wife before the decree absolute, the income from that property until the decree might be attributed to the husband. A sale of the property prior to the decree might result in the attribution of capital gains and/or recapture to the husband while if the sale was deferred until after the decree absolute, no such attribution would take place. This apparently arbitrary difference, caused by transactions not under the control of the husband, was seen as offensive and led to a call for amendment. See McNair, "The Income Tax Implications of Matrimonial Property Law Reform - The Common Law Provinces," Report of Proceedings of the Thirty-First Tax Conference, 1978 (Toronto: Canadian Tax Foundation 1979) 247-277 at 263.

556 Where, upon separation, a husband makes periodic payments of alimony to his spouse or former spouse, and such payments otherwise meet the conditions of paragraphs 60(b), (c), or (c.1), the husband may deduct such payments from his income. However, where the husband transfers capital property (i.e. a lump sum) as part of the separation agreement, such transfer of a lump sum is not deductible from his income. Therefore, the fact that alimony payments are deductible but lump sums are not, may imply that the husband will prefer, as part of the separation agreement, to have payments of capital property constitute a smaller proportion of the settlement.

557 Subsection 73(1). By virtue of paragraph 73(1)(b), the automatic rollover will also apply where property is transferred to a former spouse in settlement of rights arising out of the marriage unless, of course, the transferor elects not to have the rollover apply. Conversely, where, after 1977, capital property is transferred to a former spouse, and such transfer is not made in settlement of rights arising out of the marriage, the automatic rollover will not apply and the transferor will be considered to

have disposed of the property for proceeds of disposition equal to the fair market value at the time of the transfer (whereupon he will realize any capital gain, capital loss, recapture or terminal loss), and the former spouse who receives the property will be considered to have acquired the property for an amount equal to the transferor's proceeds of disposition. (See Interpretation Bulletin IT-325R, "Property Transfers after Divorce and Annullment," December 28, 1982, paragraphs 2, 3 and 4).

558 If, under the terms of the transfer, it is provided that the transfer is conditional upon the wife not disposing of the property until after separation, and if the transferred property is held in trust or escrowed until the parties are legally separated pursuant to a decree, order or judgment of a competent tribunal or a written separation agreement, then it can be argued that the wife will not become entitled to proceeds of disposition until after separation and therefore, at least, capital gains attribution may be avoided. See Victory Hotels Ltd. v. MNR [1962] CTC 614 (Ex. Ct.) (taxpayer held not to be entitled to proceeds of disposition until all conditions of a sale agreement had been fulfilled).

559 It should be noted that in the former situation -i.e. where the transfer is made before separation with a covenant by the transferee not to dispose of the transferred property until after separation - the avoidance of attribution by the transferor will not be complete since, if the transferred property is income-producing, any income derived therefrom prior to separation will be subject to attribution. Optimally, therefore, the husband should not transfer any income-producing property prior to separation.

560 It should be noted that this statement is made with a view to tax minimization only, and disregards the possibility that the appreciated property may continue to increase significantly in value in the near-term following separation (in which case the husband might prefer to retain such property), or that the depreciated property may continue to depreciate substantially following separation (in which case the husband might wish to transfer it to the wife).

561 An interesting, if somewhat far-fetched, notion is the possibility that the wife's release of marital and support rights in return for a property settlement may be a taxable disposition of a capital asset by her. A disposition takes place when "any debt owing to a taxpayer or any other right of a taxpayer to receive any amount is settled or cancelled" (subparagraph 54(c)(ii)(B)). Would the wife's release of her rights of support or property constitute a disposition of capital property? (See, for example, The Queen v. Compagnie Immobiliere BCN, [1979] CTC 71 (SCC), where Pratte J. was of the opinion that the word "disposition" (for the purposes of capital cost allowance under Regulation 1100(2)) should be given a very broad meaning and that it included a voluntary act by which the rights of a party are extinguished). What would be the adjusted cost base of such

rights? (See, for example, D'auteuil Lumber Co. Ltd. v. MNR, [1970] CTC 122 (Ex. Ct.), where it was held that the cost of relinquishing certain rights (in this case, the right to obtain compensation from the government in respect of the expropriation of timber limits) was equal to the value of the property received in return for such relinquishment). Would the rights qualify as her own personal-use property so that she could claim a minimal adjusted cost base of $1,000 under paragraph 46(1)(a)? Another open question is whether the release of a debt constitutes a "transfer" which would be subject to the spousal rollover under subsection 73(1). If so, then the release would not result in any capital gain whether it took place before or after separation. However, if such a release is not a "transfer," the proceeds of disposition for the release would seem to be (based on the D'auteuil Lumber case) the fair market value of the property received by the wife. With respect to the husband, the problem concerns the fair market value of the wife's marital rights to him. If the wife's release constitutes a "transfer," then the husband will be deemed to receive proceeds of disposition not less than the fair market value of the property which he transfers to the wife for the relinquishment of her rights. In practice, it is most unlikely that the Minister would assess the wife in these circumstances, but nevertheless, the parties to the separation agreement should indicate precisely what property the husband is transferring to the wife for the release of her rights and, for further clarity, they might attach a value on her release equal to the fair market value of the consideration received by her for the release. See Farwell, "Debt and Capital Gains Taxation," 20 Canadian Tax Journal (1972) 101-118; Sheppard, supra footnote 458, at 335-36.

562 Subparagraph 54(g)(i).

563 If, during de facto separation, but before a legal separation, the wife proceeds to sell the home, no gain will be attributed to the husband by virtue of subsection 40(4). And, of course, if the wife disposes of the home subsequent to legal separation, no gain will be attributed to the husband by virtue of paragraph 74.5(3)(b) so long as the requisite election is filed.

564 The examples cited are intended to be merely illustrative and by no means limitative. Obviously each marriage involves a distinct relationship and the tax planner must therefore approach the problem on a case-by-case basis.

565 The age limit provision was reduced from 19 to 18 applicable to the 1972 and subsequent taxation years. The reference to losses was added applicable to the 1975 and subsequent taxation years.

566 See, for example, Fletcher v. MNR, [1977] CTC 2256 (TRB), where the taxpayer made gifts of shares of Canadian corporations to his great nieces (minors) who resided outside Canada. It was held that former subsection 75(1) applied to attribute to the taxpayer all dividends paid in respect of the gifted shares, subject to the limitation provided by the Canada - U.K. tax

treaty.

567 [1933] 1 K.B. 507.

568 The relevant legislation read as follows (subsection 20(1), Finance Act, 1922):

> Any income ... which by virtue or in consequence of any disposition made, directly or indirectly, by any person after the fifth day of April, 1914, is payable to or applicable for the benefit of a child of that person for some period less than the life of the child; shall, subject to the provisions of this section, but in cases under the above paragraph (c) only if and so long as the child is an infant and unmarried, be deemed for the purposes of the enactments relating to income tax to be the income of the person who is or was able to obtain the beneficial enjoyment thereof, or of the person, if living, by whom the disposition was made, as the case may be, and not to be for those purposes the income of [the child].

569 For an analysis of the interrelationship between the taxation of trusts and the attribution rules see: Waters, "Trusts Law and Tax Law: A Growing Conflict," supra footnote 144; Bernstein and Hanson, "The Taxation of Accumulating Income of Personal Trusts," supra footnote 151; Goodman, "Transactions in Reversionary Interests," (May-June 1973) 21 Canadian Tax Journal 251-257; Kellough, "Basic Tax Considerations of Trusts and an Examination of Some Particular Types of Trusts," Report of Proceedings of the Twenty-Seventh Tax Conference 1975 (Toronto: Canadian Tax Foundation 1976) 478-507; Carphin, "Constituting an Inter Vivos Trust," Report of Proceedings of the Thirty-Third Tax Conference 1981 (Toronto: Canadian Tax Foundation 1982) 566-629; Nichols, "The Use of Trusts in Income Splitting and Estate Planning," Prairie Provinces Tax Conference 1979 (Toronto: Canadian Tax Foundation 1980) 251-329; Fuke, "Current Developments in Estate Planning," supra footnote 256.

570 However, in the special case of a transfer, after 1971, of farming property to a child, grandchild or great-grandchild of the taxpayer, in circumstances in which the rollover provisions of subsection 73(3) apply, section 75.1 provides that a net capital gain or loss realized by the child will be attributed to the transferor if the property was transferred for less than fair market value and if it is subsequently disposed of by the transferee before the year in which he attains 18. For this provision to apply, the transferor must be resident in Canada in the taxation year in which the capital gain or loss is realized. (Ward's Tax Law and Planning, supra footnote 79, paragraph 11.6[b]).

571 It seems that, after canvassing the relevant literature (including jurisprudence, doctrine and Interpretation Bulletins), one searches seemingly in vain to discover the policy reason for

which there is no attribution of capital gains in respect of loans or transfers of property to minor children. Clearly, if the general policy of the Department is to prevent income splitting among family members, one would think that, as in the case of inter-spousal loans or transfers of property, there would be capital gains attribution with respect to minor children. Perhaps (and this is speculation) the reason for this omission is that, unlike in the case of children, in the case of spouses, the concept of the marriage and, consequently of spouses, is that of one singular unit, indivisible by its very nature. This notion of spousal unity is apparently not carried over to the relationship between a parent and his or her child, and perhaps this is why transfers (or loans) of capital property by a parent to a minor child are not subject to capital gains attribution.

572 The concept of a "small business corporation" is described above at footnote 173.

573 Former subsection 73(5), which is in force until December 31, 1987, read as follows:

> (5) For the purposes of this Part, where at any particular time a taxpayer has transferred property to his child who was resident in Canada immediately before the transfer and the property was, immediately before the transfer, a share of the capital stock of a small business corporation except where the rules in subsection 74(2) require any taxable capital gain from the disposition by the taxpayer of that property to be included in the income of a person other than the taxpayer, the following rules apply:
>
> (a) the taxpayer shall be deemed to have disposed of the share at the time of the transfer for proceeds of disposition equal to the amount, if any, by which,
> (i) the fair market value of the share at that time exceeds the lesser of
> (ii) the taxable capital gain otherwise determined from the disposition of the share, and
> (iii) the amount of the taxpayer's cumulative small business gains account immediately before the transfer or such lesser amount as the taxpayer specifies in respect of the transfer of the share;
>
> (b) the child shall be deemed to have acquired the share at a cost equal to the proceeds of disposition determined under paragraph (a); and
>
> (c) where two or more shares have been disposed of at the same time, this subsection applies as if each share had been separately disposed of in the order designated by the taxpayer or if the taxpayer does not so designate, in the order designated by the Minister.

The transitional rules, which apply in respect of transfers of

shares of a small business corporation made after May 22, 1985, provide as follows:

> (5) For the purpose of this Part, where at any particular time a taxpayer has transferred property to his child who was resident in Canada immediately before the transfer and the property was, immediately before the transfer, a share of the capital stock of a small business corporation, except where the rules in subsection 74(2) or 74.2(1) require any taxable capital gain from the disposition by the taxpayer of that property to be included in the income of a person other than the taxpayer, the following rules apply.

574 For the purposes of the intergenerational rollover rules contained in the transitional provisions of sections 70 and 73, the definition of the term "child" in paragraph 70(10)(a) includes children, grandchildren, and great-grandchildren as well as "...a person who, at any time before he attained the age of 21 years, was wholly dependent on the taxpayer for support and of whom the taxpayer had at any time, in law or in fact, the custody and control." This latter phrase, effective for 1985 and subsequent years, makes it possible for a taxpayer to transfer eligible shares to persons such as nieces or nephews on a tax-free basis. In addition, since the definition in paragraph 70(10)(a) is inclusive and not exhaustive, a "child" for the purposes of the intergenerational rollover would include a daughter-in-law or son-in-law of the taxpayer and an adopted child, as provided by subsection 252(1). An adopted child includes a bona fide de facto adopted child as well as a legally adopted child: Anderson v. MNR [1947] CTC 223 (Ex. Ct.); No. 161 v. MNR [1954] 10 Tax ABC 277 (TAB). In addition, paragraph 252(2)(e) extends the meaning of "child" to include a son-in-law or daughter-in-law.

575 Similar rules apply under the transitional provisions of subsection 70(9.4) (in force until December 31, 1987) on transfers that occur upon the death of the taxpayer.

576 If the full available rollover has not been used previously by one or both parents, consideration may be given to rolling over shares to children before December 31, 1987. The parents should select the number of shares in respect of which existing accrued capital gains will fully utilize any unused portion of the $200,000 rollover, and transfer those shares so that under the transitional provisions of subsection 73(5) the proceeds of the shares is their adjusted cost base. The accrued gains can subsequently be realized by the children free of tax using their own $500,000 capital gains exemption. The $200,000 rollover for shares of a small business corporation does not reduce the capital gains exemption of the parent transferring the shares. (See Dart and Smith, supra footnote 103, at 31).

577 Paragraph 125(7)(a).

578 Paragraph 125(7)(d).

579 Paragraph 125(7)(e).

580 Subsection 248(1) defines a "specified shareholder" to include any person who owns at least 10 per cent of any class of shares of the corporation, either directly or through a trust.

581 A non-qualifying business was defined in former paragraph 125(6)(f) as follows:

> (f) "non-qualifying business" carried on by a corporation in a taxation year means
>
> (i) the professional practice of an accountant, dentist, lawyer, medical doctor, veterinarian or chiropractor,
>
> (ii) a business of providing services it more than 66 2/3% of the gross revenue for the year of that business derived from services
>
> (A) is derived from services provided to, or performed for or on behalf of, one entity, and
>
> (B) can reasonably be attributed to services performed by persons who are specified shareholders of the corporation or persons related thereto
>
> unless the corporation employs in the business throughout the year more than five full-time employees who are not specified shareholders of the corporation or persons related thereto, or
>
> (iii) a business the principal purpose of which is to provide managerial, administrative, financial, maintenance or other similar services, to lease property (other than real property), or to provide any such services and to lease property (other than real property), to one or more businesses connected at any time in the year with the corporation;
>
> but does not include a personal services business."

582 See Hickey, "The New Rules for Intergenerational Transfers of Family Assets," (March - April 1985) 33 Canadian Tax Journal 360-373 at 363.

583 Former paragraph 70(11)(a) (in force until December 31, 1987). To the extent that the parent has not used up his $200,000 cumulative small business gains account it will reduce the capital gain realized on the transfer of shares. If he does have cumulative small business gains available but chooses not to use it to reduce his capital gain (for instance, because he has capital losses to offset the capital gain on the disposition of the shares) he may specify a lesser amount of cumulative small business gains account to be used to reduce his capital gain. His proceeds of disposition and his child's cost of the shares are both reduced by the amount of capital gains deferred, so the child will inherit the liability for the accrued capital gain which is deferred.

584 In certain circumstances, however, it may be possible to

double the capital gains deferral during the lifetime of both parents. Assume, for example, that a small business corporation owned by the father is increasing in value and the father has an accumulated gain (on his shares) in excess of $200,000. Using section 86, father could carry out a reorganization of the share capital. Under the plan, his wife could subscribe a nominal amount for new equity shares. When the value of the wife's equity shares have an accrued gain of $200,000, both parents could, at any time, transfer shares to one or more of their children and avoid taxes on an aggregate gain of $400,000. See Smith, "Transferring the Family Business," (January - February 1979) 27 Canadian Tax Journal 1-16; Holtz, "Transfer of a Small Family Business Corporation," (May - June 1980) 28 Canadian Tax Journal 357-64.

585 The transitional provisions of subsection 70(9.7) (in force until December 31, 1987) provide for a tax-free transfer of shares of the capital stock of a small business corporation to a parent on the death of a child. The subsection applies where the child acquired the shares on a rollover basis either under the transitional provisions of subsection 70(9.4) on a testamentary transfer or under transitional subsection 73(5) on an inter vivos transfer. The shares must normally vest indefeasibly in a parent who is resident in Canada immediately before the transfer and not later than 15 months after the death of the child. The family shares, within the $200,000 limit, can then be transferred by the parent to another child on a tax-free basis. By making the appropriate election, the shares of the business can be transferred to a parent for proceeds of disposition equal to any amount between the adjusted cost base and the fair market value of the shares at the time of the child's death. This transfer to the parent has the effect of restoring the parent's cumulative small business gains account to the extent it was used on the original transfer to the child. (See Hickey, supra footnote 582, at 364).

586 Ibid.

587 Subsection 74.1(2). An interesting question is why Parliament drafted the income attribution provisions so as to cease upon the child attaining the age of 18 years since income splitting clearly may continue after this age. It would seem that there is a direct relationship between the cessation of attribution at this age and the corresponding age of majority under relevant provincial legislation. For example, in the Province of Quebec, where a child is under the age of 18 (article 246 of the Civil Code (CC) provides that a person "remains in minority until they attain the full age of 18 years") he is subject to certain disabilities and certain types of tutorial control which cease upon the child attaining majority. For example, article 290 CC provides, inter alia, that: "A tutor has the care of the [minor], and represents him in all civil acts. He is bound to manage [the minor's] property like a prudent administrator, and is liable for the damage which may result from bad management." The remaining articles of the chapter (i.e. articles 290a to 313 CC) reflect a quasi-parental influence which the tutor (usually someone closely related to the minor, including his or her parents) exercises

over the minor. In the Province of Ontario, section 13 of the Minors Act (S.O. 1980, c. 292) provides that a minor becomes of the age of majority when he reaches 18. Under section 16 of the same Act, where the court appoints a guardian (usually a parent or next best friend), such guardian, among other matters, has the charge and management of the minor's property, both real and personal, as well as the care and custody of his person and education. With respect to the attribution rules, the practical implication is that where a parent loans or transfers income-producing property to a minor child (assuming it is his own child) the child may not, because of his minority status, be able to legally control or dispose of such property as he wishes. The parent may still retain authority as to how to manage the loaned or transferred property, and will therefore control the income derived from the property, in addition to being able to split such income with the child. When the child attains 18, however, he is no longer, at least in strict legal terms, subject to the same type of quasi-tutorship or control, and with the umbilical cord legally severed at this point, he may freely dispose or otherwise deal with the loaned or transferred property as he sees fit.

588 Bruce v. Warwick [1815] 6 Taunt. 118; The King v. Rash [1923] 53 O.L.R. 245 (Ont. C.A.).

589 See the Sale of Goods Act (S.O. 1980), section 3; Clements v. London and North Western Railway Co. [1894] 2 Q.B. 482 (C.A.) (employment); Toronto Marlboro Junior 'A' Hockey Club v. Tonelli [1975] 67 D.L.R. (3d) 214 (Ont. H.C.J.) (hockey playing contract held not on the whole beneficial).

590 Hinspergers' Harness and Tent Co. Ltd. v. Koropeski [1956] O.W.N. 167 (Ont. C.A.). See, however, section 18 of the Infants Act (R.S.B.C. 1979, c.196) which provides that:

> A proceeding shall not be brought against a person on a promise made after full age to pay a debt contracted during infancy, or on a ratification made after full age of a promise or contract made during infancy, whether or not there is new consideration.

Section 2 of the Infants' Relief Act (U.K., 1874) is in the same terms -i.e. no ratification is effective in the United Kingdom. In Ontario, ratification is effective, but must be evidenced by a writing: section 5 of the Statute of Frauds (S.O. 1980, c.444).

591 Foley v. Canada Permanent Loan and Savings Co. [1883] 4 O.R. 38 (Ont. C.A.).

592 Re Sovereign Bank of Canada [1916] 35 O.L.R. 448 (Ont. C.A.).

593 Edwards v. Carter [1893] A.C. 360 (HL); Phillips v. Greater Ottawa Development Co. [1916] 33 D.L.R. 259 (Ont. S. Ct.) (repudiation after 3 1/2 years too late).

594 There is also a third class of contract which is said to be

void and incapable of ratification, namely, one that operates to the child's prejudice, such as penalty. It has been suggested that with the open recognition of the doctrine of unconscionability such a category has become unnecessary. If a child ratifies a penalty contract, or any other disadvantageous contract, after reaching majority, he should be in the same position as an adult party to such contract. That is, the contract will be prima facie binding but the obligor will have the benefit of relief on the ground of unconscionability if he can show that the agreement is unfair. See Waddams, The Law of Contracts (Toronto: Canada Law Book, 1982) 410-11.

595 Section 9 of the Sale of Goods Act (S.O. 1980) defines "necessaries" as "goods suitable to the condition in life of such infant...and to his actual requirements at the time of sale and delivery."

596 See First Charter Financial Corp. v. Musclow [1974] 49 D.L.R. (3d) 138 (B.C.S.C.) (loan contract to purchase automobile held not to be contract for necessaries).

597 In British Columbia, the common law rules with respect to loans to minors have been displaced by express statutory provisions which, except in limited circumstances, deem all such loans to be absolutely void. Section 17 of the Infants' Act (R.S.B.C. 1979, c.196) provides that:

> All contracts, whether under seal or simple contracts, entered into by infants for the repayment of money lent or to be lent, or for goods supplied or to be supplied, other than contracts for necessaries, and all accounts stated with infants, are absolutely void. This provision does not invalidate a contract authorized by an enactment or by the rules of law or equity, except those that are now by law voidable.

The British Columbia provision is essentially carried over from section 1 of the Infants' Relief Act (U.K., 1874) which provides, inter alia, that all loans of money to a child are irrecoverable. The remaining common law Provinces have not enacted any provision analogous to section 17 of the British Columbia statute and therefore in these Provinces the common law rules discussed above prevail.

598 [1912] 28 TLR 239 (C.A.).

599 This holding was based on the Infants' Relief Act (U.K., 1874). The same result obtained in Coutts and Co. v. Browne-Lecky, [1947] 1 K.B. 104, where it was held that the plaintiff, a bank, was obliged to discontinue its suit in respect of an unpaid loan contracted by one of the co-defendants, a child, because of the child's legal immunity under the relevant provisions of the Infants' Relief Act (U.K., 1874).

600 Supra footnote 596.

601 R.S.B.C. 1960, c.193.

602 Article 246 provides that:

> Persons of either sex remain in minority until they attain the full age of 18 years.

603 Article 314 CC.

604 Articles 315 - 323 CC.

605 E.g. Error (article 992 CC); fraud (article 993 CC); violence and fear (articles 994 - 999 CC).

606 For example, article 319 CC provides that an emancipated minor may validly grant a lease for a term not exceeding nine years. However, article 322 CC provides that an emancipated minor may neither sell nor encumber his immoveable property without the proper intervention and assistance of his curator.

607 In the civil law, the term "lesion" refers to economic damage suffered by a minor (whether emancipated or not) as a result of an inequality of bargaining power between the parties to the contract. In determining whether or not a minor has suffered lesion, the courts will also consider (apart from the unequal bargaining positions) the utility of the contract, any benefit derived by the minor from the contract, and the degree and extent of any arbitrary or unjust clauses contained therein. See Baudoin, Les Obligations, (Les Presses de l'université de Montréal 1982) 90-93.

608 Ibid., at 96.

609 Article 1005 CC.

610 Articles 321, 1009 CC. It has been argued, however, that the minor's relief from contractual obligations without proof of lesion is limited to the two cases specified in article 1009 CC - i.e. contracts entered into for the alienation or encumbrance of immovable property without the intervention of a tutor or curator. (See Langelier, Cours de Droit Civil, tome 3, 402 et. s.). The reasoning here is that since the general rule is that a minor (whether emancipated or not) must prove lesion in order to rescind a contract (articles 1001, 1002 CC), article 1009 CC, being an exception to this general rule, must be interpreted restrictively.

611 Article 1002 CC.

612 See Baudoin, supra footnote 607, at 96-97.

613 Article 297 CC. The judge may only grant such authorization in cases of necessity or where the loan would obviously be to the minor's advantage: article 298 CC.

614 See Mignault, supra footnote 243, tome 5, at 245 et. s.; Trudel, Traité du Droit Civil du Québec, tome 7, at 251 et. s. Both authors hold that all juridical acts entered into by minors without the intervention of their tutor or curator are absolutely null without any proof of lesion required.

615 Article 1008 CC.

616 See Baudoin, supra footnote 607, at 101.

617 See Wakeling, supra footnote 9, at 33-34.

618 Paragraph 12(11)(a) was added by 1980-81-82-83, c.140, s.4(8), applicable to taxation years commencing after 1981. The paragraph defines an "investment contract" to mean any debt obligation (other than certain enumerated bonds and debentures), and a "debt obligation" is defined (Black's Law Dictionary, 5th ed.) as "a sum of money due by certain and express agreement; as by bond for a determined sum, a bill or note, where the amount to be paid is fixed and specific."

619 Subsection 12(4).

620 A taxpayer might make such an election if it would allow him to more fully utilize the $1,000 deduction for investment income under section 110.1.

621 That is, the year in which the child attains 18. See Wakeling, supra footnote 9, at 34.

622 With respect to property which does not qualify for the limited deferral under transitional subsection 73(5), if the proceeds of disposition otherwise determined (without consideration of subsection 69(1)) exceed both the fair market value of the property and its tax value (adjusted cost base in the case of non-depreciable property, a proportional part of undepreciated capital cost in the case of depreciable property of a prescribed class, and two times cumulative eligible capital in the case of eligible capital property) the proceeds of disposition are deemed to be the greater of the two amounts. Thus, a capital gain could be realized up to the fair market value of the property transferred, if consideration is given by the child for the transfer. If the proceeds of disposition are less than the lesser of the fair market value of the property and its tax value (such as in the case of a gift), the proceeds of disposition are deemed to be equal to the lesser of the two amounts. Thus, there will be no recognition of any capital loss or terminal loss, and the child, whose cost is deemed to equal the deemed proceeds of disposition, will inherit any potential for capital gains, recapture of capital cost allowance, or recaptured eligible capital deductions. (See Wakeling, supra footnote 9, at 29-30).

623 There are a large number of stocks of publicly traded companies (usually small growth companies) which yield very little

(less than one per cent) or no dividends and which have shown significant capital appreciation in the last five years. For example, on the Toronto Stock Exchange, corporations such as CAE Industries, Laidlaw Transportation and Mackenzie Financial Services Co. (the latter being a mutual fund stock which has averaged 18 per cent annual growth over the last five years) all pay less than one per cent dividend. In the United States, Federal Express (traded on the New York Stock Exchange) and Lorimar (a broadcasting company traded on the American Stock Exchange) are two stocks which have appreciated substantially over the last five years and which do not pay any dividends at all. Where a particular stock does yield a small dividend, it may still be advantageous for the individual to acquire such stock in the child's name if the expected growth in the stock's value outweighs the attribution of dividend income. The stocks which the individual should avoid transferring are those with high dividend yields such as banks and utilities.

624 [1964] CTC 289 (Ex. Ct.).

625 Former section 111 read as follows:

> 111(1) A tax shall be paid as hereinafter required upon the gifts made in a taxation year by an individual resident in Canada or a personal corporation.
>
> (2) For the purposes of this section, "gift" includes a transfer, assignment or other disposition of property (whether situate inside or outside Canada) by way of gift, and without limiting the generality of the foregoing, includes
>
> (a) the creation of a trust of, or an interest in, property by way of gift, and
>
> (b) a transaction or transactions whereby a person disposes of property directly or indirectly by way of gift.

626 In support of its decision, the Exchequer Court cited the Supreme Court of Canada decision in Roberts and Bagwell v. The Queen, [1957] SCR 28, where the appellants, having purchased certain land with the intention of reselling it in lots, applied to the local authorities for compensation after such authorities passed zoning regulations which the appellants alleged reduced the value of their land by diminishing the possibility of resale. The Supreme Court (per Nolan J.), in granting the appellants compensation, held that, in order to prove the value of their land prior to the enactment of the zoning regulations, the appellants were permitted to tender evidence of other sales in the vicinity which were affected after the enactment of the regulations. That is, evidence of sales afer the enactment were relevant in determining the value of the land prior to the enactment so long as such sales were made within such time as the evidence showed prices and general market conditions not to have changed materially from those before the critical date.

627 [1978] CTC 235 (FCA). Reference should also be made to the

case of MNR v. Dufresne, [1967] CTC 153 (Ex. Ct.), (discussed below under heading "Indirect Payments") although here the question was whether or not a series of transactions (i.e. the granting and subsequent exercising of stock options by the taxpayer's children which increased their shareholdings in the corporation) constituted a transfer of property from the taxpayer to his children. In Joseph Simard Ltd. and Littler, it was clear that a transfer of property (i.e. the shares) had taken place, and the question was one of the valuation of the transferred property.

628 Jackett C.J. did not deal directly with the question of whether the taxpayer conferred a benefit on his children by selling them shares at an undervalued price. The Chief Justice, after concluding that the sale between the taxpayer and his children was not a sham, held that there was no gift under section 111 since a contract of sale, which is by definition a transfer of property for consideration, could not be a gift which is, by definition, a disposition of property without consideration. Although he appeared to concede that there may have been a gift by way of sale at an undervaluation, he felt that the transaction in question did not come within the definition of "gift" in section 111. Neither the Chief Justice nor LeDain J. referred to the Joseph Simard Ltd. case in their respective opinions.

629 See the discussion under heading "The Problem of Vesting." See also, Fuke, "Trusts for Children," 2 Estates and Trusts Quarterly, (1975) 60-69; Goodman, "Current Uses of Trusts in Estate Planning," 2 Estates and Trusts Quarterly (1975) 45-59; Wardlaw, "Inter Vivos Trusts - A Basic Primer," 5 Estates and Trusts Quarterly (1978-81) 297-316.

630 Section 160 was analogous to the former section 53, R.S.C. 1952, c.148.

631 In Craig v. MNR, [1973] CTC 2119 (TRB), it was held that in order for subsection 160(1) to operate in the Minister's favour, the transferred property must be an income-producing property. However, subsequent cases have not followed this decision (see, for example, Carrigan v. MNR [1981] CTC 2916 (TRB); Payette v. MNR [1978] CTC 3113 (TRB)), and have held that subsection 160(1) will operate in the Minister's favour irrespective of whether or not the transferred property is income-producing. It is submitted that the latter view is the correct one since it is more consonant with the purpose and intendment of subsection 160(1) as a tax collection section -i.e. because subsection 160(1) was enacted to prevent a taxpayer from avoiding the payment of tax by making a non-arm's length transfer of property, it should be immaterial whether or not the property is income-producing. Moreover, there is nothing in the wording of subsection 160(1) which restricts its application to transfers of income-producing property.

632 A clear illustration of the operation of subsection 160(1) can be found in the case of Dickerson v. MNR, [1967] Tax ABC 977 (TAB), where the taxpayer, who owned a small shareholding interest in a hotel company, transferred such interest to his wife at a

time when he owed $9,000 in back taxes. It was held that the assessment (made pursuant to subsection 160(1)) against the taxpayer's wife for the amount of back taxes owed by the taxpayer was well-founded since he had transferred property to her at a time when he was under a tax liability. See also Thalheimer v. MNR [1983] CTC 2498 (TCC) (husband deposited cheques in wife's bank account at a time when he owed a substantial amount of back taxes).

633 In fact this was the main purpose of subsection 160(1) when it was introduced by Parliament as section 53 in 1951. The Parliamentary debates reveal that the tax authorities were primarily concerned with the situation where a husband transferred all his property to his wife at a time when he owed income tax - the husband would continue to be liable for tax on the income from the transferred property but he would not have anything out of which the tax could be realized. The enactment of section 53 was intended to block such a loophole and was really a collection section: tax liability would still be determined in respect of the husband's income, but the authorities could collect from the wife, who had the revenue-producing assets, almost like a garnishee in her hands. See House of Commons Debates, June 13, 1951, vol. 5, at 4061-62.

634 While it would seem that an "indirect transfer of property" would be interpreted in the same manner in subsection 160(1) as in subsections 74.1(1) and 74.1(2), yet in Lamarche v. MNR, [1983] CTC 2260 TRB), the Board apparently extended the concept beyond its heretofore recognized judicial boundaries. Here the taxpayer's husband was under a tax liability in the years 1974 to 1978. In 1974, the taxpayer purchased a home and her husband paid $1,000 towards the down payment and thereafter made all the mortgage payments. The taxpayer also took out a bank loan in order to finance the purchase and this loan was paid off in 1975 by her husband. The Minister treated all the payments which the husband made to the bank as being transfers of property to his wife at a time when he was under a tax liability, and assessed the wife for tax under section 160. It was held that the repayment of the loans by the husband constituted an indirect transfer of property from the husband to the wife within the meaning of section 160. With respect, this holding is somewhat inconsistent with the notion that an "indirect transfer" does not encompass the situation where property is transferred to a legal entity which may use the property as it sees fit and which is not accountable to the transferor's spouse (see Potts' Executors v. IRC, supra footnote 220). In this case, the bank was certainly not accountable to the taxpayer in respect of the mortgage payments made by her husband. When the husband paid off the taxpayer's loans, these payments merely resulted in the assignment of indebtedness by the bank to the husband. If the husband had waived payment by his wife on the indebtedness which was assigned to him, this could, perhaps, be regarded as a transfer of property, although even this point is not entirely clear.

635 Before November 13, 1981, paragraph 160(1)(d) limited the

joint and several liability to the transferor's tax liability in respect of "income from the property so transferred or from property substituted therefor." Subsection 9(3) provides that "income from a property" does not include any capital gain on the disposition of that property. Accordingly, the joint and several liability did not extend to the attribution of capital gains as provided in subsection 74.2(1).

636 Canada Tax Service, supra footnote 97, vol. 4, paragraph 160-103.

637 Paragraph 160(1)(e).

638 Ibid.

639 That the transferee's joint liability was not reduced by the value of any consideration provided by him in exchange for the transferred property was illustrated in the case of Thorsteinson v. MNR, [1980] CTC 2415 (TRB), where the husband transferred to his wife one-half of his interest in the family residence at a time when he owed substantial unpaid taxes. Although the wife had transferred to the husband certain income-producing property in return for the husband's one-half interest, the Board did not take such consideration into account in holding that the wife was jointly and severally liable for the husband's unpaid taxes. As an evidentiary point, where, after November 12, 1981, the transferee provides consideration for the transferred property such that his or her joint liability is reduced or eliminated by virtue of subparagraph 160(1)(e)(i), care should be taken to ensure that such consideration can be absolutely and unequivocally linked to the property transferred by the transferor. A written and signed contract appears to be the best proof of such linkage. See Fisher v. MNR [1979] CTC 2771 (TRB).

640 It is possible, however, that unpaid instalments of tax under section 155 or section 156 are "amounts" which the transferee was liable to pay under the Act and for which the transferee might become jointly and severally liable. See Canada Tax Service, supra footnote 97, vol. 4, paragraph 160-104; Ward's Tax Law and Planning, supra footnote 79, vol. 5, paragraph 250.2[j].

641 [1959] 21 Tax ABC 317 (TAB).

642 The Minister, however, is not entitled to issue an assessment against the transferee under subsection 160(1) prior to issuing an assessment against the transferor. See Subsidiaries Holding Co. Ltd. v. MNR, [1956] CTC 240 (Ex. Ct.), where it was held that the phrase "amounts payable under this Act" in subsection 57(4) of the Income War Tax Act meant the amount of tax (plus interest and penalties) payable as fixed by assessment or reassessment.

643 [1984] CTC 2955 (TCC).

644 Likewise, it is open to a transferee under subsection 160(2) to challenge the bona fides of the Minister's claim that the

liability for tax of the transferor actually existed at a particular point in time. The transferee has available all the rights of any taxpayer, including the right to dislodge the basis for the liability. The basis of an assessment of the transferee must be the actual liability for the tax itself. See Thorsteinson v. MNR, supra footnote 639.

645 Paragraph 160(3)(a).

646 Paragraph 160(3)(b).

647 In Dubois v. MNR, [1982] CTC 2585 (TRB), the taxpayer's husband transferred certain sums of money to her at a time when he was under a tax liability. A few years later, the husband paid off part of his tax owing, leaving an unpaid balance. When the Minister assessed the wife under section 160 for the sums of money which she had received from her husband while he owed taxes, she argued that by virtue of article 1161 of the Quebec Civil Code her debt had been extinguished by the husband's partial payment of taxes since payments are applied first to the oldest debt. It was held that the specific provisions of paragraph 160(3)(b) overrode the generality of article 1161 CC and that a payment by the husband discharged the wife's liability only to the extent that such payment reduced the husband's liability for his total taxes owing to an amount less than that for which the wife was made jointly liable for by virtue of the transfer.

648 Paragraph 160(4)(b).

649 The term "burden of proof," as Thayer points out, is commonly used in two senses: (a)"The peculiar duty of him who has the risk of any given proposition in which parties are at issue - who will lose the case if he does not make this proposition out, when all has been said and done;" and (b) "...the duty of going forward in argument or in producing evidence, whether at the beginning of a case, or any later moment throughout the trial or discussion." (Thayer, Preliminary Treatise on Evidence at Common Law, 355, quoted in Cross on Evidence, 5th ed. (London, Butterworths 1979) at 65). We are here concerned with the burden of proof in the first of the two senses mentioned by Thayer.

650 Del Grande v. MNR [1951] 3 Tax ABC 371 (TAB); Maziade v. MNR [1951] 5 Tax ABC 184 (TAB) (dealing with subsection 74.1(1)); Thorsteinson v. MNR [1980] CTC 2415 (TRB); Thalheimer v. MNR [1983] CTC 2498 (TCC) (dealing with section 160).

651 For a discussion of the burden of proof rule with respect to income tax litigation see: MacNab, "The Burden of Proof in Income Tax Cases," (July - August 1978) 26 Canadian Tax Journal 391-422; Wolff, "The Burden of Proof in Tax Disputes," (January - February 1970) 18 Canadian Tax Journal 1-16; Nathanson, "Assessment Procedures and Practices," Corporate Management Tax Conference 1975 (Toronto: Canadian Tax Foundation 1976) 13-36; Vineberg, in Income Taxation in Canada (Prentice-Hall), supra footnote 97, vol. 4, paragraph 87,290 et. s.

652 [1917-27] CTC 198 (SCC).

653 Statutes of British Columbia, 1921 (2d. sess.) c.48.

654 Supra footnote 652, at 201-2.

655 See Johnston v. MNR [1948] CTC 195 (SCC); Dezura v. MNR [1947] CTC 375 (Ex. Ct.); Goldman v. MNR [1951] CTC 241 (Ex. Ct.); MNR v. Simpson's Ltd. [1953] CTC 203 (Ex. Ct.); MNR v. The Davidson Cooperative [1956] CTC 26 (Ex. Ct.); McLean v. MNR [1962] CTC 93 (Ex. Ct.); Fyke v. MNR [1964] CTC 54 (Ex. Ct.); MacIsaac v. MNR [1974] CTC 576 (FCA).

656 [1948] CTC 195 (SCC) at 202. In a separate concurring opinion, Kellock J. (at 204) stated that the onus was on the taxpayer to substantiate his objection to the assessment:

> ...a person who objects to an assessment is obliged to place before the Minister on his appeal the evidence and the reasons which support his objection. It is for him to substantiate the objection. If he does not do so he would, in my opinion, fail in his appeal...In my opinion, therefore, the learned judge below was right in his view that the onus lay upon the appellant.

657 It seems well established that the time for determining the findings or assumptions of fact of the Minister, for the purposes of establishing the burden of proof on a taxpayer in any given case, is the time of the assessment. See Pillsbury Holdings Ltd. v. MNR [1964] CTC 294 (Ex. Ct.); Brewster v. The Queen [1976] CTC 107 (FCTD); Tobias v. The Queen [1978] CTC 113 (FCTD); Miron and Freres Ltd. v. MNR [1955] SCR 679 (SCC).

658 Indeed, one begins a case with the assumption that the court knows the law (or at least will become aware of it upon examination of the relevant authorities), and that the facts have to be established. Hence, the taxpayer does not prove the law, rather he proves the facts. This point was emphasized by Thorson P. in Goldman v. MNR (supra footnote 655, at 248):

> When the taxpayer challenges the correctness in fact of the assessment the onus of proof that the assessment is erroneous in fact lies on him. But when the validity of the assessment is attacked in point of law it is not, strictly speaking, correct to say that the onus of establishing its validity lies on the appellant. In such a case there is really no onus on either party, for once the facts have been established, the responsibility for determining the validity of the assessment as a matter of law is solely that of the court. It must decide the question according to the applicable law regardless of the submissions of the parties.

659 Supra footnote 652, at 50.

660 Supra footnote 655, at 203. Although, since the Johnston case, it has generally been assumed that the burden of proof is always on the taxpayer, in the case of The Queen v. McKay, [1975] CTC 279 (FCTD), Collier J. questioned the correctness of this rule and, in what was admittedly obiter dicta (since the taxpayer had accepted that the burden of proof was on him to proceed first at the trial), suggested that the dissenting opinion of Locke J. in the Johnston case might be relevant in cases where the Minister is plaintiff so that the position of the Crown, at least in respect of the burden of proving its case, would be the same as that of any other litigant. In ths respect, the learned judge said (at 291):

> I am not convinced, however, that the so-called "onus" on the taxpayer rule is a rigid rule, capable of no exception. I incline to the view that, in cases where Her Majesty is the plaintiff, there should be no hard and fast rule. Each action should be looked at on its own issues and in its own circumstances. In this particular case...where serious allegations charging crime are made by Her Majesty, as plaintiff, the onus of proving them and of leading evidence should be on the party who raises them. It is not sufficient to say that "tax cases" are somewhat different from other civil cases tried in this court.

Notwithstanding the obvious fairness of such a viewpoint, it has not been accepted by the Supreme Court of Canada. See Campbell v. MNR [1952] CTC 334 (SCC); Smith v. MNR [1965] CTC 257 (SCC).

661 The specific statutory bas's for asserting that the burden of proof rests on the taxpayer has never been clearly defined by the courts. In the Exchequer Court in Johnston, [1947] CTC 258, O'Connor J. appeared to base the presumption of validity of the assessment on the former subsection 60(2) of the Income War Tax Act (R.S.C. 1927, c.97) which provided that the onus was on the appellant to establish from the "facts, statutory provisions and reasons which he intends to submit to the Court in support of the appeal" that the assessment was incorrect. In the Supreme Court the justices referred to several provisions of the same Act, but did not appear to base their reasoning on any particular section thereof. However, in Miron and Freres Ltd. v. MNR, [1955] SCR 679 (SCC), where the Supreme Court again considered the burden of proof in an income tax case, Kellock J. referred to subsection 42(6) of the Income War Tax Act (R.S.C. 1948, c.52) (a predecessor section identical to the present subsection 152(8)) as providing the underlying basis for the burden of proof being on the taxpayer. In respect of this provision, the learned justice commented (at 682):

> Notwithstanding that an assessment is, by virtue of subsection 42(6) deemed to be valid and binding subject to appeal, the appellant saw fit to adduce no evidence with respect to the shares or the subject matter of

> control apart from the shareholdings as above set out. It is now argued on behalf of the appellant that it was for the [Minister] to support his decision by such evidence relative to control of the shares so held as he saw fit. In my view this is a misconception.

Looked at in terms of the underlying rationale which was applied by Rand and Kellock JJ. in the Johnston case, which Kellock J. followed in the Miron and Freres Ltd. case, Kellock J.'s reference to subsection 42(6) would appear to exist only for the purpose of demonstrating that it was the taxpayer who was required to appeal the assessment. See MacNab, supra footnote 651, at 399-400.

662 See Wolff, supra footnote 651, at 7. It is interesting to note that neither Duff J. in the Anderson Logging case nor Rand J. in the Johnston case made any reference to the case of Spooner v. MNR, [1928-34] CTC 178 (SCC), where Newcombe J., in applying the opinion of the Earl of Halsbury in Secretary of State in Council of India v. Scoble, [1903] A.C. 299 (J.C.P.C.), stated that (at 183):

> The case is not without its difficulties, but I am not satisfied that the Crown has made out its claim. And inasmuch as it is the duty of those who assert and not those who deny, to establish the proposition sought to established, I think that the Crown must fail.

While the Supreme Court's discussion with respect to the question of burden of proof was devoid of any detailed analysis or effort to distinguish fact from law, it was apparent from Newcombe J.'s words that his lordship felt that since the Crown was opposing the taxpayer's returns, therefore the burden rested on it to establish the case for the assessment. It is arguable, however, that since the main issue involved a determination of whether certain proceeds received by the taxpayer were to be treated as income or capital (a question of law) the question of the burden of proof was dealt with in relation to the principle of statutory interpretation established in Partington v. Attorney-General [1869] L.R. 4 (HL) - namely that the "burden" rests on the Crown to bring the subject or the amount within the charging provisions. Indeed, it has been in this sense that the term "burden of proof" has been applied in certain Canadian cases where the dispute centred on a question of law: see Holden v. MNR [1931] CTC 116 (Ex. Ct.); O'Connor v. MNR [1943] CTC 255 (Ex. Ct.); Bell Telephone Co. v. MNR [1944] CTC 207 (Ex. Ct.); Wolff, supra footnote 651, at 5. On the other hand, where the issue involved the deduction or exemption from taxation of an item which the Crown has, in accordance with the above principle, shown to be prima facie taxable, then the situation is the converse, and the courts have stated that the onus of showing compliance with the requirements of an exempting provision of the Act is on the taxpayer claiming the exemption. See Wilder v. MNR [1949] CTC 302 (Ex. Ct.); Moose Jaw Flying Club v. MNR [1949] CTC 279 (Ex. Ct.); Millstock Co. Ltd. v. MNR [1943] CTC 155 (SCC).

663 That is, the Minister must offer prima facie proof that a change of some nature in the holding of the property has taken place. (See Hansen, supra footnote 24, at 613; Cullity, supra footnote 24, at 102).

664 [1951] 3 Tax ABC 371 (TAB).

665 [1951] 5 Tax ABC 184 (TAB).

666 The statutory basis of the assessment was subsection 32(2) of the Income War Tax Act (R.S.C. 1927, c.97).

667 Supra footnote 664, (at 372):

> The fact remains that the assessment under appeal was made on the basis of subsection (2) of section 32 of the Income War Tax Act, and absolutely no evidence has been produced [by the Minister] before the Board in respect of any transfer of cash or property by the appellant husband herein to his wife. Under these circumstances, I cannot find that the assessment in question is in accordance with the provisions of the Act.

It should be noted that nowhere in its judgment did the Board refer to any of the relevant authorities which have dealt with the issue of the burden of proof.

668 See Groulx v. MNR, [1967] CTC 422 (SCC), per Hall J. (at 425):

> In the first place, I am of the opinion that the [taxpayer] has at least established a prima facie case that the property was sold at a price higher than its market price and that the [Minister] has not discharged the onus, which fell upon him, to prove to the contrary.

669 See the discussion under heading "Tax Liability on Property Transferred not at Arm's Length." In the United States, as noted above, the onus is on the government to prove the liability of the transferee in situations analogous to those envisaged by section 160. The underlying rationale is that the government is assessing a third party in respect of the tax owed by another and fairness dictates that the third party should not have the onus of proving that he does not owe someone else's taxes. (See Bittker, infra footnote 955, at 43-17).

670 See Canada Tax Service, supra footnote 97, vol. 4, paragraph 160-105. The reference to section 152 may, in effect, be read as a reference to subsection 152(8) which Kellock J. referred to in Miron Freres Ltd. v. MNR, supra footnote 661, as providing the underlying basis for the burden of proof being on the taxpayer.

671 [1980] CTC 2415 (TRB).

672 [1983] CTC 2498 (TCC).

673 The legal regime of separation of property was repealed on April 2, 1981 (L.Q. 1980, c.39, s.45). However, as stated above, the parties are free to stipulate in their marriage contract that their conventional regime will be that of separation of property.

674 Article 1266c et. s. CC. The legal regime of partnership of acquests became effective on July 1, 1970 (1969 Eliz. II, S.Q., c.77).

675 Article 1270 et. s. CC.

676 Subsections 74.1(1) and 74.2(1).

677 Article 1266o CC.

678 Article 1266e CC.

679 Article 1266o CC.

680 See Cuddihy, supra footnote 292, at 251.

681 Ibid. It should be noted that, as such a transfer takes place on the day of the celebration of the marriage, the provisions of subsection 73(1) will automatically apply to prevent any immediate capital gains and/or recapture in respect of the transferred property unless an election is made not to have the rollover apply.

682 Article 1275 et. s. CC.

683 Article 1272 CC.

684 Article 1425a CC.

685 Articles 1274 to 1279 CC and article 1297 CC.

686 Article 1272 CC.

687 Article 1272 CC.

688 See the discussion under heading "Transfer by Operation of Law." In Fasken Estate v. MNR, supra footnote 65, Thorson P. stated that:

> It is not necessary to a transfer of property from a husband to his wife that it should be made in any particular form or that it should be made directly. All that is required is that the husband should so deal with the property so as to divest himself of it and vest it in his wife, that is to say, pass the property from himself to her. The means by which he accomplishes this result, whether direct or circuitous, may properly be called a transfer.

One conclusion to be drawn from this statement is that the spouse who owns the moveable property in question must engage in a positive act, irrespective of the form, in order for there to be a transfer of property within the meaning of the attribution sections.

689 For couples married after July 1, 1970, the issue of whether the legal formation of a marital regime results in a transfer of property for the purposes of subsection 74.1(1) would seem to be largely academic. This is because, in the absence of a marriage contract, the spouses will be subject to the regime of partnership of acquests under which, by virtue of articles 1266c and 1266e of the Civil Code, each spouse will retain all private property respectively owned at the time of the marriage. Thus, it seems that only spouses married before July 1, 1970, under the legal regime of community of property (or the conventional regime of community of property, depending on the terms of the marriage contract), may be, prima facie, subject to attribution of income only.

690 Supra footnote 127.

691 Ibid. at 260.

692 Supra footnote 304.

693 Ibid. at 1008. As well, the Sura case did not involve income from property which was owned by one of the spouses before the marriage, but rather employment income and rental income. With respect to the rental income, it was derived from community property acquired after the marriage.

694 Cuddihy, supra footnote 292, at 255.

695 Supra footnote 304, at 1009. While the second argument, perhaps, retains more validity from a taxation point of view and is obviously much simpler to apply, the first argument appears to be more reconcilable with the civilian concept of ownership.

696 Since capital gains were not taxable at this time, subsection 74.2(1) would not apply.

697 As noted above, since 1969, the husband's right to absolutely dispose of community property has been restricted by an amendment to article 1297 CC which requires the consent of the wife to gift or alienate certain property. Such restrictions imposed on the husband's powers as administrator may serve as a basis for distinguishing the Sura case and open up possibilities for income splitting. Alternatively, since the spouses now are entitled to contractually modify the community regime (articles 1384, 1258, 1259 CC), a provision may be inserted in the marriage agreement entitling both spouses to jointly administer the community property and therefore split income derived therefrom. (See Bernstein, supra footnote 266, at 633-34).

698 Article 1266o CC.

699 Ibid.

700 Former article 1292 CC.

701 Article 1266d CC.

702 Subsection 9(3).

703 See Comtois, "Les Incidences Fiscales de la Loi des Régimes Matrimoniaux," (1971) Cours de Perfectionnement de la Chambres des Notaires du Québec, 103-121 at 110; Brière, "Les Dispositions Essentielles du Bill 10 sur les Régimes Matrimoniaux," in Lois Nouvelles II, P.U.M. at 29.

704 Ibid. (Comtois).

705 Subsections 48(1); 70(6); paragraphs 54(f), (g); paragraphs 70(5)(a), (b).

706 See Cuddihy, supra footnote 292, at 262-63. While it is true that in Sura Taschereau J. stated that "... the Act does not address itself to capital or ownership of property..." (supra footnote 304, at 1009), it should be noted that this case was decided in 1962 before the taxation of capital gains was introduced into the Act. It is therefore possible to conclude that each spouse should only be taxed in respect of one-half of the capital gain resulting from the disposition of his acquests.

707 Article 1266n CC.

708 Article 1266o CC.

709 With respect to the question of whether all or only one-half of the capital gain is subject to attribution, the same argument advanced above concerning the disposition of an acquest by one of the spouses should apply.

710 It should be noted that if a taxpayer transfers an acquest to his spouse by onerous title, such property becomes an acquest of the transferee. However, if the acquest is transferred by way of gift, the transferred property becomes private property of the transferee by virtue of article 1266e(2) CC. (See Comtois, supra footnote 703, at 119).

711 Article 1272(3) CC.

712 Article 1297 CC.

713 Ibid.

714 Articles 1297, 1425a CC.

715 See Jolin, supra footnote 294, at 282-85. Given the fact, however, that private property is not, per se, indeterminate since its owner possesses the enjoyment and free disposition thereof, it is arguable that income derived therefrom should be taxed in the hands of such owner. Thus, only the wife should be taxed in respect of income derived from her private property, because although the husband can demand the unconsumed revenues, unless and until he elects to do so, the wife has absolute control of such property without any recourse on the husband's part. See Cuddihy, supra footnote 292, at 266.

716 Article 1425f CC.

717 Article 1425a CC.

718 Ibid.

719 Article 1425f CC.

720 Ibid.

721 The jurisprudence which exists appears to support this view, namely, that capital gains realized upon the disposition of the wife's reserved property should be taxed in her hands only. In Laporte v. MNR, [1984] CTC 2260 (TCC), the husband transferred to his wife 50 per cent of the shares in a private company owned by him immediately prior to their disposition (to an unrelated third party) and on the basis of such transfer he argued that the capital gain realized upon such disposition should be divided evenly between the spouses on a 50-50 basis. The Minister argued that former subsection 74(2) (now subsection 74.2(1) applied to attribute the entire gain back to the husband because of the prior transfer of shares to the wife. It was held that the shares transferred to the wife were part of her reserved property since she had previously paid for them with her own salary, and this was not negated by the fact that the husband had not previously transferred them to her. Since the wife is entitled to the complete enjoyment and administration of her reserved property, it followed that she alone should be taxed in respect of the disposition of such property and accordingly former subsection 74(2) did not apply.

722 Supra footnote 715.

723 Supra footnote 304, at 1007-1008.

724 Article 1272 CC.

725 Per Taschereau J., supra footnote 304, at 1004:

> As I have pointed out earlier, the Act does not address itself to capital or ownership of property. It addresses itself to the person and the amount of the tax is determined by the benefits the person receives. Since the wife withdraws no benefit derived from the community

property, it follows that the Department of Revenue cannot claim anything from her.

726 Supra footnote 705.

727 See Dussault, supra footnote 309, at 346. In support of this argument, the writer refers to a decision of the Tax Appeal Board which held that, for the purposes of gift tax, a gift of community property was deemed to be made one-half by each of the spouses: "Si donc l'épouse de l'appellant pouvait et devait concourir à faire telle ou telle donation permise par la loi et suivant les formes exigées par le Code civil, elle devenait contribuable et comme tel elle était imposable personnellement pour la valeur globale des droits qu'elle a donnés." (Leduc v. MNR [1967] Tax ABC 771 (TAB) at 773). In referring to the Sura case, the Board in Leduc stated that: "Dans cette cause la Cour Suprême a reconnu que le mari et la femme sont copropriétaires des biens communautaires. Si donc commes copropriétaires l'épouse peut faire don de sa part de la communauté elle doit être considerée comme un contribuable ordinaire et traitée comme tel." (Ibid. at 774). Given the fact that taxation of capital gains was introduced by Parliament at the same time that it abandoned the domain of gift tax (perhaps to replace it?), perhaps the legislator intended that capital gains (i.e. gains realized on the disposition of community property) should be taxed in the hands of both spouses.

728 [1978] 2 WWR 101 (SCC) (per Martland J. at 111-12). The limitations on this approach were illustrated by the Supreme Court's decision in Murdock v. Murdock, [1975] 1 SCR 423, a decision which played a large part in creating a groundswell of public opinion in favour of marital law reform. This case involved a couple who, during their 25 years of marriage, both worked to develop and improve the family ranch holdings. Although title to all the ranch property was taken in the husband's name only, throughout most of the marriage the wife participated in the operation of the ranch and for certain periods, was solely responsible for these operations. Upon the break-up of the marriage, the Supreme Court held that the work done by the wife "was the work done by any ranch wife" and did not qualify as an indirect contribution and that combined with the absence of an express common intention of the parties to share the properties held by the husband in his name, it did not justify the granting of a beneficial interest therein to the wife. This decision added to other pressures already present for the reform of marital law and the later decision in Rathwell v. Rathwell, which arrived at a substantially different result on similar facts, did little to alleviate the pressure for reform. This decision, on the basis of a modest monetary contribution by the wife to the family assets in the early years of marriage, and an expression by the husband of the couple's intention to work as a team, held that the wife had an interest in the property as the beneficiary of either a resulting trust or a constructive trust. (See especially the comments of Dickson J. at 113).

729 Family Law Act, S.O. 1986, c.54.

730 Marital Property Act, R.S.M. 1978, c.48.

731 Matrimonial Property Act, S.S. 1979, c.M-6.1.

732 Matrimonial Property Act, S.A. 1978, c.22.

733 Family Relations Act, S.B.C. 1978, c.20.

734 A constructive trust is a trust arising by operation of law, as distinguished from an express trust, which arises by act of the parties. Wherever the circumstances of a transaction are such that the person who takes the legal estate in property cannot also enjoy the beneficial interest without necessarily violating some established principle of equity, the court will immediately raise a constructive trust, and fasten it upon the conscience of the legal owner, so as to convert him into a trustee for the party who in equity is entitled to the beneficial enjoyment. (Taylor v. Davies, [1917] 41 O.L.R. 403, per Meredith C.J.O. at 412-13). A resulting trust is a trust which also arises by operation of law and which is established as consonant with the presumed intention of the parties as gathered from the nature of the transaction. It arises where the legal estate in property is disposed of, conveyed or transferred, but the intention appears or is inferred from the terms of the disposition, or from the accompanying facts and circumstances, that the beneficial interest is not to go or be enjoyed with the legal title. (See Rathwell v. Rathwell, supra footnote 728, per Martland J. at 114).

735 In Leatherdale v. Leatherdale, [1982] 2 SCR 743 (SCC), a case involving the division of "business assets" between spouses upon a marital breakdown pursuant to the former Ontario Family Law Reform Act (R.S.O. 1980, c.152), Laskin C.J.C., speaking for the majority, refused to consider whether or not the equitable remedies of resulting or constructive trust survived the enactment of the Family Law Reform Act. Estey J., however, (dissenting in part), stated categorically that in his opinion such remedies had been superceded by the enactment of the Family Law Reform Act. See, however, Miller v. Miller, [1982] 39 O.R. (2d) 75 (Ont. C.A.); (appeal to the Supreme Court dismissed without written reasons) where the court was of the opinion that with respect to "non-family assets" (in this case, shares of a private corporation owned by the wife) the presumption of a resulting trust only applied if it was not rebutted by the objective facts. Since the purpose for which the shares were issued to the wife (to avoid the "associated corporation" rules) required her to own both the legal and beneficial title thereto, this rebutted any presumption that she held the shares on a resulting trust for her husband.

736 For an analysis of the different statutes governing the division of matrimonial property in the common law Provinces see Wuester, "Income Tax Implications of Matrimonial Property Law Reform," Report of Proceedings of the Thirty-First Tax Conference, 1979 (Toronto: Canadian Tax Foundation, 1980) 208-245; McNair,

"The Income Tax Implications of Matrimonial Law Reform - The Common Law Provinces," Report of Proceedings of the Thirty-First Tax Conference, 1979 (Toronto: Canadian Tax Foundation, 1980) 246-277; Eng, "Tax Consequences of Provincial Family Law Reform Legislation," (September - October 1978) 26 Canadian Tax Journal 554-576; Goodwin, "Provincial Marital Property Laws Recently Enacted or Proposed," Report of Proceedings of the Twenty-Ninth Tax Conference, 1977 (Toronto: Canadian Tax Foundation, 1980) 215-240; Dart and Smith, supra footnote 103, at 37-45).

737 S.O. 1986, c.54.

738 Subsections 4(1) and (2).

739 "Valuation date" under subsection 4(1) is defined to mean the the earliest of the following dates: (i) the date the spouses separate and there is no reasonable prospect that they will resume cohabitation; (ii) the date a divorce is granted; or (iii) the date the marriage is declared a nullity.

740 See McNair, supra footnote 736, at 263.

741 A "matrimonial home" is defined in subsection 18(1) as property in which a person has an interest and that is or has been occupied by the person and his or her spouse as their family residence. Subsection 20(1) provides that the family can have greater than one matrimonial home and section 19 provides that the spouses are entitled to an equal right to possession which ceases on the termination of the marriage and may be altered by a court order. The spouses may jointly designate one or more properties as matrimonial homes and upon the registration of the designation(s), any other property that is not so designated ceases to be a matrimonial home: subsection 20(4).

742 Subsection 21(1) is analogous to former subsection 42(1) of the former Family Law Reform Act (S.O. 1980, c.152).

743 This "veto right" is based on the fact that if the registered owner spouse sells the home without the consent of the non-registered owner spouse, the transaction can be set aside by virtue of subsection 21(2), unless an innocent third party has acquired the interest in the property for value and in good faith and without notice that the property was a matrimonial home. Thus, although the statute does not grant "ownership" as such, there is something more than the mere right to sue the registered owner for breach of the law - there is the right to void the transaction of sale and reacquire the interest in the matrimonial home.

744 See Goodwin, supra footnote 736, at 225. Eng, supra footnote 736, at 559, however, argues that, notwithstanding the equal right to possession and the power of veto against alienation, the non-owning spouse does not acquire an immediate property interest in the matrimonial home. She argues that certain detractions from full property rights, such as the non-sharing of proceeds from the disposition of any matrimonial home which is sold with the non-

owning spouse's consent, the absence of any right to direct or force the disposition of the matrimonial home, and the fact that the veto may be overridden by a court order negate the assertion that the non-owning spouse acquires an immediate property interest in the matrimonial home. In Re Kozub and Timko, [1984] 45 O.R. (2d) 558 (Ont. C.A.), the court stated that former section 42 of the Family Law Reform Act (which granted the non-owning spouse the right of veto) concerned proprietary rights and not mere possessory rights. While such a statement might, prima facie, lend support to the argument that the non-owning spouse acquires an immediate property interest in the matrimonial home, the decision did not, however, express any such firm conclusion.

745 That is, such an ownership interest was created under section 42 of the former Family Law Reform Act and was carried forward, into section 21 of the Family Law Act.

746 At the time of enactment of the former Family Law Reform Act there was concern that a transfer of an interest in the matrimonial home (as well as other family assets) to the non-registered owning spouse would result in the realization of accrued capital gains in the hands of the registered owner spouse, notwithstanding that such transfer would occur involuntarily. The enactment of subsection 73(1.1) resolved this problem by deeming the creation of a joint property interest by operation of the legislation to be capital property of the taxpayer that has been transferred to the other person, thereby extending the application of the inter vivos spousal rollover rules to cover such changes in ownership. Where subsection 73(1.1) applies, the effect is to deem the registered owner spouse to have received proceeds of disposition equal to one-half of the adjusted cost base of that property, and to deem the non-registered owner spouse to have acquired the property at a cost equal to the deemed proceeds of the registered owner spouse. See Eng, supra footnote 736, at 561; McNair, supra footnote 736, at 255.

747 Where a matrimonial home also qualifies as a principal residence, the possibility of capital gains splitting need not concern the spouses since such gain on the disposition of the home will normally be tax-exempt by virtue of paragraph 40(2)(b). However, since the spouses may designate greater than one matrimonial home but are restricted to designating only one principal residence between them, the prospect of capital gains splitting in respect of two (or more) matrimonial homes may be attractive. To the extent that a gain on the disposition of a second matrimonial home falls within the spouse's lifetime capital gains exemption (section 110.6), the prospect of capital gains splitting will become attractive once the spouses have exhausted such exemption.

748 Subsection 4(1) FLA.

749 The reference to the division of net family property is a reference to subsection 5(1) (FLA) which provides that:

> 5(1) When a divorce is granted or a marriage is declared a nullity, or when the spouses are separated and there is no reasonable prospect that they will resume cohabitation, the spouse whose net family is the lesser of the two net family properties is entitled to the one-half of the difference between them.

750 Supra footnote 304.

751 Reese v. MNR, [1955] 13 Tax ABC 379 (TAB).

752 Wertman v. MNR, supra footnote 127.

753 See the preamble to the Family Law Act, supra at 223; see also subsection 5(7) which provides that:

> The purpose of this section [division of "Family Property"] is to recognize that child care, household management, and financial provision are the joint responsibilities of the spouses and that inherent in the marital relationship there is equal contribution, whether financial or otherwise, by the spouses to the assumption of these responsibilities, entitling each spouse to the equalization of the net family properties, subject only to the equitable considerations set out in section 6.

754 Goodwin, supra footnote 736, at 234-36; Eng, supra footnote 736, at 561-62. It should be noted, however, that these writers' comments were made in respect of the provisions of the former Family Law Reform Act and not in respect of the new Family Law Act. However, given the fact that many of the provisions of the Family Law Act are substantially similar to those of the Family Law Reform Act and, moreover, that the general tenor of the Family Law Act is to strengthen the equalization of assets classified as "net family property," it seems that such comments may well be applicable to the Family Law Act.

755 Section 51 FLA.

756 In Nightingale v. Nightingale, [1978] 3 A.C.W.S. 451 (Ont. HCJ), Boland J., in striking out a petition for divorce insofar as it claimed a division of family and non-family assets, gave the following reasons, inter alia, for the insertion of provisions relating to domestic contracts in the former Family Law Reform Act:

> These agreements are clearly domestic contracts in accordance with subsection 2(9) of the Family Law Reform Act, 1978, and thus the release clauses contained in these agreements prevail over any right of family or non-family assets. Spouses should be encouraged to settle their affairs by separation agreement and not by continuing litigation, and the Courts, in the spirit of the Act, should recognize such agreement.

757 Paragraph 52(1)(a) FLA.

758 Clearly, the owning spouse would be divesting himself of such an ownership interest and vesting it in the non-owning spouse. See Fasken Estate v. MNR, supra footnote 65.

759 Assuming that the agreement transfers an ownership interest during the marriage, there will be a rollover of the transferred property by virtue of subsection 73(1), unless an election is made not to have such rollover apply.

760 Whether such transfer is made while the spouses are still married or after they have been divorced, the rollover under subsection 73(1) will apply. In the latter case, the rollover will apply so long as the transfer is made in settlement of rights arising out of the marriage: subsection 73(1)(b). Where a settlement of property rights is made pursuant to a court vesting order under subsection 9(1) of the Family Law Act, any inter-spousal transfer of property will be subject to a rollover by virtue of subsection 73(1.1).

761 It should be noted that where, by a separation agreement, one spouse agrees to release and discharge the other spouse from any future claims (for example, a release of future claims "of any nature or kind whatsoever") arising upon marital breakdown, such agreement may bar the former spouse to any claim for a division of net family property as well as excluded property. In Engel v. Engel, [1980] 30 O.R. (2d) 152 (Ont. HCJ), (decided under the former Family Law Reform Act) it was held that a separation agreement containing such a release clause barred the wife from any claims which she otherwise might have had in respect of a division of the husband's non-family assets. See also Nikolic v. Nikolic, [1980] 29 O.R. (2d) 661 (Ont. HCJ), (also decided under the Family Law Reform Act) where it was held that a domestic contract under which the wife conveyed her interest in the matrimonial home to her husband precluded her from asserting any statutory rights she might otherwise have possessed in the home under the provisions of the former Family Law Reform Act. Since the provisions of section 52 of the Family Law Act which govern the rights of spouses flowing from the making of domestic contracts are identical with those of former section 52 of the Family Law Reform Act, these judgments would seem to be applicable to the provisions of the new Family Law Act.

762 I.e., provisions concerning "Family Property" and the division thereof between the spouses.

763 [1978] 2 O.R. (2d) 185 (Ont. HCJ).

764 The vesting order was made pursuant to subsection 6(a) of the Family Law Reform Act which provided that:

> ...the court may order that the title to any specified property directed to a spouse in the division be

> transferred to or in trust for or vested in the spouse whether absolutely, for life or for a term of years;
>
> [while the declaration of the husband's one-half interest in the matrimonial home was made pursuant to subsection 7(a) which provided that] ... where an application is made as to the ownership of any particular property ... the court may declare the ownership or right to possession.

The provisions of former subsection 6(a) and subsection 7(a) are continued in the new Family Law Act under sections 9 and 10 respectively. In addition, the new Family Law Act contains provisions (sections 12 and 13) which entitle one spouse to ask the court for an order to restrain the depleting of the other spouse's net family property, as well as an order to preserve such property, including the imposition of a charge thereon, in satisfaction of obligations arising under the Family Law Act or under a domestic contract.

765 Supra footnote 763, at 204.

766 [1982] 2 SCR 743.

767 It is, perhaps, open to argument that the decision in Leatherdale v. Leatherdale did not entirely settle the question of whether the non-owning spouse acquires an interest in the family assets upon marriage. In Leatherdale, the Supreme Court was concerned only with the division of personal property assets (i.e. stocks and a registered retirement savings plan), and did not consider a division of the matrimonial home, a real property asset which neither spouse may legally dispose of without the consent of the other. Thus, it may still be the case that the non-owning spouse acquires an undivided one-half interest in the matrimonial home upon marriage. However, given the fact that the Supreme Court based its decision upon the effect of former subsection 4(1) (continued as subsection 5(1) under the Family Law Act) which provided, inter alia, that "...where a decree nisi of divorce is pronounced or a marriage is declared a nullity or where the spouses are separated and there is no reasonable prospect of the resumption of cohabitation, each spouse is entitled to have the family assets divided in equal shares notwithstanding the ownership of the assets by the spouses...", it would seem that the judgment would also encompass a division of the matrimonial home since subsection 4(1) (as in the case of subsection 5(1) of the Family Law Act) did not distinguish between which types of family assets were subject to division upon separation.

768 See Prentice-Hall, supra footnote 97, paragraph 79,705; see Fraser Companies Ltd. v. The Queen, [1981] CTC 61 (FCTD), where Cattanach J. held that proceeds from a gain realized on the sale of a capital asset was not subject to tax under subsection 56(2) because, inter alia, the gain was not taxable under any other section of the Act, capital gains tax not having been enacted at

the time the gain was realized; see also Goldblatt v. MNR, [1964] CTC 185 (Ex. Ct.), where it was held that a commission earned by the taxpayer but paid, at the taxpayer's direction, to a corporation controlled by him, had to be included in the taxpayer's income under former subsection 16(1) (the present subsection 56(2)) since the commission was otherwise includable in his income under subsection 5(1).

769 Ward's Tax Law and Planning, supra footnote 79, paragraph 11.2. A clear enunciation of the doctrine of constructive receipt is contained in Regulation 1.451-2 of the United States Internal Revenue Code:

> General Rule. Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some further date, the mere crediting on the books of the corporation does not constitute receipt.

770 See Morin v. The Queen [1975] CTC 106 (FCTD) (subsection 56(2) properly invoked to include in the income of an employee an amount witheld from his salary by his employer and paid to the Quebec provincial government on behalf of the employee's provincial income tax liability).

771 In paragraph 6 of Interpretation Bulletin IT-440 ("Transfers of Rights to Income," November 5, 1979), in dealing with subsection 56(4), the Department states that:

> 6. An amount to which subsection 56(4) applies could be included in the income of both the transferor and the transferee. However, where the transfer or assignment of the right to an amount that is income does not constitute a deliberate attempt to evade or avoid tax, it is the Department's practice to include the amount in the income of the transferor only.

Interpretation Bulletin IT-335 ("Indirect Payments," August 9, 1976) which deals specifically with subsection 56(2)), contains no statement similar to that of paragraph 6 in Interpretation Bulletin IT-440. However, in cases in which subsection 56(2) has been applied (see, for example, MNR v. Bronfman [1965] CTC 378 (Ex. Ct.); MNR v. Bisson [1972] CTC 446 (FCTD); Perrault v. The Queen [1978] CTC 395 (FCA) (discussed infra); Adams v. MNR [1960] 24 Tax ABC 154 (TAB); Titeley v. MNR [1977] CTC 2045 (TRB); Champ v. The Queen [1983] CTC 1 (FCTD); McClurg v. The Queen [1986] 1

CTC 355 (FCTD)) there does not appear to be any instance where the Department requested that the amount in question be added to both the taxpayer's as well as the recipient's income. Hence, the policy enunciated by the Department in paragraph 6 of Interpretation Bulletin IT-440 should not apply to assessments made under subsection 56(2). However, it is interesting to note that for the purposes of subsection 56(4) (as well as subsections 74.1(1) and 74.1(2)), where the amount is paid or credited to a transferee who is a non-resident, double taxation (i.e. of the transferee and the resident taxpayer) is expressly avoided by subsection 212(12).

772 [1962] CTC 199 (Ex. Ct.).

773 Former subsection 16(1) provided that:

> 16(1) A payment or transfer of property made pursuant to the direction of, or with the concurrence of, a taxpayer to some other person for the benefit of the taxpayer or as a benefit that the taxpayer desired to have conferred on the other person shall be included in computing the taxpayer's income to the extent that it would be if the payment or transfer had been made to him.

774 In The Queen v. LePain, [1978] CTC 711 (FCTD), the taxpayer was a shareholder and manager of an Ontario corporation. Rather than paying a salary, the practice of the corporation was to accrue a management bonus at the end of the corporation's fiscal year and to pay this sum to the taxpayer in equal monthly instalments over the following fiscal year. Several other shareholders maintained the same arrangement. In 1972, all the shareholders accepted an offer to purchase their shares of the corporation for $225,000. Prior to closing, the purchaser (an arm's length party) learned of the existence of the management bonuses and insisted on an assignment of these bonuses as well as the shares. The taxpayer and other shareholders complied with the purchaser's wishes. There was no alteration in the original price of $225,000. When the corporation paid the bonus money to the purchaser, the taxpayer, much to his surprise, was assessed for his share of the accrued bonus under subsection 56(2). The assessment was upheld on the ground that the payment of the bonus to the purchaser was an indirect benefit which the taxpayer had conferred on another, notwithstanding that the transaction was an arm's length business transaction for adequate consideration. It appears from the judgment that the taxpayer did not argue that both the shares and the right to the accrued management bonus were sold for a total consideration of $225,000. If that was the case, then, on the basis of Thurlow J.'s decision in Miller v. MNR, supra footnote 772, subsection 56(2) should not have been applicable in respect of the sale of the accrued bonus.

775 In Murphy v. The Queen, supra footnote 257, Cattanach J. stated (at 390) in obiter that:

> Subsection 56(2) is to impute receipt of income to the

taxpayer that was diverted at his instance to someone else. It is to cover cases where the taxpayer seeks to avoid receipt of what in his hands would be income by arranging to transfer that amount to some other person he wishes to benefit or for his own benefit in doing so. Apart from any moral satisfaction the practical benefit to the taxpayer is the reduction of his income tax.

776 See Pitt Estate v. MNR [1959] 22 Tax ABC 57 (TAB) (forgiveness of a debt held to be a benefit conferred by a father upon his son notwithstanding that there were sound business reasons in forgiving the debt); Watts v. MNR [1961] 27 Tax ABC 432 (TAB) (employee taxed on that part of her salary which, by her direction, was paid directly by her employer to her housekeeper).

777 See The Queen v. Campbell [1980] CTC 319 (SCC) (no prohibition against a doctor being employed on a salary by a hospital and endorsing his fees to a corporation of which he was an employee); Sazio v. MNR [1968] CTC 579 (Ex. Ct.) (football coach forming a corporation to carry on the coaching activities formerly provided by him as an employee of a professional football team); Feinstein v. The Queen [1979] CTC 329 (FCTD) (manufacturer's agent in the clothing industry forming a corporation and arranging for his commissions to be paid to the corporation); Barbeau v. The Queen [1981] CTC 496 (FCTD) (commissions paid to a corporation interposed between a manager and his employer imputed to the manager under subsection 56(2)).

778 Titeley v. MNR, supra footnote 771; Champ v. The Queen, supra footnote 771; McClurg v. The Queen, supra footnote 771; (the preceding cases are discussed below in detail); see also Nelson v. The Queen [1974] CTC 360 (FCA) (no imputation under subsection 56(2) of dividends paid by a company controlled by the taxpayer to his sons since there existed a bona fide partnership between the taxpayer and his sons in carrying on a logging business).

779 Loans: Reininger v. MNR [1958] 20 Tax ABC 242 (TAB); Caspari v. MNR [1983] CTC 2001 (TRB); Waddell v. MNR [1983] CTC 2205 (TRB); Mele v. MNR [1985] 1 CTC 257 (FCTD); and see also Fraser Companies Ltd. v. The Queen [1981] CTC 59 (FCTD) (intercorporate loan held not to be a "payment or transfer" within the meaning of subsection 56(2)). Gifts: MNR v. Bronfman [1965] CTC 378 (Ex. Ct.); Copp v. MNR [1954] 11 Tax ABC 147 (TAB).

780 See Kellough, "Selecting an Appropriate Share Capital Structure for Private Corporations," Report of Proceedings of the Thirty-Third Tax Conference, 1981 (Toronto: Canadian Tax Foundation, 1982) 49-81 at 73; Gordon, "Tax Problems of Small Businesses," Report of Proceedings of the Thirty-Third Tax Conference, 1981 (Toronto: Canadian Tax Foundation, 1982) 354-89; Krishna, "Share Capital Structures and Indirect Payments: An Indirect Attack on Income Splitting?" in Canadian Current Tax, Issues 15 and 16 (Toronto: Butterworths, April 15 and 22, 1983) (looseleaf); Krishna, "Designing Share Capital Structures for

Income Splitting," in Canadian Current Tax, vol. 1, No. 10 (Toronto: Butterworths, October 1984) C51-C55 (looseleaf); Strother, "Avoidance and Evasion: The World Beyond Stubart," Report of Proceedings of the Thirty-Sixth Tax Conference, 1984 (Toronto: Canadian Tax Foundation, 1985) 105-147 at 109-110.

781 Supra footnote 768, at 70-71.

782 See the discussion under heading "Judicial Interpretation of Transfer."

783 Supra footnote 768, at 71.

784 Supra footnote 257.

785 Supra footnote 65.

786 Black's Law Dictionary, 5th ed.

787 See Kellough, supra footnote 780, at 71; Welling, Corporate Law in Canada: The Governing Principles (Toronto: Butterworths, 1984) states (at 574):

> ... the first thing that must be kept in mind is that ongoing profits belong to the corporation, not to the shareholders. They are entitled to participate in profits only to the extent that the corporation decides to give away part of its money in a given year. This is done by the payment of dividends, which the corporation 'declares.'

788 See, for example, Watts v. MNR, supra footnote 776.

789 Supra footnote 257.

790 Ibid. at 391.

791 While Cattanach J. based his decision on the former subsection 74(1) and not on subsection 56(2), it was apparent from his analysis of the two subsections that, in his view, the common element of a "transfer of property" could be interpreted in the same manner in each subsection.

792 The term "preferred share" is defined in subsection 248(1) of the Act to mean "a share other than a common share." Generally speaking, it is common business practice to label certain classes of shares as "preferred shares," which usually indicates that such classes have priority over common shares in terms of the right to receive dividend payments. The result is that the common shareholders have no entitlement to dividends until dividends have been paid on the company's preferred shares. (See Welling, supra footnote 787, at 616-17).

793 Scott v. Scott [1943] 1 All ER 582 (Ch. D.); Strother, supra footnote 780, at 109; Welling, supra footnote 787, at 613.

Further, at least in corporate law, unless there are provisions to the contrary in the corporate constitution, the shareholders cannot compel the directors to declare a dividend and they must, in most circumstances (i.e. in the absence of bad faith on the part of the directors), acquiesce in the decision of the Board of Directors, so long as the directors are acting in good faith. (See Fairhall v. Butler [1928] SCR 369 (SCC); Re Canada Tea Co. Ltd. [1959] OWN 378 (Ont. HCJ); DeVall v. Wainwright Gas Co. Ltd. [1932] 1 WWR 281 (Alta. CA)); In Burland v. Earle, [1902] AC 83 (JCPC), Lord Davey said (at 71): "It is an elementary principle of the law relating to joint stock companies that the court will not interfere with the internal management of companies acting within their powers, and in fact has no jurisdiction to do so." Under the Canada Business Corporations Act (CBCA) (S.C. 1978, c.9), there is no specific provision which both grants and constrains the directors' dividend power. Rather, the power is assumed to emanate from the statutory power to manage corporate affairs: section 97 CBCA; (see Welling, supra footnote 787, at 614).

794 Supra footnote 257.

795 Strother, supra footnote 780, at 618.

796 A "class" of shares, as a subdivision of the share capital, is a group of shares which have the same similarities among themselves and the same differences from other classes of shares. The concept was described in the English case of Sovereign Life Assurance v. Dodd, [1892] 2 Q.B. 573 (CA), where Bowen L.J. said (at 583): "The term 'class' ... must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest." In other words, a class is a sub-group of shares with rights and conditions in common which distinguish them from other shares. Section 24 of the CBCA specifically notes the possibility that classes of shares may be differentiated as to voting rights, dividends and participation upon dissolution but does not restrict the corporate charter in these respects. However, paragraph 24(4)(a) of the CBCA provides that the rights, restrictions and conditions attached to each class of shares must be set forth in the company's articles.

797 See Champ v. The Queen, supra footnote 771; McClurg v. The Queen, supra footnote 771. Both cases are discussed below. See also Kellough, supra footnote 780, at 72-73.

798 Supra footnote 257.

799 See Strother, "Small Business Problems: Life Insurance Funded Corporate Buy-Sell and Buy-Back Agreements and Recent Developments in Share Capital Structures for Income Splitting," 1983 British Columbia Tax Conference (Toronto: Canadian Tax Foundation 1983) 251-99 at 281 (hereinafter referred to as Strother "2"); Kellough, supra footnote 780, at 71.

800 Supra footnote 771.

801 See also Copp v. MNR, supra footnote 779, where it was held that the value of gifts made by a corporation to certain of its shareholders' relatives should be attributed back to the shareholders under former subsection 16(1) (the present subsection 56(2)). The Copp case is distinguishable from the Bronfman case because in Copp, unlike in Bronfman, the shareholders were majority shareholders as well as directors of the company and therefore had sufficient control, by virtue of their office, to personally direct the payments of the gifts in question.

802 This was precisely the result in Copp v. MNR, ibid.

803 See Strother "2", supra footnote 799, at 285-86; Kellough, supra footnote 780, at 71-72.

804 See Watts v. MNR, supra footnote 776.

805 This type of benefit was summarized by Cattanach J. in Murphy v. The Queen, supra footnote 257, (at 391):

> Subsection 56(2) is to impute receipt of income to the taxpayer that was diverted at his instance to someone else. It is to cover cases where the taxpayer seeks to avoid the receipt of what in his hands would be income by arranging to transfer that amount to some other person [i.e. a family member] he wishes to benefit or for his own benefit in doing so. Apart from any moral satisfaction the practical benefit to the taxpayer is the reduction in his income tax.

806 Goldblatt v. MNR, supra footnote 768; Feinstein v. The Queen, supra footnote 777; Barbeau v. The Queen, supra footnote 777.

807 See Farand v. MNR, [1983] CTC 2275 (TRB), where it was held that a payment made by a company (which the taxpayer controlled) to extinguish the personal liabilty of the taxpayer in respect of another company (in which the taxpayer was a shareholder) which went bankrupt, was imputed to the taxpayer since the funds used to extinguish the taxpayer's personal liablity would have otherwise been included in his income for the taxation year in question. This decision is, perhaps, questionable, since it could not be said with any degree of certainty that the funds in the first company (i.e. which the taxpayer controlled) would automatically be paid to the taxpayer or withdrawn at his direction; such funds might have otherwise remained in the company. The Board was apparently influenced by the fact that the taxpayer had direct control of the company.

808 See Strother, supra footnote 780, at 110.

809 Supra footnote 768, at 71.

810 Kellough, supra footnote 780, at 72.

811 See McClurg v. The Queen, supra footnote 771; Champ v. The Queen, supra footnote 771; Titeley v. MNR supra footnote 771.

812 See Strother "2", supra footnote 799, at 285-86.

813 [1984] 84 DTC 1502 (TCC).

814 Ibid. at 1505.

815 See Kellough, supra footnote 780, at 72; Strother, supra footnote 780, at 112.

816 Supra footnote 771.

817 See Strother, supra footnote 780, at 113.

818 Supra footnote 768.

819 See Kellough, supra footnote 780, at 72.

820 Supra footnote 771.

821 See Strother, supra footnote 780, at 113.

822 "Revenue Canada Round Table," in Report of Proceedings of the Thirty - Third Tax Conference, 1981 (Toronto: Canadian Tax Foundation, 1982) 726-66 at 746. In Interpretation Bulletin IT-335 ("Indirect Payments," August 9, 1976), the Department reiterates its view with respect to the applicability of subsection 56(2) to counter income splitting through dividends. Paragraph 3 of the Bulletin provides that:

> A taxpayer to whom subsection 56(2) applies need not be legally entitled to the property paid or transferred but he must have some degree of control over its payment or transfer. Thus a shareholder who does not specifically direct a payment that falls under subsection 56(2) to be made but acquiesces in its payment will be taxable on the portion of the payment equal to the proportion of his shares to the total number of shares. Whether or not a shareholder will be viewed as having acquiesced in the payment will depend on the facts of the particular case.

823 Section 67 provides that:

> In computing income, no deduction shall be made in respect of any outlay or expense in respect of which any amount is otherwise deductible under this Act, except to the extent that the outlay or expense was reasonable in the circumstances.

See Mulder Brothers Sand and Gravel Ltd v. MNR, [1967] Tax ABC, 761 (TAB), where it was held that part of the salary paid to the taxpayer's wife by the company was disallowed as a deductible expense because it was unreasonable in the circumstances for her

to receive such a large salary. See also Gabco Ltd. v. MNR, [1968] CTC 313 (Ex. Ct.), where it was held that the test was whether a reasonable businessman would have paid approximately the same remuneration in the circumstances; Hotel Cartier Inc. v. MNR [1978] CTC 3029 (TRB) (salary paid by father to son held to be reasonable in view of the services rendered by the son to the company); No. 712 v. MNR [1960] 24 Tax ABC 282 (TAB) (salary paid by father to son held to be reasonable since it was not in excess of what the company would have paid to an arm's length third party for the same duties).

824 Kellough and McQuillan, Taxation of Private Corporations and Their Shareholders, (Toronto: Canadian Tax Foundation, 1983) at 44.

825 See Titeley v. MNR, supra footnote 771; and McClurg v. The Queen, supra footnote 771 (in both cases wives subscribing for shares at commencement of the company's operations); Champ v. The Queen, supra footnote 771 (wife subscribing for shares after company had been carrying on business).

826 A share of a corporation can be issued for whatever price is set by the directors: subsection 25(1) CBCA. As the directors' obligation is to exercise all their powers with the best interests of the corporation in mind (section 117 CBCA), this price will normally fluctuate in tandem with the corporation's fortunes. However, the shares cannot be issued until the full price is paid, in money, property or past services: subsection 25(3) CBCA.

827 See Dart, "Specific Uses of Companies in Tax Planning," Report of Proceedings of the Thirty - First Tax Conference, 1979 (Toronto: Canadian Tax Foundation, 1980) 117 - 154, at 120-24; Dierker, "Formation, Operation and Disposition of Closely Held Corporations," Report of Proceedings of the Thirtieth Tax Conference, 1979 (Toronto: Canadian Tax Foundation, 1979) 681-712 at 587-88; Kellough and McQuillan, supra footnote 828, at 44.

828 Supra footnote 771.

829 The CBCA authorizes the corporate constitution to provide for more than one class of shares. If this is done, then it is mandatory to set out in the articles the "rights, privileges, restrictions and conditions attaching to the shares of each class:" Subsection 24(4) CBCA. It is not mandatory to have one class equivalent to the traditional "common shares:" the CBCA requires only that, somewhere spread among the classes, voting rights at shareholders meetings, dividend rights, and the rights to succeed to the corporate property on dissolution must be found: subsections 24(3), 24(4)(b). It is a matter of legislative indifference whether all the participatory rights are attached to one class or whether they are distributed among various classes. (See Welling, supra footnote 787, at 581).

830 Supra footnote 771, at 2047-48.

831 Ibid.

832 Ibid.

833 Ibid.

834 The reported judgment itself apparently failed to describe fully certain facts surrounding this income splitting arrangement. Kellough, (supra footnote 780, at 69), indicates that the additional facts not reported were as follows: (a) the taxpayers had received shareholders loans from the company for the years under assessment; (b) the taxpayers' wives transferred their notional dividends to the taxpayers in consideration of promissory notes issued to them; and (c) the taxpayers repaid their shareholder loans with the notional dividends notionally transferred.

835 Supra footnote 771, at 2048.

836 It is arguable that allowing a non-arm's length individual to acquire shares in a private, closely-held corporation at the commencement of its operations for a nominal amount does not result in the conferral of a benefit upon the individual. Subsection 25(3) CBCA provides, inter alia, that "a share shall not be issued until the consideration for the share is fully paid in money or in property or past services that is not less in value than the fair equivalent of the money that the corporation would have received if the share had been issued for money." However, when a company is first established and before it commences to carry on business (as in Titeley), it will generally have few net tangible assets and obviously no positive record of earnings performance. Thus, it may be that the market value of the share is, at least in an accounting sense, very nominal. In fact, the vast majority of shares in private companies, at least in their embryonic stages, are acquired for nominal amounts. (See Gordon, supra footnote 780, at 391).

837 This latter approach, however, is impractical since the benefit is very difficult to quantify at this time. Perhaps it is more appropriate to say that the benefit is conferred at the time the dividend is declared because until that time the wives had only a potential benefit. See McDonnell, "Use of Management Company for Income Splitting Purposes Ineffective - Another Crack in the Ice?," in "Current Cases Feature," (May - June, 1977) 25 Canadian Tax Journal 255-57 at 256.

838 Supra footnote 771.

839 The taxpayer's appeal in Titeley was allowed by consent to judgment on June 12, 1979. However, the Department stated that it did not consent to the appeal on the basis that subsection 56(2) would not apply.

840 August, 1981; cited in Kellough, supra footnote 780, at 69-70.

841 In Perrault v. The Queen, [1978] CTC 394 (FCA), the taxpayer caused a corporation controlled by him to pay a dividend to a third party (with whom the taxpayer was apparently dealing at arm's length) in satisfaction of a debt owed by the taxpayer to the third party. The Minister included the amount of the dividend in the taxpayer's income under former subsection 8(1) (the present subsection 15(1)) as a benefit which the corporation conferred on the taxpayer. LeDain J. upheld the assessment on the ground that, by extinguishing the taxpayer's debt, the corporation had thereby conferred a benefit on him. In obiter dicta, the learned judge also stated that (without giving any reasons in support) former subsection 16(1) (the present subsection 56(2)) did not apply to a corporate payment of dividends. The Perrault case is distinguishable from the income splitting cases (i.e. Titeley; Champ v. The Queen, supra footnote 771; McClurg v. The Queen, supra footnote 771) because in Perrault the dividends were paid to an arm's length party in circumstances which did not involve an attempt to split income among family members. However, apart from the fact that subsection 56(2) (unlike subsection 56(4)) is not restricted to non-arm's length transactions, it seems that the subsection would apply to the transaction in question since it involved a payment made pursuant to the direction of the taxpayer, to some other person for the benefit of the taxpayer (i.e. the reduction of the taxpayer's indebtedness). Since LeDain J. had already reached a decision based on subsection 8(1), he apparently did not feel the need to engage in a discussion involving subsection 16(1).

842 The fact that the assessment was made alternatively under former subsection 75(1) indicates that the children were under 18 years of age at the time that the dividends were paid to the trust. Thus, in view of a minor's relative incapacity to own shares, (see the discussion under heading "Transfers or Loans to Minor Children") only the trust itself could have become a shareholder on the company's books of record.

843 [1983] CTC 1 (FCTD).

844 The relevant portion of the articles read as follows:

> (e) Subject to the rights of persons (if any) entitled to shares with special rights as to dividends, all dividends shall be declared and paid according to the amount of the shares, or, in the case of shares without nominal or par value, the number of shares held.

845 A basic rule of corporate law is that each share carries equal dividend rights and that no discrimination can be made among the shareholders in this regard: Welling, supra footnote 787, at 588. However, there is nothing to preclude the directors of the company from displacing this presumption of dividend equality by differentiating among the shares and providing in the corporate constituition for the issuance of different classes of shares with each class carrying, inter alia, different dividend entitlement: subsection 27(1) CBCA. See also Gower, Principles of Modern

Company Law, 4th ed. (London: Steven and Sons, 1979) 403-05.

846 Supra footnote 843, at 3. This argument begs the question because the issue is not whether a corporation is obligated to pay a dividend (and it is submitted that no such corporate obligation exists since dividends are paid at the directors' discretion) but rather whether the dividend could be paid in the manner chosen by the directors. However, one might speculate and say that payment of the dividend on the Class B shares but not on the Class A shares gave the holder of the Class A shares a right against the corporation to the payment of a dividend equal in amount to that paid to the holders of the Class B shares. If such were the case, it might be argued that the taxpayer had a right of action against the company and that no property was transferred to his wife so long as his right of action existed. (See McDonnell, "Current Cases," (March-April, 1983) 31 Canadian Tax Journal 233-35 at 234).

847 Palmer's Company Law, 21st ed. (Toronto: Butterworths, 1978).

848 Supra footnote 843, at 5.

849 See Krishna, "Share Capital Structures and Indirect Payments: An Indirect Attack on Income Splitting?" in Canadian Current Tax, Issues 17 and 18 (Toronto: Butterworths, April 29 and May 6, 1983) (looseleaf); also Krishna, "Share Capital Structures and Indirect Payments: An Indirect Attack on Income Splitting?" in Canadian Current Tax, Issues 15 and 16 (Toronto: Butterworths, April 15 and 22, 1983) (looseleaf).

850 See Krishna, ibid. at 2. (Issues 17 and 18). A basic principle of corporate law, established in Salomon v. Salomon and Co. Ltd., [1897] AC 22 (HL), is that a corporation is a separate legal entity distinct from its shareholders, meaning, inter alia, that the company's assets and liabilities are separate from those of its shareholders. In piercing the corporate veil (i.e. ignoring the existence of the corporation and treating it and its shareholder(s) as one, singular entity) in tax law, the aim, as Durnford has indicated, "is to make sure that the burden of taxation falls on the right person, and in particular to ensure that an individual does not escape his fair share of the burden through the use of a company." (Durnford, "The Corporate Veil in Tax Law," (May - June 1979) 27 Canadian Tax Journal 281 - 326 at 291). Thus, in Champ, Rouleau J. disregarded the corporate entity, on the basis of principles of corporation law, in order to ensure that the taxpayer did not escape taxation in respect of dividends which should have also been paid on his own shares.

851 See Strother, supra footnote 780, at 116; McDonnell, supra footnote 837, at 235.

852 See Krishna, supra footnote 849, Issues 17 and 18, at 3.

853 Ibid.

854 See Strother "2," supra footnote 799, at 291.

855 [1986] 1 CTC 355 (FCTD).

856 The relevant portion of the articles provided that:

> Each class of shares has the right to receive dividends exclusive of the other classes of shares in the company and the company is authorized to issue an unlimited number of shares in each class. ([1984] CTC 2469 (TCC) at 2470).

857 Supra footnote 855, at 357.

858 Ibid.

859 R.S.S. 1976-77, c.10.

860 [1984] CTC 2469 (TCC).

861 Ibid. at 2472.

862 Supra footnote 855, at 357.

863 Supra footnote 772.

864 See Tax Topics, Part I, No. 737, (CCH, April 24, 1986) 9-10.

865 Subsection 24(3) of the Saskatchewan Business Corporations Act (SBCA) provided that:

> (3) The articles may provide for more than one class of shares and, if they so provide, there shall be set out therein the rights, privileges, restrictions and conditions attaching to the shares of each class.

It will be noted that, as in the case of the CBCA, the SBCA did not provide that dividends must be paid equally to the holders of all classes of shares. The position is the same today: section 27 SBCA. See Welling, supra footnote 787, at 589.

866 Supra footnote 771.

867 Strayer J. also distinguished the cases of Murphy v. The Queen, supra footnote 257, and MNR v. Bronfman, supra footnote 771, on the basis that in both cases the taxpayers would have been legally entitled to the money had they not taken steps to divert it to others. It is difficult to see why the learned judge referred to these cases at all, since neither of them dealt with income splitting through the payment of corporate dividends.

868 Supra footnote 855, at 360.

869 Supra footnote 860.

870 Supra footnote 771.

871 See Report Bulletin No. 472, (Prentice-Hall, April 8, 1986) 10-11.

872 See Strother, supra footnote 780, at 117. Since the directors have the power to determine when, how and to what extent dividends will be paid (by virtue of their general power to manage corporate affairs: subsection 97(1) CBCA), apart from the fact that they may elect not to pay any dividends at all, there would appear to be no theoretical limit in respect of the amount of any particular dividend which they choose to declare. In practice, however, there are two limitations which will render a corporation incapable of paying a dividend: (a) the corporation has simply run out of money and cannot get more; or (b) the payment of the dividend would violate the statutory solvency requirements designed to protect the corporate capital base. For example, section 40 CBCA provides that:

> A corporation shall not declare or pay a dividend if there are reasonable grounds for believing that
> (a) the corporation is, or would after the payment be, unable to pay its liabilities as they become due; or
> (b) the realizable value of the corporation's assets would thereby be less than the aggregate of its liabilities and stated capital of all classes.

See Welling, supra footnote 787, at 624-26.

873 [1984] CTC 354 (FCA).

874 [1967] 1 All ER 518 (C.A.).

875 [1984] CTC 294 (SCC) at 313.

876 Ibid.

877 Supra footnote 772.

878 Supra footnote 823.

879 One might speculate that, irrespective of the non-managing spouse's contribution (whether in the form of services and/or capital), an income splitting share structure will pass scrutiny if the conditions attached to the shares provide for rateable participation in dividends and, unlike in Champ, dividends are, in fact, paid rateably. Presumably, equal dividends would be the point at which no benefit would be conferred upon the non-managing spouse.

880 It is submitted that the Titeley decision may not be considered an authority in this regard since there was only a notional payment of dividends to the wives as the funds in question never actually left the company's account.

881 Supra footnote 875, at 315.

882 See Strother, supra footnote 780, at 120; Wakeling, supra footnote 9, at 63-65.

883 Mr. John Stacey, then Director General, Corporate Rulings Directorate, in a speech delivered in Edmonton, Alberta, in 1979, stated that this form of share capital would be acceptable. (Cited in Strother, ibid., at 120).

884 Supra footnote 872.

885 An "assignment" is defined as: "A transfer or making over to another of the whole of any property, real or personal, in possession or in action, or of any estate or right therein. It includes transfers of all kinds of property [but] is ordinarily limited to transfers of choses in action and to rights in or connected with property, as distinguished from the particular item of property. It is generally appropriate to the transfer of equitable interests." (Black's Law Dictionary, 5th ed.)

886 As to when persons will be found not to be dealing with each other at arm's length, see Couzin, supra footnote 117. The purpose of the arm's length concept was outlined by Jackett P. in Viking Food Products v. MNR, [1967] CTC 101 (at 106), in the following terms:

> Generally speaking, it may be said that the effect of a determination that a [taxpayer] does not deal at arm's length with some other person is that either [the taxpayer] or someone else is denied an advantage that ... he would otherwise have in the computation of the tax payable under the Act ...
>
> While it is impossible to generalize with any degree of precision, it is probably not too inaccurate to say that, where special rules are made for situations where persons are not dealing at arm's length, the legislative purpose is to guard against tax avoidance, which tax avoidance would put some persons in a specially favoured position with a resultant unfairness to taxpayers not in a position to make similar arrangements.

This rationale applies to inter-family loans and transfers of property since the purpose of such transfers is to enable the high-income earner in the family to avoid tax by transferring or loaning income-producing property to low-income members of his family. In the case of subsection 56(4), the taxpayer attempts to transfer only the income without also transferring the property from which such income is derived.

887 Whereas subsection 56(2) is directed to income that is only taxable when received -i.e. on the cash basis - subsection 56(4) taxes an amount, depending on the circumstances, either when it is received or when it becomes receivable -i.e. on the accrual

basis. See Income Taxation in Canada, (Prentice-Hall) supra footnote 97, vol. 4, paragraph 79,079.

888 Ward's Tax Law and Planning, supra footnote 79, paragraph 11.2[c]; Canada Tax Service, supra footnote 97, paragraph 56-2009.

889 See Goldblatt v. MNR, supra footnote 768; The Queen v. Canadian-American Loan Investment Corp. Ltd. [1974] CTC 101 (FCTD); Fraser Companies Ltd. v. The Queen, supra footnote 768. In Adams v. MNR, [1959] 24 Tax ABC 154 (TAB), the taxpayer had arranged for commission income to be paid to two corporations controlled by him. The Board, in likening the companies to agents of the taxpayer, offered the following remarks (at 157):

> I do not think it matters much whether subsection 16(1) or section 23 is taken into account, although the latter section would seem to be the more applicable of the two. It appears to me that on the facts alone the [taxpayer's] appeal must fail. His alleged employment by either of the two new companies impresses me ... as notional rather than real.

890 Paragraph 6 of Interpretation Bulletin IT-440 ("Transfer of Rights to Income," November 5, 1979) states that:

> 6. An amount to which subsection 56(4) applies could be included in the income of both the transferor and the transferee. However, where the transfer or assignment of the right to an amount that is income does not constitute a deliberate attempt to evade or avoid tax, it is the Department's practice to include the amount in the income of the transferor only.

891 See Canada Tax Service, supra footnote 97; Cullity, supra footnote 24, at 113, cites the following hypothetical cases of where subsection 56(4) might apply: (i) an assignment of rights to future income from bonds; (ii) an assignment of rights to future royalties due under a licence agreement relating to a copyright, patent or franchise; and (iii) an assignment of an income interest under a trust. In the first case, it would seem that the property consists of the bond itself, whereas the amount capable of being transferred or assigned would be the right to receive the interest from the bond. (See Evans v. MNR, [1960] CTC 69 (SCC), and Purcell v. MNR, [1961] CTC 199 (Ex. Ct.), where the courts distinguished between a capital asset and the right to receive income derived from such capital asset). In the second case, the result would seem to be the same unless the copyright, patent or franchise has also been assigned. (See Simson-Maxwell Ltd. v. MNR, [1962] 29 Tax ABC 169 (TAB), where sales made by one corporation were imputed to another non-arm's length corporation since the latter did not transfer to the former the franchise under which the sales were made). In the third case, if the taxpayer divests himself of all his rights under the trust, the transfer is presumably outside the scope of subsection 56(4). This coincides with the Department's

view (paragraph 2 of IT-440, supra footnote 890) that the transfer of a life interest in a trust or estate, being a property separate and distinct from the income which arises from it, would fall under the exempting provision of subsection 56(4). In effect, for the purposes of the distinction between "property" and "income rights" the statutory definition of "property" is not helpful and perhaps one guiding principle might be the familiar but unsophisticated analogy of the fruit (income) and the tree (capital).

892 See Robins v. MNR, supra footnote 26; McGlaughlin v. MNR, supra footnote 94; German v. MNR, supra footnote 90.

893 The Department is of the same view: see Interpretation Bulletin IT-440, paragraph 1.

894 Supra footnote 772.

895 Spouses would be deemed not to be dealing with each other at arm's length by virtue of paragraphs 251(1)(a) and 251(2)(a); a taxpayer would be deemed not to be dealing at arm's length with his own child by virtue of paragraphs 251(1)(a), 251(2)(a) and 251(6)(a); and a taxpayer would be held not to be dealing at arm's length with a minor child who was not his own child if, at the relevant time, it was found as a matter of fact that both parties were not dealing with each other at arm's length. See Couzin, supra footnote 117, at 277-80, as to when a factual non-arm's length relationship will be held to exist.

896 Supra footnote 768.

897 See the discussion under heading "Loan or Transfer of Property."

898 [1960] CTC 69 (SCC) at 72.

899 [1961] CTC 199 (Ex. Ct.).

900 Canada Tax Service, supra footnote 97, vol. 2, paragraph 56-2010.

901 [1985] 1 CTC 2054 (TCC).

902 Snook v. London and West Riding Investments [1967] 1 All ER 518 at 528, per Lord Diplock.

903 See the discussion under heading "Only Income from Property is Subject to Attribution."

904 See The Queen v. Littler, supra footnote 505, at 239.

905 See Boultbee, "Gifts and Rollovers," (January - February 1983) 31 Canadian Tax Journal, 84-94 at 86.

906 Canada Tax Service supra footnote 97, vol. 5, paragraph

25,978.

907 [1967] CTC 153 (Ex. Ct.).

908 Former subsection 137(2) provided that:

> (2) Where the result of one or more sales, exchanges, declarations of trust, or other transactions of any kind whatsoever is that a person confers a benefit on a taxpayer, that person shall be deemed to have made a payment to the taxpayer equal to the amount of the benefit conferred notwithstanding the form or legal effect of the transaction or that one or more persons were also parties thereto; and, whether or not there was an intention to avoid or evade taxes under this Act, the payment shall, depending upon the circumstances, be
> (a) included in computing the taxpayer's income for the purposes of Part I,
> (b) deemed to be a payment to a non-resident person to which Part III applies, or
> (c) deemed to be a disposition by way of gift to which Part IV applies.

909 Former subsection 8(1) provided that:

> 8(1) Where, in a taxation year,
> (a) a payment has been made by a corporation to a shareholder otherwise than pursuant to a bona fide business transaction
> (b) funds or property of a corporation have been appropriated in any manner whatsoever to, or for the benefit of, a shareholder, or
> (c) a benefit or advantage has been conferred on the shareholder by a corporation, otherwise than
> (i) on the reduction of capital, the redemption of shares or the winding-up, discontinuance or reorganization of its business,
> (ii) by payment of a stock dividend, or
> (iii) by conferring on all holders of common shares in the capital of the corporation a right to buy additional shares therein,
> the amount or value thereof shall be included in computing the income of the shareholder for the year.

910 Supra footnote 907, at 161.

911 Ibid. at 162.

912 Ibid.

913 One could argue, on the basis of the Bronfman case (supra footnote 771) that the shareholders who did not exercise their rights might be held to have conferred a benefit on the other shareholders since they might be said to have acquiesced in the issuance of the rights by not voting against such issuance at a

shareholders' meeting. The Bronfman case, however, concerned a private, closely-held corporation, where the shareholders were all family members (or trusts representing family members) who presumably were on intimate terms with themselves as well as with the directors. This is quite different from a widely-held public corporation where the average shareholder normally holds only a fraction of the company's outstanding shares and possesses very little influence, if any, in respect of decisions made by the Board of Directors.

914 See "Around the Courts" feature in (March - April, 1967) 14 Canadian Tax Journal, 384-386.

915 [1973] CTC 219 (FCTD).

916 See "Around the Courts" feature in (May - June, 1973) 21 Canadian Tax Journal, 207-209. This statement evidently refers to the fact that, as in Dufresne, the taxpayer, (in Levine) in effect, transferred a portion of his shares to his children by not exercising his subscription rights to a share offering. However, the taxpayer, as director, was responsible for passing a resolution enabling the company to offer the rights in the first place, and to this extent there was some activity on his part.

917 Supra footnote 625.

918 Supra footnote 908.

919 Supra footnote 915, at 223.

920 Ibid.

921 Ibid. at 226.

922 In Applebaum v. MNR, [1971] Tax ABC 550 (TAB), the facts were essentially indistinguishable from the Dufresne and Levine cases. Prior to a rights offering, the taxpayer owned 51 per cent of the shares in a private, closely-held company, with his two daughters and one son-in-law owning the remaining 49 per cent. Pursuant to the rights offering, the three minority shareholders subscribed for additional shares made available to them, whereas the taxpayer only subscribed for ten additional shares as opposed to the 500 shares to which he was entitled. As a result, the taxpayer's shareholding in the company declined from 51 per cent to 16 per cent, while the shareholdings of his daughters and son-in-law increased from 49 per cent to 84 per cent. It was held that, by virtue of the minority shareholders exercising their subscription rights, coupled with the taxpayer's non-exercise of his subscription rights, the taxpayer had conferred a benefit (such benefit being the increase in the minority shareholders' interest in the corporation) upon the minority shareholders within the meaning of former paragraph 137(2)(c).

923 Supra footnote 24.

924 Black's Law Dictionary, 5th ed.

925 [1970] Tax ABC 49 (TAB).

926 In this case, the parties (i.e. parents and their children) would be deemed not to be dealing with each other at arm's length by virtue of paragraphs 251(1)(a), 251(2)(a) and 251(6)(a).

927 [1951] CTC 241 (Ex. Ct.).

928 Ibid. at 248.

929 [1953] CTC 203 (Ex. Ct.).

930 Ibid. at 207.

931 The conclusions reached by Thorson P. in Simpson's Ltd. were endorsed by the Supreme Court of Canada both in respect of trial de novo and in respect of the burden of proof. See Campbell v. MNR [1952] CTC 334 (SCC); Smith v. MNR [1965] CTC 257 (SCC).

932 Supra footnote 655, at 206. It should be noted that while Rand J. placed the burden of proof on the taxpayer, he also stated that the Crown had the duty to disclose to the taxpayer the findings and assumptions upon which it based its assessment: "It must, of course, be assumed that the Crown, as is its duty, has fully disclosed to the taxpayer the precise findings of fact and rulings of law which have given rise to the controversy." Ibid. at 207.

933 [1964] CTC 294 (Ex. Ct.). In this case, P Co. had borrowed money from two subsidiary companies, giving in return promissory notes payable at the interest rate of 4 1/2 per cent semi-annually. At the request of P Co., the two subsidiaries unconditionally waived payment of the interest owing to them on the notes in respect of the taxation years in question. The issue was whether benefits were conferred on a shareholder by the two subsidiaries within the meaning of former subsection 8(1) (now subsection 15(1)) of the Income Tax Act (R.S.C. 1952, c.148). In its notice of appeal, the Crown alleged, inter alia, that in assessing P Co., it assumed: (a) that P Co. was a shareholder of each of the two subsidiaries; (b) that P Co. borrowed certain sums of money from the subsidiaries and gave promissory notes as payment in return; and (c) that the subsidiaries waived the interest payable by P Co. during the taxation years in question. The Minister had not alleged that he assumed, in making the assessment, that the waiver of interest was an arrangement adopted by the company to confer a benefit on P Co. qua shareholder. Accordingly, as Cattanach J. saw it, on the basis of Rand J.'s limitation in Johnston, there was no onus on P Co. to disprove that fact. The learned judge went on to dismiss the appeal on the ground that the transaction had not been attacked in the Minister's Notice of Appeal as being an arrangement for conferring a benefit on P Co. qua shareholder. Apart from being a good example of how the burden of proof on the taxpayer is hinged to the assumptions of fact made by the Minister at the time of the

assessment, the Pillsbury Holdings case indicates how strictly Rand J.'s limitation will be applied. Where the assumptions of fact had been made and pleaded, the burden of proof shifted to the Minister beyond those acts.

934 See Talon Exploration Ltd. v. MNR [1964] CTC 468 (Ex. Ct.); Conway Estate v. MNR [1965] CTC 283 (Ex. Ct.); MNR v. Consolidated Mogul Mines [1966] CTC 16 (Ex. Ct.); Yardley Plastics Ltd. v. MNR [1966] CTC 215 (Ex. Ct.); MNR v. Dufresne [1967] CTC 153 (Ex. Ct.).

935 Per Rand J. in Johnston v. MNR, supra footnote 655, at 206. This alternative was illustrated in The Queen v. Littler, supra footnote 624, where the Minister assessed the taxpayer for gift tax on the contention that he was deemed to have made a gift to his sons to the extent of the difference between the market price of certain shares and the actual price received on a subsequent take-over. Although the Minister's reply to the taxpayer's notice of objection referred to subsection 137(2), this provision was not mentioned in the Crown's statement of defence, reliance being limited to the provisions of subsection 111(2) which defined the term "gift." All three justices agreed, and it was conceded by the Crown, that the provisions of subsection 137(2) could not be considered by the court because that provision had not been pleaded. See also Kingsdale Securities Co. Ltd. v. MNR, [1975] CTC 10 (FCA), where the court refused to consider new allegations which were not raised in the pleadings or at the trial.

936 [1869] L.R. 4 (HL).

937 See Talon Exploration Ltd. v. MNR, supra footnote 934.

938 Supra footnote 933, at 302.

939 [1965] CTC 283 (Ex. Ct.).

940 Ibid. at 287.

941 [1976] CTC 107 (FCTD).

942 Ibid. at 110.

943 Gibson J.'s position in this respect would appear to be based simply on a sense of fairness -i.e. it is unfair for the Minister to plead alternate assumptions which result in evasiveness about the main assumption or which obscure the applicability of, and the limits to, the rule under which the burden of proof falls upon the taxpayer. However, a strict application of the Brewster rule would mean that the Minister could not allege an alternative argument of law based on the facts that are the basis of the main assessing position, without having the burden of proof with respect to those alternatives. For example, the main assessment might be that an amount sought to be deducted was not an expense incurred for the purpose of earning income within the meaning of subparagraph 18(1)(a). In the alternative, the Minister might argue that the

amount was a capital expenditure under subparagraph 18(1)(b). In theory, it would be possible for a taxpayer to succeed on a point of law on the main assessment without adducing sufficient evidence to enable the Minister to succeed on the alternative argument. If the Brewster case has such a strict application, there may be instances where both the taxpayer and the Minister will carry the burden of proof with respect to the same facts. See MacNab, supra footnote 651, at 404.

944 [1978] CTC 113 (FCTD).

945 Ibid. at 120.

946 In effect, the failure by the Minister to plead the findings or assumptions upon which the assessment is based constitutes a disregard of Rand J.'s directive in Johnston (supra footnote 575) that the Crown has the duty to disclose to the taxpayer the findings of fact and the rulings of law which gave rise to the litigation. Therefore, not only must the Minister disclose the factual as well as legal basis of his assessment, he must also avoid couching his allegations in general and abstract terms and provide pertinent information as to exactly what is involved in order to permit the taxpayer to provide adequate proof of his contentions. See Lapointe v. MNR [1973] CTC 2001 (TRB).

947 See Cross on Evidence, supra footnote 649, at 66. Some question has been raised as to whether the effect of subsection 175(3) is to place the burden of proof on the Minister when he institutes an appeal in the Federal Court since the subsection deems an appeal instituted therein to be equivalent to an ordinary action taken in the Federal Court. Since Her Majesty The Queen appears as "plaintiff" in such a proceeding, the burden of proof may be on the Crown as it normally is in any trial. This point was raised by Collier J. in The Queen v. McKay, supra footnote 660, at 288, but the learned justice did not adjudicate on it definitively. While it may seem anomalous for a defendant to be obliged to assume the burden of proof, this is considered to be the current rule when the taxpayer is the defendant. See MNR v. Simpson's Ltd., supra footnote 929; Campbell v. MNR, supra footnote 931; Smith v. MNR, supra footnote 931.

948 Supra footnote 924. In discharging the burden of proof, it may be initially sufficient for the taxpayer to establish a prima facie case or create a presumption in his favour which, in the absence of any convincing evidence to the contrary, would be sufficient to discharge the burden of proof. Thus, in Vancouver Pile Driving and Constructing Co. Ltd. v. MNR, [1963] CTC 10 (Ex. Ct.), when it was established that the taxpayer was in the construction business and did not ordinarily deal in bonds, any gain or loss with respect to a fluctuation in the value of bonds was held to be, prima facie, be on capital account. See also Reicher v. The Queen, [1975] CTC 659 (FCTD), dealing with the taxability of the gain on the purchase and sale of real estate, where it was pointed out that the disposition of a revenue-producing asset would, prima facie, not be on income account.

949 See MacNab, supra footnote 657, at 406.

950 Ibid. Where the taxpayer establishes a prima facie case in his favour, the evidentiary burden of proof (i.e. the second type of burden of proof mentioned by Thayer, supra footnote 649) will shift to the Minister and may then shift back and forth between the parties within the issue in question as evidence is led first by one party and then by the other. (See a discussion in MNR v. Hellner, [1969] Tax ABC 354 (TAB), per Weldon Q.C., at 357).

951 See Stickel v. MNR [1973] CTC 202 (FCA); Dobieco Ltd. v. MNR [1965] CTC 507 (SCC); Inland Resources Ltd. v. MNR [1964] CTC 393 (Ex. Ct.); Pashovitz v. MNR [1961] CTC 288 (Ex. Ct.); Brampton Brick Ltd. v. MNR [1963] CTC 57 (Ex. Ct.); MNR v. Thibeault [1964] CTC 232 (Ex. Ct.).

952 See Medicine Hat Greenhouses Ltd. v. The Queen [1981] CTC 141 (ACA); Usarco Ltd. v. The Queen [1980] CTC 308 (FCTD).

953 Rule 32 of the Tax Court Rules of Practice provides that:

> The burden of proof shall be upon the petitioner, except as otherwise provided by statute, and except that in respect of any new matter pleaded in his answer, it shall be upon the respondent.

954 [1935] 293 U.S. 507 (U.S. S. Ct.).

955 The taxpayer will discharge the initial burden of proof by offering enough evidence to support a finding contrary to the Internal Revenue Service's determination - at which point he still carries the ultimate risk of non-persuasion, but the IRS will no longer benefit from the presumption of a correct assessment. See Rockwell v. CIR [1975] 512 F.2d 882 (9th Cir.); Bittker, Fundamentals of Federal Income Taxation, 2d ed. (New York: Warren, Gorham and Lamont 1983) at 43-16.

956 [1950] 179 F.2d 483 (4th Cir.).

957 See Tax Court Rule 143 - new contentions; subsection 7454(a) IRC - fraud; subsection 6902(a) IRC - transferee liability. When it is unable to collect from a delinquent taxpayer, the IRS may assert transferee liability against persons who are secondarily liable for the taxpayer's debts by contract or by virtue of having received property from the taxpayer without adequate consideration in circumstances rendering the taxpayer insolvent. In the case of successive transfers, liability may be imposed on a transferee of a transferee. (See Fibel v. CIR [1965] 44 TC 647 (several layers of inter-family transfers)). With respect to subsection 6901(a) IRC, which provides that "the liability of a transferee of property" of a taxpayer subject to income taxes shall "be assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of taxes with respect to which the liabilities were incurred," the United States

Supreme Court in CIR v. Stern held that it "neither creates nor defines a substantive liability but provides merely a new procedure by which the government may collect taxes"; [1958] 357 U.S. 39 at 42-43 (U.S. S. Ct.). Subsection 6901(a) does not define the "liabilities" of the transferor for which the transferee is liable, but it has been held that the transferee liability includes not only the underlying tax but also any related interest and civil penalties owed by the transferor. See Ruderman v. U.S. [1966] 355 F.2d 995 (2d Cir.) (transferee liability for transferor's taxes and fraud penalties).

958 Section 7463 IRC provides a statutory basis for a simplified method of trying small tax cases in the Tax Court, which apply only if (a) the amount of the assessment does not exceed $5,000 for any one taxation year; (b) the taxpayer requests that the simplified procedure be followed; and (c) the court concurs in the request. The decision is not reviewable by any other court and is not to be treated as a precedent in any other case.

959 Section 7482 IRC; Industrial Addition Association v. CIR [1945] 323 U.S. 310 (U.S. S. Ct.).

960 Helvering v. Taylor [1935] 293 U.S. 507 (U.S. S. Ct.).

961 Association of Data Processing Service v. Camp [1970] 397 U.S. 150 (U.S. S. Ct.).

962 This result flowed from the wording of the statute establishing the appeal procedure, subsection 137(4) of the Income Tax Act (8 & 9 Geo. 5, 1918, c.40) which read as follows:

> If, on appeal, it appears to the majority of the Commissioners present at the hearing by examination of the appellant on oath or affirmation, or by other lawful evidence, that the appellant is overcharged by any assessment or surcharge, the Commissioners shall abate or reduce the assessment or surcharge accordingly, but otherwise every such assessment or surcharge shall stand good.

(Subsection 137(4) has been carried over, in almost identical terms, to the present subsection 50(6) of the Taxes Management Act, 1970, c.9).

963 Generally speaking, an assessment is made by an inspector of taxes for the district in which the taxpayer resides (subsection 29(1) TMA). If the taxpayer feels that the inspector erred in making the assessment, he may make a claim to the Board of Inland Revenue for relief (subsection 33(1) TMA) and the Board must consider the claim and may give relief by way of repayment as is reasonable and just (subsection 33(2) TMA). If the taxpayer is dissatisfied with the decision of the Board, he may appeal such decision to the Special Commissioners (subsection 31(4) TMA) who are bound to hear the appeal unless a settlement is reached beforehand (section 54 TMA). The Special Commissioners, in

deciding the appeal, may confirm, vary or vacate the assessment as they see fit (subsection 50(8) TMA).

964 The issue of the burden of proof first arose in the case of Haythornthwaite and Sons Ltd. v. Kelly, [1927] 11 T.C. 659 (C.A.). In holding that the burden of proof was on the taxpayer to upset the assessment, Lord Hanworth said (at 667-68): "It is quite plain that the Commissioners are to hold the assessment standing unless [the taxpayer] establishes before the Commissioners, by evidence satisfactory to them, that the assessment ought to be reduced or set aside...and there is no doubt that the onus lay upon [the taxpayer] to displace the assessment..." The issue subsequently arose in Norman v. Golder, [1944] 26 T.C. 293 (C.A.), where Lord Greene agreed with the above-cited opinion of Lord Hanworth, and held that the onus of establishing the incorrectness of the assessment lay on the taxpayer. In his lordship's view, the point was not really arguable.

965 See Eagles v. Rose [1945] 26 T.C. 427 (High Court).

966 Partington v. Attorney-General, supra footnote 569; Russell v. Scott [1948] A.C. 422 (HL) (per Lord Simonds at 433); Re Ralli's Settlement [1965] Ch. D. 286 (C.A.) (per Russell L.J. at 327).

967 Pinson, supra footnote 96, at 425-26; IRC v. Reinhold [1953] 34 T.C. 389 (C.A.).

968 Subsection 56(2) Taxes Management Act.

969 Subsection 56(1) Taxes Management Act.

970 [1960] 40 T.C. 281 (C.A.) at 289-90.

971 Subsection 56(6) Taxes Management Act.

972 Subsection 56(8) Taxes Management Act.

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