

Welcome to the fifth UBC Tax newsletter. This issue of UBC Tax highlights the important events of 2009, introduces David Duff and calls attention to some of the accomplishments of the Faculty's LL.M. graduates in Taxation.



Tax Consequences of a Government Bailout

by Tony Sheppard

Introduction

Government bailouts are in the daily news, but the term, "bailout," is still novel. Most standard dictionaries do not include "bailout" as yet, but one defines it as: "a rescue from financial distress."

¹ Another defines it as: "an act of giving financial assistance to a failing business

or economy to save it from collapse."² What are the Canadian income tax consequences of a bailout to the recipient? Though the term might be new, the concept of government financial assistance to business and its tax consequences have been litigated since the 1930's. Over the ensuing years, the tax consequences have gone from simple to complex and elaborate, thanks to evolving case law and statutory provisions.

Case law

In the earliest case on the tax consequences of government financial assistance to industry, *Seaham Harbour Dock Co.*, the House of Lords unanimously sought to avoid the illogical circularity of requiring a taxpayer to return some of the government funds received, by interpreting the legislation as implying a Parliamentary intention for exemption from taxation.³ The taxpayer was in the business of operating a dock, and had received government financial assistance to defray costs of constructing an extension to its dock. The government program was intended to provide financial assistance with construction projects that were approved as in the public interest and relieving unemployment. The House of Lords disagreed with the reasoning of the lower courts, which had held that the tax consequences should be determined by characterizing the receipt of government assistance as income or capital to the taxpayer.

To their Lordships, the issue was not one of characterizing receipts as capital or income, but rather of fulfilling a worthwhile statutory purpose. Their Lordships interpreted the program as intended by Parliament to assist in funding worthwhile projects to relieve unemployment,

and felt that the imposition of taxation would contradict this intention. Their Lordships held Parliament intended the program to reduce unemployment, not to create taxable income in any circumstances. For example, Lord Atkin, delivering a concurring judgment, stated as follows: "It would appear to me to be a remarkable proposition that Parliament assented to that sum being appropriated for that purpose [job-creation], but intended in certain events at any rate, only fifteen shillings in the pound to be appropriated for that purpose, five shillings in the pound of the full amount coming back by way of Income Tax. I do not think that was the effect."

In a decision only six years later, *Lincolnshire Sugar Co. Ltd.*⁴, the House of Lords did not refer to the broad exempting principle stated in the *Seaham Harbour* case, holding that the taxpayer's receipt of a government subsidy should be included in the operating income of its business. The taxpayer ran a sugar refinery, purchasing and refining sugar beets. The market price of sugar beets had collapsed, and the British government enacted a price support program to sustain domestic growers, until the market price recovered. Under the program, a refiner received government subsidies to defray the extra cost of paying domestic suppliers at the previous higher price. This price support was payable only to assist refiners with purchases from domestic growers of sugar beets. Under the terms of the program, a refiner might be required to repay the subsidy in certain circumstances. The taxpayer received the subsidy and was entitled to keep it, as none of the conditions for repayment applied. The lower courts regarded the subsidy as a tax-free loan, because of the possibility of repayment. The House of Lords unanimously held because the subsidy lowered the taxpayer's cost of raw materials used in its refining operations it should be included in the taxpayer's operating income as supplementary trade receipts.

The *Lincolnshire Sugar* decision prevails in Britain and the Commonwealth: according to recent case law, the tax consequences of a government bailout depend on its characterization as income or capital to the taxpayer under general principles of business income.⁵ Current cases rationalize and limit *Seaham Harbour* to its facts by regarding it

as an example of a capital receipt, rather than as authority for a broad exemption from tax for government bailouts.⁶

In Canada, Thorson P. of the Exchequer Court approved of both *Seaham Harbour* and *Lincolnshire Sugar* in a leading case, *St. John Dry Dock & Shipbuilding Company Limited. v. MNR*.⁷ At the end of WW I, the east coast of Canada needed a suitable dry dock, and the taxpayer built such a dock financing the cost of construction by issuing shares and bonds, with the assistance of a federal statutory subsidy. The taxpayer assigned its entitlement to the subsidy as collateral security for the bondholders. The main issue was whether the subsidy was taxable as income to the taxpayer. The learned judge held the subsidy was not income for two reasons.

First, Thorson P. applied the case-law principles of *Lincolnshire Sugar*, determining that he should classify the subsidy as a tax-free capital receipt. Thorson P. made an authoritative analysis of the issue of classification as follows: "The subsidy payments in this case clearly fall outside the ambit of the cases which I have cited as illustrations or instances of income subsidies, such as amount to a guarantee of profits or earnings or result in supplementary or additional revenues. Such subsidies come into the hands of the recipient in the course of trade or business operations or because of them and, being operational revenues, may properly be described as income subsidies subject to tax. The situation in the present case is quite different. The appellant was not entitled to receive nor did it receive the subsidy in the course of its trade or business operations or because of them. The subsidy was not a trade or business receipt or revenue or an item of trade or business profit or gain. There was no guarantee of trade or business profits or earnings nor was the subsidy given to supplement or increase the operational revenues of the appellant. Indeed, the subsidy payments had nothing to do with the trade or business operations of the appellant at all."⁸

Second, Thorson P. also held the subsidy was exempt applying the *Seaham Harbour* case. Thorson P. quoted and applied the rea-

soning of Lord Atkin, stating: "In the present case, the purpose of the Act and Orders in Council made under its authority was to secure the construction of a dry dock of the first class on the Atlantic Coast and the subsidy payments were made as an aid to such construction in order to accomplish the purpose of the Act. That purpose was a special one, in the public interest, quite apart from the trade and business operations of the appellant and had nothing whatever to do with its trade or business profits or gains. Since the subsidy was paid and received for such special purpose, in the national interest, it cannot be said to be a trade or business receipt or revenue in the hands of the appellant or an item of trade or business profit or gain to it."⁹ Thorson P. held, as a matter of statutory interpretation, federal legislation creating a bailout for a special purpose in the national interest can by implication confer tax-exempt status. Parliament could make its intention clearer by conferring explicit exemption, which would take effect under paragraph 81(1)(a) of the *Income Tax Act*.

In a more recent case,¹⁰ the Federal Court of Appeal applied similar reasoning to that of Thorson P., to confer exemption from income tax on an amount received by a business from local government, for the public purpose of reducing pollution. The local government had made the payment in 1992 to get rid of a source of pollution, which the court commended, as a "civic purpose." The taxpayer had operated a secondary lead refining plant in Toronto. The city, concerned about the taxpayer's "pollution and noxious use" of land within its boundaries, wanted the taxpayer to close down and relocate. The city informed the taxpayer it could not continue in its current location. The taxpayer could not find a new place of business, and had to shut down. Under threat of expropriation, the city bought the taxpayer's land and buildings, paying the taxpayer an additional \$9 million as compensation for its inability to relocate. Revenue Canada argued the \$9 million was taxable as proceeds of the sale to the city of the taxpayer's goodwill. The court, however, characterized the \$9 million received from the city as

tax-free damages for the termination of the taxpayer's business, and for the destruction of its goodwill, payable for the civic purpose of eliminating a polluter.

Statutory Provisions

Amendments to the *Income Tax Act* have complicated the tax consequences elucidated in the case law. As a result of these provisions, a recipient of a bailout must consider if it reduces the tax cost of property, reduces a tax deduction, or must be included in business (or property) income. If these provisions do not catch the bailout, a recipient would next analyze the possible application of case-law to categorize the receipt as: (1) tax-exempt under *Seaham Harbour*; or (2) taxable income or tax-free capital according to the general principles illustrated by *Lincolnshire Sugar*.

Parliament allows a taxpayer to claim capital cost allowance on the cost of acquiring depreciable property, but requires the taxpayer to have actually borne the cost. Under subsections 13(7.1) and (7.2) of the Act, if a taxpayer receives financial assistance from a government, municipality or other public authority towards the purchase of depreciable property, the taxpayer must reduce the cost accordingly before claiming capital cost allowance on the asset. For this purpose, public financial aid may take the form of a grant, subsidy, forgivable loan, deduction from tax, allowance or any other assistance. Subsection 13(7.1) can catch an expenditure characterized as a capital outlay according to the case law.¹¹

Next, paragraph 12(1)(x) of the Act, overrides the case law by requiring a taxpayer to include in income an amount received from government in the course of earning business (or property income) in the following circumstances. The payer of the amount received by the taxpayer may be a government, municipality or other public authority. The payment must either induce the taxpayer to act in some way, or recompense the taxpayer for a deductible cost, outlay or expense. Recompense to the taxpayer covers a refund, reimbursement, contribution, allowance or assistance. The item must be included in the taxpayer's

income regardless of whether it takes the form of a grant, subsidy, forgivable loan, deduction from tax, allowance or any other assistance. If the taxpayer is already taxable on the amount, or it reduces relief under some other provision such as subsections 13(7.1) and (7.2), it escapes the additional tax consequence of inclusion in income under paragraph 12(1)(x).

By including in the taxpayer's income amounts received from government as incentives or bailouts, paragraph 12(1)(x) of the Act frustrates and can undermine the public purpose of making these payments. Like Lord Atkin, the Supreme Court of Canada prefers consistency of purpose between taxation and other enactments, as opposed to contradiction or even nullification.¹² The US Congress's proposed claw-back by the imposition of a 90% tax on the bonuses received by AIG executives out of bailout funds is an extreme example of nullification by taxation

Finally, government financial assistance to a taxpayer defraying the purchase price of capital property may have repercussions when the taxpayer disposes of the property. On computing the capital gain or loss on the disposition, a taxpayer must reduce the cost of the property by the amount of the assistance received, under paragraph 53(1)(k).

These provisions of the Act can impose adverse income-tax consequences on transactions that provincial and local-governments are trying to encourage through incentive programs in the Province of British Columbia. The programs serve legitimate public purposes e.g., to reduce pollution or stimulate investment in tough times, and are popular with the public. For example, the provincial government offers an incentive to scrap older motor-vehicles throughout the entire province, called the Scrap-It Program. The owner of a pre-1995 vehicle can receive the benefit of up to \$1,250 towards the purchase of a new fuel-efficient car, which would reduce the cost base of the car for income tax purposes. (In the rest of Canada, the federal government offers a less generous (\$300) National Vehicle Scrappage Program, called "Retire Your Ride.") The City of Surry recently announced the creation of two Economic Investment Zones, to encourage major new business developments in lagging areas, offering the incentives of reduced municipal charges and a three-year exemption from city taxes. Adverse income tax consequences claw back the positive effect of such incentives.

Other tax repercussions may befall the recipient of financial assistance, but they are rarer and beyond the scope of this brief and simplified discussion.¹³

Conclusion

Bailouts in the news often consist of genuine loans to distressed taxpayers requiring repayment, guarantees of their debts, or purchases of their treasury stock. These forms of bailout do not entail adverse tax consequences to a recipient, as long as they avoid the pitfalls of re-characterization as income under the case law, and skirt paragraph 12(1)(x) of the Act.¹⁴ Other forms of bailouts or government incentives, however, can attract adverse income-tax consequences, and this contradiction in public policies is a matter of the gravest concern during an economic crisis.

¹Merriam-Webster Online Dictionary, online: <http://www.merriam-webster.com/dictionary/bailout>.

²The Oxford Pocket Dictionary of Current English, online: <http://www.encyclopedia.com/doc/10999-bailout.html>.

³Seaham Harbour Dock Co. v. Crook (Inspector of Taxes) (1931), 16 TC 333, 48 T.L.R. 91 (HL); applied by San Antonio Gold Mines Ltd. v. Attorney-General for Manitoba, [1951] 3 DLR 45, [1951] MJ No. 41 (QL) (Man. CA).

⁴Lincolnshire Sugar Co. Ltd. v. Smart (Inspector of Taxes), [1937] AC 697, sub nom. Smart (Inspector of Taxes) v. Lincolnshire Sugar Co., 20 TC 643 (HL).

⁵Berghofer and Commissioner of Taxation, [2008] AATA 1138 (19 December 2008).

⁶Ibid.

⁷[1944] Ex. C.R. 186.

⁸Ibid., pp. 200-201. In *Ikea Ltd. v. Canada*, [1998] 1 SCR 196, 155 DLR (4th) 295, at para. 22. Iacobucci J approved of the analysis by Thorson P. as 'most instructive in setting out useful criteria for the classification of "unusual" receipts as income or capital.' See also *Hall v. MNR*, 90 DTC 1431, [1989] TCJ No. 1123 (QL); *Deputy Minister of Revenue for Quebec v. Alex Couture Inc.*, 2001 DTC 5072 (Que. CA).

⁹Ibid., pp. 206-207. See also *Valley Camp Ltd. v. MNR*, [1974] 1 FC 623, 74 DTC 6337, [1974] CTC 418 (TD); *Boreal Express Ltee v. MNR*, 79 DTC 791 (TRB).

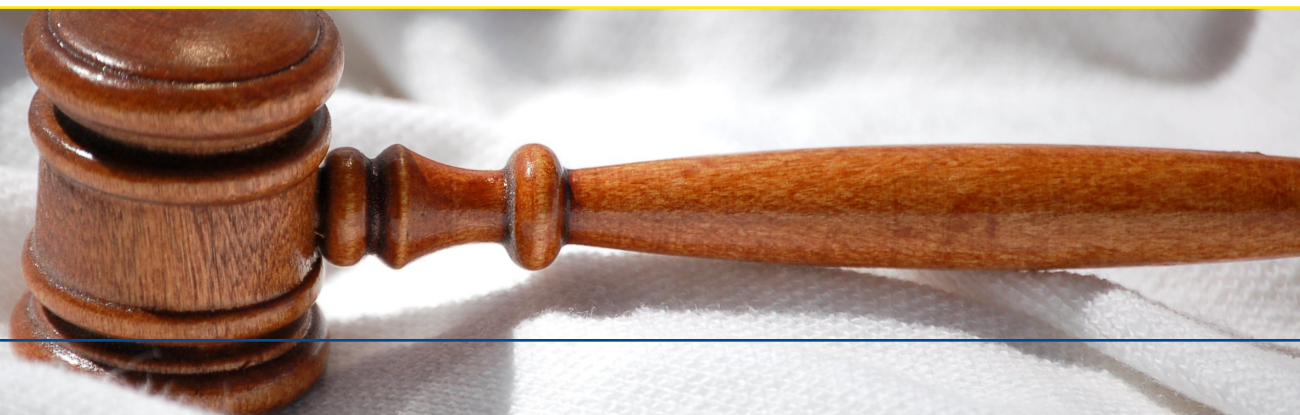
¹⁰*The Queen v. Toronto Refiners and Smelter Limited*, 2002 FCA 476, 57 DTC 5001, [2003] 1 CTC 365.

¹¹See also *Auberge Des Quatre Vents Inc. v. MNR*, 85 DTC 522 (TCC).

¹²65302 *British Columbia Ltd. v. The Queen*, [1999] 3 SCR 804, 179 DLR (4th) 577 (per Bastarache J).

¹³E.g. ss. 14, 66 and 127 of the Income Tax Act, and s. 141.01 of the Excise Tax Act. For detailed tax consequences of a bailout, including taxpayers' elections, see IT-273R2, *Government Assistance – General Comments* (September 13, 2000).

¹⁴See *Fraser Cos. v. Canada*, [1981] CTC 61, 81 DTC 5051 (FCTD) (the taxpayer, a parent company, made an interest-free loan to its financially distressed wholly-owned subsidiary to assist it to stay in business and the subsidiary repaid the principal amount of the loan to the parent; the court held the transaction entailed no adverse tax consequences to the parent company).



Events

Working through the Faculty of Law's National Centre for Business Law (NCBL), tax faculty at UBC Law organized and participated in two symposia on topical issues in tax law and policy in January and February 2009.

Symposium on International Tax Reform

On January 22, 2009, the NCBL and KPMG co-sponsored a symposium on international tax reform, at which academics, practitioners and business representatives discussed the Final Report of an Advisory Panel on Canada's System of International Taxation which the federal Minister of Finance established in November 2007. The Advisory Panel's final report was released on December 10, 2008 and is available at the Advisory Panel's website at <http://www.apcsit-gcrfi.ca/index-eng.html>.

The symposium discussed each of the recommendations in the report, as well as its implications for Canadian international tax reform. After a brief introduction by Walter Pela (the Managing Partner of KPMG's Vancouver Office) and Mary Condon (Co-Director of the National Centre for Business Law), the symposium began with a general overview of the Advisory Panel and its Final Report by the Panel's Executive Director, Brian Mustard.

This introductory session was followed by two sessions addressing the Advisory Panel's recommendations concerning the taxation of inbound direct investment (chapters 5 to 7 of the Final Report) and the taxation of outbound direct investment (chapter 4 of the Final Report). Each of these sessions involved a back-and-forth discussion between a tax academic and a tax practitioner – Tim Edgar (University of Western Ontario Faculty of Law) and Mark Meredith (Moskowitz and Meredith) discussing the taxation of inbound direct investment, and David Duff (University of British Columbia) and Tony Martin (KPMG) discussing the taxation of outbound direct investment.

A final session involved a panel discussion with academics, practitioners, and business representatives, including Rod Bergen (Managing Director of Taxation for the Pattison Group and Chair of the Tax Executives Institute) and Bruce Flexman (President of the British Columbia International Financial Centre). More information on the symposium can be found on the NCBL's website at <http://www.law.ubc.ca/ncbl/index.html>.



Symposium on Tax Avoidance After Lipson

On February 9, 2009, the NCBL co-sponsored a symposium on the recent Supreme Court of Canada decision in *Lipson v. Canada*, 2009 SCC 1, together with the Canadian Tax Foundation and the University of Toronto Faculty of Law. The decision (which can be accessed at <http://csc.lexum.umontreal.ca/en/2009/2009scc1/2009scc1.html>) is the third Supreme Court of Canada decision to address the general anti-avoidance rule (GAAR) in section 245 of the federal Income Tax Act, and is a highly controversial judgment in which a slim majority of four justices applied the rule, with three justices dissenting.

The symposium consisted of two sessions, the first discussing the case itself and the second discussing its implications for tax planning, followed by comments by Chief Justice Gerald Rip of the Tax Court of Canada. The first session was chaired by Claire Young (University of British Columbia) and involved comments on the case by David Duff (University of British Columbia), Ben Alarie (University of Toronto), Tim Edgar (University of Western Ontario), Robert Carvalho (Department of Justice) and Ed Kroft (McCarthy's). The second session was chaired by Tim Duholke (Davis LLP) and involved comments by Mark Meredith (Moskowitz and Meredith), Deen Olsen (Department of Justice), Warren Mitchell (Thorsteinsens), and Wayne Adams (Canada Revenue Agency). The symposium was webcast live, and can be accessed at the NCBL's website at <http://www.law.ubc.ca/ncbl/index.html>.

Where are they Now?

For this issue of the tax newsletter, we inquired of our LL.M. graduates in Taxation whom we could contact, what professional activities they were performing now. Here are their replies (by year of graduation), including name, LL.M. thesis title, personal statement and contact information.

2007

Zhe (“Bonnie”) Jin, The Legal Environment of Corporate Income Taxation for FDI in China: Policy, Changes, Risks

“I obtained my LLB at Fudan University in China and the LLM degree from University of British Columbia in Canada. With the honor degrees, I was offered by Zhonglun Law Firm (ranking top five local firms in China) and have been working as an attorney-at-law since 2007.

Focusing on the M&A area, I have provided corporate, regulatory and transactional legal services in the areas of growth and buyout private equity/venture capital investments, mergers and acquisitions, capital markets, corporate finance and restructuring, and foreign direct investments.

Also, I conducted due diligence research of the industry, market and technology, drafted legal due diligence reports on the analysis of legal issues, and advised on the equity and cooperative joint ventures, mergers and acquisitions of foreign and domestic companies.”

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Douglas Edward Dent, The Small Business Deduction and a Canadian Tax on Unreasonable Accumulations

“Since completing my LL.M. program in taxation, I have returned to the practice of law as a full-time practitioner. For most of my career, I have focused on business law - serving corporate and commercial clients. About five years ago, however, I decided that I wanted a change from life in the “big city” of Vancouver. I relocated to the very small town of 100 Mile House in British Columbia. Almost by definition, a small-town practitioner must be a general practitioner. Nowadays, I continue to serve a corporate and commercial clientele but I also have an active real estate, wills and estates and family law practice. It turns out that small-town practice is very satisfying in the sense that clients appreciate the assistance which a general practitioner can provide and, indeed, are generally grateful for the help. In retrospect, it is probably a move which I should have made many years previously. There is obviously a lifestyle component to the move as well and small-town life is very comfortable.”

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Patricia Anne Johnson, The Taxation of Trust Income: Some Inherent Problems and Comparative Perspectives

“After graduating, I practiced with Crease & Company in Victoria until 1992, then with Patterson Adams (a firm created by a breakaway group from Crease) until 2001. From 2001 I have been practicing on my own through my law corp, Pat Johnson Law Corporation.

My practice is focused primarily on:

- incorporated professionals
- corporate reorganizations
- inter vivos and testamentary trusts
- wills and estate planning
- probate”

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We would have liked to reach more of our LL.M (Taxation) alums this year, but unfortunately we lack current contact information, and heartily encourage the rest to contact us, so that we can include more of these items in a future issue of this tax newsletter.

NEW FACULTY



David G. Duff is the newest faculty member to join UBC Law. He has an LL.M. from Harvard and an LL.B. from the University of Toronto, master's degrees in political theory from the University of Toronto and economics from York University, and a B.A. (Honours) from Queen's University. Most recently, he was an Associate Professor at the University of Toronto Faculty of Law, which he joined in 1996.

Prior to joining the Faculty of Law at the University of Toronto, Professor Duff was a tax associate at the Toronto office of Stikeman, Elliott. He was also employed as a researcher with the Ontario Fair Tax Commission from 1991 to 1993 and as a tax policy analyst with the Ontario Ministry of Finance in 1993-1994. He is a member of the Law Society of Upper Canada and was called to the Bar in 1996. He has been a visiting scholar at the law faculties at Oxford University, the University of Sydney and McGill University, and is a Research Fellow of the Monash University Taxation Law and Policy Research Institute and an International Research Fellow of the Oxford University Centre for Business Taxation.

Professor Duff's teaching and research interests are in the areas of tax law and policy, environmental taxation, comparative and international taxation, and distributive justice. He has published numerous articles in the areas of tax law and policy, accident law and family law, and environmental taxation and policy, has co-authored a book on accident law and a textbook/casebook on Canadian income tax law, and has co-edited books on tax avoidance in Canada and Canadian climate change policy. He has also served as a consultant to the Canadian Department of Justice, the Ontario Panel on the Role of Government, and to the Commission of Inquiry into the Investigation of the Bombing of Air India Flight 182 (Air India Inquiry).

Congratulations, Professor Ed Kroft, Q.C.

The UBC Law Faculty heartily congratulates adjunct tax law professor, Ed Kroft, on his much-deserved appointment as a Queen's Counsel in February 2009, by the Lieutenant-Governor in Council of the Province of British Columbia. A criterion for appointment is "outstanding work in the fields of legal education and legal scholarship."

Ed fulfills both admirably. Among his achievements as a legal educator, Ed remains a long-serving and popular adjunct professor here, having taught tax at the Law Faculty since 1989. Ed's legal scholarship includes an LL.M. degree awarded by this Faculty in 1980, and his numerous legal publications include his Masters' thesis entitled, The "Going Private" Transaction: A Genre of Minority Shareholder Squeezeout.

The first issue of this newsletter contained a profile of Ed, see online: <http://www.law.ubc.ca/ncbl/>, Tax Newsletter Fall 2005. Ed is a tax partner at the law firm of McCarthy Tétrault, and further details of the appointment are available from the firm's website, online: http://www.mccarthy.ca/news_release_detail.aspx?id=4337.

THANK YOU!

Thanks Again This Year to Thorsteinssons LLP.

Grateful thanks are due to Thorsteinssons LLP (www.thor.ca) for their generosity in providing a copy of the current edition of the CCH, Canadian Income Tax Act with Regulations, Annotated, free of charge to every student taking tax at the UBC Faculty of Law.

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Check out UBC's tax webpage at <http://faculty.law.ubc.ca/brooks>

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