Recent Developments in the Taxation of Securities

The Taxation of Securities Transactions, which was published in two recent numbers of this journal,[1] was drafted shortly after Parliament amended the *Income Tax Act*[2] to include business investment loss[3] and the capital gains election[4] rules relating to the taxation of securities. Subsequent regulations, statutory amendments and cases are reviewed in this note.

I. Business investment losses

The business investment loss (BIL) rules confer some relief beyond the limit of $2,000.00 in section 3(e) where investors in Canadian controlled private corporations (CCPC) have sustained a capital loss on equity or debt investments. The basic mechanism of the loss relief is to treat the amount of an allowable capital loss (*i.e.*, half of the total loss on the transaction) as an ordinary business loss. While the amount of the loss is halved by this scheme, the scope of application is enlarged because the loss is taken under section 3(d) instead of under section 3(e). For taxpayers who do not have large taxable capital gains, this device generates more complete loss relief since the relief is more immediate than that available under the rules governing carry-over losses. For the taxpayer who does have large taxable capital gains, this slight change in the method of computation of taxable income is largely irrelevant, since ordinary losses can be used to off-set taxable capital gains. Of course all taxpayers will still prefer ordinary loss treatment for the full amount of a loss on an investment rather than a deemed ordinary loss, which is limited to half the amount of the loss. When this legislation was introduced in 1978, it contained several defects. Perhaps the most important flaw was the provision's dependence on the case law to give it meaning. Since 1978, the cases which distinguished capital and income transactions in close corporation securities have become more con-

[1] Lahey, *The Taxation of Securities Transactions — I: Policy Analysis and Canadian Treatment* (1980) 25 McGill L.J. 478; *The Taxation of Securities Transactions — II: Recent Legislation* (1980) 26 McGill L.J. 45.

[2] S.C. 1970-71-72, c. 63 as am. [Unless otherwise noted, all references to the *Income Tax Act* are to this version.]

[3] *Income Tax Act*, s. 3(d), added by S.C. 1977-78, c. 42, s. 1(2), and ss. 38(c) and 39(1)(c), which were added by S.C. 1977-78, c. 42, ss. 2, 3.

[4] *Income Tax Act*, ss. 39(4), (5), (6), added by S.C. 1977-78, c. 1, s. 16(2).

fused, and so this aspect of the provision is a continuing problem. Second, the linguistic formula used in the original section 39(1) (c) to describe "capital losses" created technical statutory problems. Third, the BIL rules invited double counting of dividends in computing losses which qualify. These last two problems have been largely resolved by subsequent changes in the provision.

A. *Capital loss v. ordinary loss of close corporation securities*

The business investment loss rules operate when the taxpayer has incurred a loss on the disposition of Canadian controlled private corporation securities, whether debt or equity.[5] General principles are of course applicable in deciding whether a transaction is of an income or capital character. Thus, transactions in corporate securities will give rise to capital treatment if they are of an investment nature and to revenue treatment if there is evidence that the taxpayer is a trader in securities. When the corporation is closely held, or where there is sufficient identity between the corporate decision-makers and the shareholder-taxpayer, the courts will consider the possibility that a single share transaction which cannot be characterized as being in the course of trading in shares is a revenue transaction, if the shares dealt with are a substitute for the property owned by the corporation.[6] An additional exception to the basic trading-or-investment dichotomy has been made where a business undertaking is so speculative that gains and losses on corporate securities which are issued to finance the venture are dealt with as revenue of a financer who is personally involved in the business activity. This last exception was adopted by the Supreme Court of Canada in *M.N.R.* v. *Freud*,[7] when it held that loans and disbursements to and on behalf of a close corporation were deductible losses by the controlling shareholder.

Pigeon J. was of the opinion that the corporate undertaking in *Freud* would have been at the least an adventure in the nature of trade if the taxpayer had carried it on himself instead of through a corporation, and that the interposition of the corporate entity did not affect the character of the taxpayer's expenditures, but rather the reverse: the character of the business venture imbued the securities with the quality of an adventure. He went even further and stated that the precise method of finance was irrelevant; volun-

[5] *Income Tax Act*, ss. 39(1)(c)(iii), (iv), added by S.C. 1977-78, c. 42, s. 3(1) as am. by S.C. 1979-80, c. 5, s. 11(1).

[6] See *Fraser* v. *M.N.R.* [1964] S.C.R. 647. Debt obligations are not likely to be used in the same fashion; thus there is no corollary ruling for loans.

[7] [1969] S.C.R. 75.

tary disbursements were to be treated no differently from debts due by the company:

> [w]hether it is considered as a payment in anticipation of shares to be issued or as an advance to be refunded if the venture was successful, it is clear that the monies were not invested to derive an income therefrom but in the hope of making a profit on the whole transaction.[8]

The obvious implication is that in "quite exceptional or unusual circumstances", such as those in the *Freud* case, losses on loans or shares issued by a small corporation will be treated in the same way, and both kinds of losses will be deductible when the business scheme can be realized either by exploiting the enterprise itself or by using the enterprise to increase the value of the shares, which can then be sold at a profit.

The *Freud* case describes a difficult and elusive standard by which to differentiate income and capital transactions in corporate debt and equity securities. In the last few years several decisions have re-examined and applied that standard, and it is now possible to draw some tentative conclusions from them. One emerging theme is that the taxpayer whose personal business efforts are capable of affecting the fortunes of the corporation's business, and therefore the value of its securities, is more likely to have a deductible loss, whether in shares or debt instruments, than a capital loss (and of course more likely to have business income than a capital gain should the securities be disposed of at a gain). In *The Queen* v. *Garneau*,[9] the *Freud* approach was used to justify treating the *gain* on shares as a revenue item where the taxpayer had acquired a controlling interest in a corporation in order to maintain its operations, enhance its profit picture and attractiveness to an investor, and then quickly sell out.[10] The element of the taxpayer's personal control was also the determining factor in *Malone* v. *M.N.R.*,[11] which extended the *Freud* doctrine to losses on loans to controlled corporations as well as to equity securities. In *Malone* the taxpayer controlled a stock-brokerage corporation which regularly distributed its surplus to the taxpayer, who just as regularly loaned the distributions back to the company, partly to enable it to meet minimum capital requirements. When the corporation went bankrupt, the Board held that the loans were properly treated as revenue losses. Mr St-Onge's analysis of the matter stayed well within the issue as framed in *Freud*: whether "a loan made by a person who is not in the business of lending money ... should be considered as a specu-

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[8] *Ibid.*, 82.
[9] [1977] C.T.C. 288 (F.C.T.D.) *per* Marceau J.
[10] See *McDonald* v. *M.N.R.* [1979] C.T.C. 3001, 3003 (T.R.B.) *per* Taylor.
[11] [1979] C.T.C. 2619 (T.R.B.) *per* St-Onge.

lation".[12] He answered the question in the taxpayer's favour but did not analyse the relationship between control and speculation in the written judgment. Although the reported opinion does not fully amplify the reasoning, the facts of the *Malone* case should be taken as an example of the "quite exceptional or unusual circumstances" that are required to bring a case within the *Freud* doctrine.

It has been suggested that "the taxpayer was fortunate in winning his appeal" and that "it is unlikely that the case will become a precedent of general application",[13] presumably because the case was initially argued as a money-lending case.[14] When *Malone* is viewed as a money-lending case, it certainly is aberrant. When it is seen as an affirmation of the *Freud* doctrine, however, it takes on greater significance. Because the type of situation in *Malone* straddles fact patterns appropriate to a money-lending business and speculative securities, it is difficult to categorize it conclusively. Perhaps because the close corporation securities cases do shade off into the money-lending cases, where the standard for defining a business transaction is more difficult for taxpayers to meet, subsequent decisions have tended to go against taxpayer appellants, at least where losses are in issue. Looking at 1979 and 1980 decisions generally, it appears that the *Freud* emphasis on a speculative intent that expresses itself in exploitation of the undertaking directly, *or* in the resulting value of the shares, has shifted to the requirement that the taxpayer's dominant intent be to exploit securities by means of exploiting the underlying venture. This shift in emphasis is clearest in *McDonald* v. *M.N.R.*,[15] which at least superficially resembled the *Garneau* case. Mr McDonald had acquired a controlling interest in a stock brokerage company and several years later instituted a programme of selling participating interests to some of his colleagues.[16] Shortly after reducing his holdings to a minority position, difficult economic conditions prompted him to reacquire control in order "to hold the business together" and "to turn it around", presumably with the intention to dispose of the shares at a profit. When the shares ultimately were sold at a loss, the taxpayer argued *inter alia* that the second

[12] *Supra*, note 7, 82 *per* Pigeon J.

[13] McDonnell, *Current Cases* (1979) 27 Can. Tax J. 604, 605.

[14] See Lahey, *supra*, note 1, Pt II, 66-70.

[15] *Supra*, note 10.

[16] One of these was George Sher, the unsuccessful appellant in *Sher* v. *The Queen* [1980] C.T.C. 168 (F.C.T.D.) *per* Grant D.J., *aff'g* [1978] C.T.C. 2486 (T.R.B.) *per* Taylor (appeal to Federal Court of Appeal pending). Although he received a directorship and a higher commission rate as a shareholder, he remained a salesperson. When he sold his shares at a loss he was held to have incurred only a capital loss.

share acquisition was intended to result in a profit, but Mr Taylor held that the share losses were on capital account because "Mr McDonald did not ... allege that in the acquisition of the capital stock his *major motivation* was to sell that stock at a profit."[17] Mr Taylor also distinguished *Malone* on the form of the investment, observing that the loan of money to a company cannot be equated with the purchase of equity capital from third parties.[18]

The application of cases such as these present a challenge to the litigant, especially since they will not be accepted automatically as authority. One should rely upon them as persuasive analyses of similar problems, with the *caveat* that the policy objectives of the business investment loss rules run counter to the Minister's perception of the purpose of the system which they modify.

B. *Technical statutory defects*

1. Definition of capital loss

When section 39(1)(c) was added to the Act,[19] it defined business investment losses as losses determined according to subdivision c, which deals with taxable capital gains. Until its amendment in 1979, the preamble to section 39(1)(c) reiterated the clumsy formula in sections 39(1)(a) and (b) which defines capital gains and losses by reference to pre-1972 ordinary income and losses. Not only was this a cumbersome way of making a simple point, but it allowed taxpayers to take the position that sections 39(1)(b) and (c) were not mutually exclusive and were designed to treat half of a capital loss as an allowable capital loss, and the other half as an allowable business investment loss. A subsequent amendment[20] has substituted the words "capital loss" for the verbose formula, and now

[17] *Supra*, note 10, 3004 [emphasis in the original].

[18] *Ibid.*, 3002. For two other recent Board decisions which held that investments by controlling shareholders were of capital nature, see *Santel Investments Ltd* v. *M.N.R.* [1980] C.T.C. 2353 (T.R.B.) *per* Tremblay (loans to protect corporate investment) and *Whitehouse* v. *M.N.R.* [1979] C.T.C. 2448 (T.R.B.) *per* Goetz (loans for working capital). It is not surprising that where there is an element of personal control over the enterprise and some speculative risk which results in a *gain* on close corporation securities the courts have been more anxious to apply the *Freud dictum.* See *Perkins* v. *The Queen* [1980] C.T.C. 199 (F.C.A.) *per curiam, aff'g* [1978] C.T.C. 389 (F.C.T.D.) *per* Collier J. (taxable profit on acquisition of book debts in revival of loss company); *The Queen* v. *Eidinger* [1979] C.T.C. 296 (F.C.T.D.) *per* Walsh J., *aff'g* unreported T.R.B. decision, noted in (1979) 27 Can. Tax J. 596 (gain on debt assigned to controlling shareholder taxable as profits from adventure due to element of personal control).

[19] S.C. 1977-78, c. 42, s. 3.

[20] S.C. 1979, c. 5, s. 11, applicable to 1978 and subsequent taxation years.

section 39(1)(c) clearly creates special treatment for certain capital losses and the term "capital loss" is defined in section 39(1)(b). It is no longer open to taxpayers to argue that they are entitled to utilize more than a total of fifty *per cent* of an amount lost for tax purposes.

2. Double counting dividends

The new technical provision in section 39(1)(c)(vi) is an interesting addition. At its simplest, it ensures that when a capital loss on a share is partially attributable to the payment of taxable dividends since 1971, the capital loss cannot be treated as a business investment loss. The formula in this section is arbitrary in that it limits the amount of a business investment loss to the excess over post-1971 taxable dividends. The new sub-section also appears to ensure that when a CCPC has paid taxable dividends since 1971, which reduce its cumulative deduction account or trigger refundable dividend tax,[21] those taxable dividends will not also be counted in computing the amount of the business investment loss. Note that the distributions are still counted, in effect, in computing the amount of a capital loss on the shares. As of yet, capital losses on shares are not adjusted to exclude the effect of such events.[22] Section 55 has not yet been applied by the Minister in an attempt to reduce capital losses by the amount of dividends paid on the shares.[23]

An interesting aspect of this amendment is that it adjusts the quantum of business investment loss arising only on shares (or shares substituted therefor) issued before 1972. Because of this limitation, its operation is severely restricted. It will not block double counting of taxable dividends for corporations organized after 1971, and this omission makes CCPC shares attractive tax-planning vehicles. However the 1972 cut-off does mean that another technical anomaly relating to pre-1972 undistributed surplus has been eliminated, at least in some instances. Before 1979, undistributed surplus which was earned before 1972 could be tax paid at a

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[21] See *Income Tax Act*, ss. 125, 129.

[22] Except in *Income Tax Act*, s. 112(3): see also s. 46(4).

[23] The Minister's chances of success in such an enterprise are questionable, given the artificial nature of the corporate entity and of the tax rules dealing with corporations. For a discussion of the possible implications of s. 55, see Friesen & Timbrell, *Shams and Simulacra II — The Capital Gains Aspect* (1979) 27 Can. Tax J. 135. For an analysis of the avoidance difficulties of the capital gains v. dividends planning prompted by the present structure of the Act, see Gould & Laiken, *Dividends* v. *Capital Gains Under Share Redemptions* (1979) 27 Can. Tax J. 161.

fifteen *per cent* rate at the corporate level and then distributed as tax-exempt dividends if the corporation made a special election.[24] Shareholders were required to reduce the cost base of their shares by the amount of TPUS distributions,[25] which in effect levied a deferred capital gains tax on the distributed amount on the ultimate distribution of the shares. For taxpayers who were taxed at a high marginal rate, the effective rate of the two taxes together was lower than the personal rate on taxable post-1971 dividends[26] and reflected an initial reluctance to treat pre-1972 corporate surpluses as fully taxable income on distribution when pre-1972 capital gains on corporate shares which were attributable to pre-1972 retained earnings were exempt in most cases from capital gains taxation by the Valuation-Day rules. In effect, the TPUS rules functioned as Valuation-Day rules for pre-1972 surpluses, and created a partial shelter for on-going distributions and almost all other corporate transfers including reorganization.

For the 1979 tax year a number of fundamental changes were made in the corporate tax rules, one of which was the abolition of the TPUS system.[27] Heralded as a major component of a tax simplification program,[28] the termination of the TPUS shelter for all private and most public corporations widened the gap between the tax payable on pre-1972 retained earnings brought out as capital gains and those brought out as taxable dividends.[29] The original drafting in section 39(1)(c) in effect invited taxpayers who found the deemed dividends plus capital loss useful to exploit this differential by converting the capital loss which arises on liquidation or redemption into an even more useful ordinary loss.

Although there is no fixed formula for valuing corporate shares, as a general proposition the amount of paid-up capital (PUC), capital or other surplus and undistributed profits attributable to a share bears some relationship to the value of the share. This pro-

[24] The rules concerning tax-paid undistributed surplus (TPUS) were contained in old ss. 83(1) and 89 (1)(k), repealed by S.C. 1977-78, c. 1, ss. 37(1) and 44(5) respectively, effective after 1978.

[25] *Income Tax Act*, s. 53(2)(a)(i).

[26] Even before the dividend tax credit was enriched in 1978, low rate taxpayers were better off with taxable dividends than with deferred taxable capital gains.

[27] See *Income Tax Act*, ss. 83(1), (6) and *Income Tax Regulations*, s. 2107.

[28] Also scrapped were admittedly complex provisions relating to capital deficiencies, pre-1972 capital surpluses and the computation of various special surplus accounts. See generally Subdivision h. Ironically enough all of these concepts still operate in some circumstances.

[29] See, *e.g.*, *Income Tax Act*, s. 84.1.

position is especially true for smaller corporations or those which have ceased regular business operations and hold assets in highly liquid forms. Using a simplified example which assumes that the market value of a share equals a *pro rata* share of the corporation's capital and surplus, we can quantify the discrepancy left by the elimination of the TPUS shelter for most corporations. (The example deals only with pre-1972 earnings in order to minimize the numerical factors that affect the result.) Assume a corporation with one issued share with PUC of $50.00 and pre-1972 undistributed income of $100.00. Using our simplified valuation method, the Valuation-Day value of the share would have been $150.00 and current market value is roughly $150.00.[30] There are two basic methods that the shareholder can use to extract the capital and surplus or equivalent value from the share; arm's length sale of the share[31] or liquidation of the corporation.[32] Without the TPUS shelter, and assuming that the modified rule in section 39 (1) (c) (vi) has not yet been brought into application, the taxpayer who uses the liquidation route recognizes a deemed dividend of $100.00 and a capital loss of $100.00,[33] while the taxpayer who disposes of the share in an arm's length sale recognizes no capital gain or loss nor any ordinary income.[34]

While the impact of the elimination of the TPUS shelter on liquidating distributions of pre-1972 profits will vary with the individual taxpayer's marginal rate and overall financial position, it seems fair to say that the two extremes invite abuse. The discre-

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[30] For these purposes of illustration, inflation is not taken into account.

[31] S. 84.1 of the *Income Tax Act* offers a hybrid result in a sale to a controlled corporation, but the technique is not central to the analysis here.

[32] Other corporate transfers such as redemption, or a full distribution of undistributed income followed by the sale of the share, will achieve roughly the same result as liquidation.

[33] S. 84(2) yields a deemed dividend of $100.00 (amount received in excess of PUC). The combined operation of ss. 88(2), 84(2) and 54(h)(x) give the taxpayer deemed proceeds of disposition of the share for capital gains purposes of the amount received in excess of the amount of any deemed dividends ($50.00). With deemed proceeds of $50.00 and deemed cost of $150.00 (V-Day value) the capital loss is $100.00 — the same amount as the deemed dividend. If the taxpayer has a low marginal rate, there will be an excess dividend tax credit plus an allowable capital loss of $50.00 which can be off-set against other ordinary income under the $2000 limit. At present there is no mechanism for limiting the amount of the creditable dividend to the net after capital losses. But see *Income Tax Act*, s. 112(3), which disallows capital losses on shares to corporations which exhibit a certain degree of control.

[34] If the market value of the share was the same on Valuation-Day and the date of disposition, cost and proceeds are the same.

pancy between the two routes was increased when the original version of the BIL rules deemed taxable capital losses such as the one in this example to be allowable business losses. Apparently this may have been an unintended result, for section 39(1)(c)(vi) now reduces the amount of the business investment loss recognized on a share by the aggregate of all taxable dividends paid on the share.[35] While the modification minimizes this anomaly, it creates new ones. Liquidation of a controlled corporation will not generate a business investment loss because the disposition is not at arm's length,[36] and thus the amendment has no application. Liquidation of a corporation that does not fall within the arm's length rules will result in a reduction of the business investment loss by the amount of the deemed dividend. The statute does not indicate what happens to the amount of the reduction of the business investment loss, but presumably it reverts to its original condition as a capital loss, which should be perfectly acceptable to many taxpayers.

II. Lifetime election

The lifetime election rules, which very broadly permit a taxpayer to make an irrevocable election to treat all transactions in "securities" as capital transactions, have not yet reached the courts, nor will they for several more years. Interim litigation will affect the interpretation of key terms in the provisions, however, and thus the courts should take some care when deciding securities cases, lest ill-considered language turn up as "precedent" in unanticipated contexts. A few recent cases deserve mention in this regard. In addition, the regulations under section 39(6) attempt to foil some of the more obvious non-arm's length abuses of the election.

A. *Litigation*

Dubé J. made some provocative remarks about the legal definition of "trader" in *Montfort Lakes Estates Inc.* v. *The Queen*.[37] The controlling shareholder of the taxpayer was an immigrant who alleged a need for a large landed estate because he was from

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[35] Or predecessor shares. Note that this opportunity for abuse has not been completely closed off. If a taxpayer received distributions out of TPUS before that account lost its special status as a source of tax deferral dividends for other than the privileged few corporations, those were not taxable dividends and the stop-loss rule in s. 39(1)(c)(vi) will not apply unless other taxable dividends have been paid since 1971.

[36] See *Income Tax Act*, s. 39(1)(c)(ii).

[37] [1979] C.T.C. 27 (F.C.T.D.): see note in (1980) 28 Can. Tax. J. 190.

landed nobility; the family jewels were sold to finance the $100,000 purchase of 2000 undeveloped acres in what appeared to be prime Quebec wilderness near a small town. The year after buying the land, the shareholder began a systematic course of improving a small section of the land for subdivision and sale. The proceeds were used to finance further business activities and to improve the holdings generally. Particulars of the improvements and expenditures were not given in the judgment. Some seventeen years after acquiring the land, now held by the taxpayer corporation to which the development business had been transferred, the taxpayer accepted an unsolicited and somewhat staggering offer of $1.2 million for the remaining land (still over 1800 acres). In ruling that the sale of the balance of the land was a capital transaction, Dubé J. was of the opinion that

> while the plaintiff ... was a trader with reference to the sub-divided lots which it sold throughout the years, and on which it paid business income tax, it was not a trader with reference to the sale of the remainder of the undeveloped estate.[38]

This position is relevant to the construction of section 39(5)(a), which denies the benefit of the capital gains election to "a trader or dealer in securities". The statute does not indicate whether this exception will apply to *all* securities transactions of a taxpayer who carries on the vocation of securities trading, including those on personal account, or whether the courts will be inclined to read the *proviso* "with relation to the transaction in issue" into section 39(5)(a).

More persuasive authority for a schizoid view of "trader in securities" is Mr Taylor's ruling in *Sher* v. *M.N.R.*, which was recently affirmed by the Federal Court.[39] When the taxpayer stockbroker argued that his professional status as a securities trader imposed a business character on all of his securities transactions, Mr Taylor stated that "trader" in the sense of a commission salesperson of investment securities "is not synonymous with being a trader in securities in his own right."[40] He went further and concluded that on the evidence the taxpayer was not a trader "in his own right" or as a principal. Keeping in mind that this case is of course not concerned with the actual application of section 39(5)(a), and that it involves a loss on shares and not a gain, it is interesting that the Minister viewed professional trading as severable from the taxpayer's personal financial transactions. The parties

[38] *Ibid.*, 31.
[39] See note 16, *supra*, and accompanying text.
[40] *Supra*, note 16, 2489 (T.R.B.) *per* Taylor.

did not explore the relationship between the taxpayer's professional expertise and his choice of personal investments.

In the companion case, *McDonald* v. *M.N.R.*,[41] the applicant would have been in a stronger position to argue that his status governed the tax treatment of all of his securities transactions, since he controlled the corporation in question, but he was also found not to have engaged in trading or an adventure with respect to the shares in question. If *Sher* and *McDonald* do not assist taxpayers in establishing that section 39(5)(a) applies only to the professional activities of participants in the securities industry, they at least give "investment" broad meaning for securities salespeople and would be favourable authorities for taxpayers who are denied the blanket election.

Aside from a few minor Board decisions which might be consulted when applying other aspects of the election,[42] recent decisions do little more than raise interesting questions as to the eventual interpretation of the election provisions. Will an interest in a partnership which owns real estate be treated as a "security?"[43] Will the election override circumstances which suggest that a capital gain was manufactured to provide an employment benefit?[44] Are people who take over and resurrect loss companies "traders in securities" or will they be able to take advantage of the election?[45]

B. *Prescribed securities*

The election does not apply to "prescribed securities" of electing taxpayers. The *Income Tax Regulations*, Part LXII,[46] define prescribed securities in a manner designed to block the most blatant,

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[41] *Supra*, note 10, and see text at note 15, *supra*.

[42] *E.g.*, *Jack Dichter Developments Ltd* v. *M.N.R.* [1979] C.T.C. 2707 (T.R.B.) *per* Bonner (appeal to Federal Court pending); *Swystun Management Ltd* v. *M.N.R.* [1979] C.T.C. 2476 (T.R.B.) *per* Bonner; *Whitehouse* v. *M.N.R.*, *supra*, note 18, (all dealing with whether taxpayers carried on the business of lending money).

[43] See *Gamble* v. *The Queen* [1979] C.T.C. 463 (F.C.T.D.) *per* Grant D.J. (capital gains treatment denied because legal documentation for major long-term investment would have been more meticulously prepared).

[44] See *Mountjoy* v. *M.N.R.* [1979] C.T.C. 2232 (T.R.B.) *per* Bonner (an employee was allowed to make a superficial gain on shares issued by employer as an inducement to remain; held income from employment).

[45] See *Spencer* v. *M.N.R.* [1978] C.T.C. 2109 (T.R.B.) *per* Taylor (profits on redemption of shares and notes held income from adventure where taxpayers took over loss company).

[46] For purposes of s. 39(6) of the *Income Tax Act*, amended by P.C. 1978-3729, December 14, 1978 (S.O.R. 78-946).

non-arm's length abuses of the election. Non-public company shares are prescribed securities when their value is "wholly or primarily attributable" to real property owned by the issuing company or, apparently, by anyone else. This is an open-ended category because of the vagueness of "primarily attributable". The provision apparently attempts to prevent taxpayers from taking advantage of the *Fraser*[47] analysis, but does not provide an escape clause for arm's length transactions.

The definition of prescribed securities prevents taxpayers from simply transferring investment portfolios to electing corporations as surrogate legal entities. In the Regulations the key provisions are sections 6200(c)(iii) and (iv), which deny deemed capital gains treatment to debt or an equity security "that was acquired by the taxpayer in a transaction in which that taxpayer was not dealing at arm's length" or that was acquired in a section 85(1) or (2) rollover. Given the broad reach of the non-arm's length concept in sections 251(1)-(5) of the Act, even taxpayers who are willing to recognize accrued gain in order to transfer securities to controlled corporations will be blocked by this rule. This subsection can still be avoided by a taxpayer who finances a controlled corporation which makes all acquisitions from arm's length parties, but the holding company is thus limited to a forward-planning function.

Some caution must be used in financing the holding company, for ITR section 6200(e) extends prescribed securities to include debt or equity securities acquired by that taxpayer as proceeds of disposition for another prescribed security, and securities acquired "as a result of one or more transactions that may reasonably be considered to have been an exchange or substitution" of the acquired security for a prescribed security. Where the use of an electing holding company is restricted to acquisitions of new securities, this provision should be no threat.[48] However, it does prevent a taxpayer from eventually making an election that would apply to the issued securities of the holding company, which means that taxpayers should not form holding companies rashly. The election remains irrevocable.

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[47] *Supra*, note 6.

[48] Note also s. 6200(b) of the *Income Tax Regulations*, which included certain non-public company debt instruments as prescribed securities — again where the transaction is not at arm's length.

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