MARCH 2009

Blaney McMurtry
BARRISTERS & SOLICITORS LLP

Blaneys on Business

"...the general rule that prohibits people from arranging their affairs specifically so that they can avoid tax...is called the general anti-avoidance rule, or GAAR."

This newsletter is designed to bring news of changes to the law, new law, interesting deals and other matters of interest to our commercial clients and friends. We hope you will find it interesting, and welcome your comments.

Feel free to contact any of the lawyers who wrote or are quoted in these articles for more information, or call the head of our Corporate/Commercial Group, Stanley Kugelmass at 416.593.3943 or skugelmass@blaney.com.

SUPREME COURT HAS GOOD NEWS AND BAD NEWS ON TAX AVOIDANCE

Paul Schnier

Readers of Blaneys on Business may recall that, in December, 2005, we wrote about the Supreme Court of Canada's position with respect to the general rule that prohibits people from arranging their affairs specifically so that they can avoid tax. This rule is called the general anti-avoidance rule, or GAAR.

At that time the Court had rendered decisions in two cases concerning the application of the GAAR to tax avoidance transactions. We had hoped that further jurisprudence would help clarify where the line is drawn between what the courts will consider legitimate tax planning versus what it will consider abusive tax avoidance. In the recent Lipson case the Supreme Court of Canada has done just that with regard to the specific case in question. It has not, however, provided clarity as to where the line will be drawn in future cases.

The facts of the Lipson case are fairly simple: Mrs. Lipson borrowed $562,500 from a bank in order to finance the purchase from Mr. Lipson of some shares in a family holding company. This transaction was completed.

At the same time the Lipsons used the borrowed money, together with additional monies, to buy a home for $750,000. On the closing of the home purchase, the Lipsons took out a mortgage of $562,500 on the security of the home and used this money to repay Mrs. Lipson's original bank loan.

When you transfer property to any relative except your spouse, the *Income Tax Act* deems that the transfer has taken place at fair market value. If fair market value is different from the value of the property when it was acquired originally, a capital gain or capital loss will arise and you will have to deal with the tax consequences accordingly.

When you transfer property to your spouse, however, the *Income Tax Act* deems that a "rollover" has been made *not* at fair market value, but at the original value. In other words, there no gain or loss associated with the transaction. If, as and when your spouse realizes a gain or loss, it is attributed back to you for income tax purposes.

This normal spousal rollover provision takes effect automatically unless, as the Act permits, you explicitly elect to opt out. If you do opt out, the transfer is deemed to have taken place at fair market value and you absorb its tax consequences. Any tax consequences after that belong to your spouse.

"The Canada Revenue Agency's position was that the Lipsons, in essence, used the provisions of the Act to manipulate the interest on a loan used to purchase a home into a tax deduction for Mr. Lipson."

Paul L. Schnier chairs Blaney McMurtry's tax group. He restricts his practice to income tax law with emphasis on tax planning and implementation and advising as to the tax consequences of proposed transactions. He has advised a variety of public and private corporations on numerous domestic and international undertakings.

Paul may be reached directly at 416.593.3956 or pschnier@blaney.com

The Lipsons did *not* file such an election under the provisions of the *Income Tax Act*. The result was that no gain or loss was recognized by Mr. Lipson on the sale of his shares in the family holding company to Mrs. Lipson. As a consequence of not electing out of this spousal rollover, a loss (arising from the fact that the interest expense on the loan was greater than the dividend income on the shares) was attributed to Mr. Lipson. He claimed this loss on his income tax return. The Canada Revenue Agency (CRA) disallowed this loss under the GAAR and it was this disallowance that was the subject of the Supreme Court of Canada decision.

The specific provisions of the Act applicable to this transaction yield the following results:

1. Mrs. Lipson is allowed to deduct the interest expense on her original borrowing since the loan was used for the purpose of purchasing an income-producing asset.

2. Interest on the mortgage is deductible since the money was used to repay a loan, the interest on which was originally deductible.

3. Because the parties were content to have the spousal rollover provisions apply with respect to the share sale, the attribution provisions of the Act require Mr. Lipson to report on his tax return any income or loss with respect to the shares.

The CRA's position was that the Lipsons, in essence, used the provisions of the Act to manipulate the interest on a loan used to purchase a home into a tax deduction for Mr. Lipson. The Supreme Court of Canada in a four to three decision (with two very strong dissenting opinions) largely agreed with this position, the justification being that the use of the attribution provisions of the Act to generate a tax deduction for Mr. Lipson in these circumstances constituted abusive tax avoidance.

So what's the good news?

The good news is that, up until the "spousal twist," the Supreme Court of Canada had no difficulty with the transaction. There would have been no problem with Mrs. Lipson claiming the interest deduction on the mortgage and the Court confirmed its earlier decision in the Singleton case which stands for the proposition that we are entitled to organize our affairs so that borrowed money is used for the purpose of acquiring income producing assets and other cash is used for the purpose of acquiring non-income producing assets so long as a tracing can be established.

In the Singleton case the taxpayer withdrew his capital account in a partnership of which he was a member and used the money to purchase a home. He then borrowed money to replace his capital account and the interest deduction on this borrowed money was allowed.

Where the majority drew the line in this case, which is essentially the same as the Singleton case, was with the use of the attribution provisions of the Act to allow Mr. Lipson to claim the interest deduction.

And now for the bad news.

In our view the bad news is twofold. First, the line between legitimate tax planning and abusive

BLANEYS ON BUSINESS

"...the line between legitimate tax planning and abusive tax avoidance is as ambiguous as ever."

Jill E. McCutcheon, a Blaney McMurtry partner, advises financial institutions on all aspects of the law. She acts as counsel to insurers, reinsurers, banks, intermediaries, marketers, retailers, employers, sponsors and associations in Canada and has particular expertise in federal and provincial legislation applicable to the business of domestic and foreign insurance and reinsurance companies operating in this country.

Jill may be reached directly at 416.593.2956 or jmccutcheon@blaney.com

tax avoidance is as ambiguous as ever. We cannot understand why the mere operation of the attribution provisions of the Act would have been sufficient to have this transaction fall under the GAAR. The Lipsons did nothing to cause the attribution provisions to apply. They did not chose to have the share sale generate capital gains for Mr. Lipson, a choice that would have required a positive action on their part. By not taking this action, the attribution provisions applied automatically.

Why, then, would what is acknowledged to be a perfectly legitimate transaction turn into abusive tax avoidance merely because they were content with the application of specific provisions of the Act?

Unfortunately, the Court gives us no explanation for this and thus, no help on where the line will be drawn in future cases.

Second, the CRA will undoubtedly chalk this case up as a clear victory and threaten to apply the GAAR in a myriad of situations in the future in order to gain taxpayer acquiescence. Once again, how could anyone confidently say to them that the GAAR will not apply?

We concluded our earlier article by suggesting that "paper transactions" would likely be subject to the GAAR while real commercial transactions (albeit with associated tax benefits) would survive. We cannot be so sure any more. ■

REAL ESTATE DEVELOPERS REQUIRED TO COMPLY WITH FEDERAL ANTI-MONEY LAUNDERING LEGISLATION

Jill McCutcheon and Kelly Morris

As of February 20, 2009, real estate developers joined the class of entities, including financial institutions, life insurance companies, securities dealers, foreign exchange dealers and real estate brokers, covered by the provisions of the *Proceeds of Crime (Money Laundering) and Terrorist Financing Act* (the "Act"). Real estate developers are now required to comply with the reporting, client identification and record keeping requirements set out in the Act, and are also required to implement the compliance regime mandated by the Act.

Definition of real estate developer

A real estate developer is defined as any individual or entity that has sold to the public in any calendar year after 2007 any of the following:

- five or more new houses or condominium units;
- one or more new commercial or industrial buildings; or
- one or more new multi-unit residential buildings that total five dwelling units or more.

The definition does not include the sale or development of land without buildings.

Once a person or entity satisfies this definition, they are required to comply with the obligations that apply to real estate developers set out in the Act for the remainder of that calendar year and all subsequent years, whether or not they satisfy the definition in those subsequent years. The

"Real estate developers are now required to comply with the reporting, client identification and record keeping requirements set out in the (Proceeds of Crime (Money Laundering) and Terrorist Financing Act)..."

Kelly Morris is a partner practicing in the firm's Corporate Insurance Group. In addition to providing advice to insurers, reinsurers and insurance intermediaries, Kelly has experience in regulatory, compliance and market conduct matters, privacy law issues and anti-money laundering issues.

Kelly may be reached directly at 416.596.2898 or kmorris@blaney.com

obligation to comply with the Act will only terminate if the real estate developer is able to show that its business has changed substantially and permanently such that it no longer carries on the functions of a real estate developer.

Reporting, client identification and record keeping requirements

When real estate developers sell a house, condominium unit or building to the public, they are required to file, and keep copies of, the following reports:

- reports of suspicious transactions and suspicious attempted transactions (a transaction the client intended to complete, and took some form of action to complete, but that was not actually completed) - when there are reasonable grounds to suspect that the transaction or attempted transaction is related to a money laundering or terrorist financing offence. The real estate developer must also take reasonable measures to ascertain the identity of the person conducting or attempting to conduct the suspicious transaction, subject to certain exceptions;

- terrorist property reports - when a real estate developer knows that it holds property owned or controlled by or on behalf of a terrorist or terrorist group it must immediately report to the Financial Transactions and Reports Analysis Centre of Canada, Canada's financial intelligence agency, as well as to the RCMP and CSIS; and

- large cash transaction reports - when a real estate developer receives $10,000 or more in cash within a 24 hour period in respect of a single transaction, unless the cash is received from a financial entity or public body. The real estate developer must also inquire whether the cash is being provided on behalf of a third party and, if so, obtain information about the third party and the third party's relationship to the person providing the cash to the developer.

Real estate developers are also required to identify any individual, and confirm the existence of any corporation or other legal entity, that:

- purchases a new home, condominium unit or building;

- provides to the developer any part of the funds used to purchase a new home, condominium unit or building, such as the deposit; or

- is a party to an Agreement of Purchase and Sale with respect to the purchase of a new home, condominium unit or building.

Real estate developers are also required to keep client information records on all parties to the Agreement of Purchase and Sale and a receipt of funds record with respect to all amounts received in the course of a single transaction, other than amounts received from a financial entity or public body.

The Act contains specific and detailed requirements as to how to identify individuals and corporate or other entities, what forms of identification are permitted, when a reporting entity may rely on an agent to identify clients and when clients who have been previously identified must be identified again, as well as the information that must be included in a client information record and receipt of funds record.

BLANEYS ON BUSINESS

"Real estate agents and brokers have been covered by the Act since 2002, so are already required to comply with the client identification and record keeping requirements."

Laura McLennan is a member of Blaney McMurtry's Corporate/Commercial practice group. Her practice includes secured lending, mergers and acquisitions and general commercial matters. A Dalhousie University LL.B, Laura is also a University of Waterloo B.Sc. graduate in Honours Biology and Chemistry, Co-op, and has done research at Agriculture Canada, the University of Toronto and the WM Keck Center for Transgene Research at the University of Notre Dame.

Laura may be reached directly at 416.596.2897 or lmclennan@blaney.com

The record keeping and client identification requirements do not apply to a real estate developer if a real estate broker or real estate sales representative actually sells the property to the public, unless the agent or broker is an employee of the developer. Real estate agents and brokers have been covered by the Act since 2002, so are already required to comply with the client identification and record keeping requirements.

Compliance Regime

Real estate developers that sell new homes or buildings to the public must implement a compliance regime that includes:

- the appointment of a compliance officer, who must be someone with access to senior management and sufficient authority to carry out the obligations of the position;
- the assessment and documentation of the risks relating to the occurrence of money laundering and terrorist financing offences in a manner that is appropriate to the developer, along with the adoption of policies and procedures to mitigate any identified risks that are higher than normal. The risk assessment must take into account the real estate developer's clients, business relationships, products and services, delivery channels, and geographic location, as well as the geographic locations of its clients;
- the development and application of written compliance policies and procedures;
- a written ongoing compliance training program for employees and agents; and
- a documented review of the compliance policies and procedures, risk assessment and training program for effectiveness at least every two years, conducted by an internal or external auditor if the developer has an auditor, including a written report on the findings of the review to a senior officer of the developer, if the developer is a corporation.

Blaney McMurtry LLP has substantial experience assisting reporting entities in complying with their obligations under the Act. If you have any questions about the Act, please contact Jill McCutcheon or Kelly Morris. ■

PROMISSORY NOTE HOLDERS CAN REST EASY THANKS TO CHANGE IN LAW

Laura McLennan

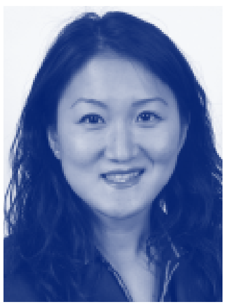
Two years ago, *Blaneys on Business* reported to you on a case out of the Ontario Court of Appeal, *Hare v. Hare*.

To refresh your memory, Ms. Hare gave her son a loan, secured by a demand promissory note. The son did not repay the loan and Ms. Hare sued on the note. She lost her case because the court held that she had started her action after the limitation period had expired.

Of interest was the Court's ruling that, in spite of the new rules in the *Limitations Act, 2002* regarding the "discoverability" of claims - that the limitation period only starts running when it is "discovered" that a claim would be appropriate - the old common law rule, that an action lies on a demand note as soon as the note is given, continued to apply. In the case of an action on a demand note, the limitation period, two years under the *Limitations Act, 2002*, began running

BLANEYS ON BUSINESS

"In light of a recent Delaware court decision, corporate directors named in these lawsuits could be in for a surprise when they ask their corporations for advances on their legal expenses."



Regina Ko is a member of Blaneys' Corporate/ Commercial practice group. She was assisted in the preparation of this article by Brendan Jones, an articling student at Blaneys.

Regina may be reached directly at 416.593.3933 or rko@blaney.com

as soon as the demand note was given (and was restarted each time the debt was acknowledged, either by the making of an interest payment or otherwise).

The ruling rightfully left many holders of demand promissory notes nervous about their chances of enforcing a demand promissory note if no payment or other acknowledgment of the debt had been made in the past two years.

Holders of demand notes can now rest easy because Ontario has amended the *Limitations Act, 2002*. The amendments, which came into force November 27, 2008, provide that in the case of an action on a demand obligation, the limitation period begins to run on "the first day on which there is a failure to perform the obligation, once a demand for the performance is made."

There is no deadline for the demand to be made. It can be issued a month after the loan is given, or a decade. But once it has been issued, the two-year limit on legal action to recover the debt begins. As in the original law, the two-year clock is restarted whenever the borrower acknowledges the debt, whether by making an interest payment or by some other means.

The amendments go further and make the change retroactive to cover all demand obligations since the act first came into force on January 1, 2004.

Simply put, the limitation period for an action on a demand promissory note, which is still two years, won't begin running until a demand for repayment is made. ■

CORPORATE DIRECTORS COULD BE IN FOR SURPRISE

Regina Ko

Along with the current economic slowdown, we can expect to see an increase in litigation alleging mismanagement of corporate affairs. In light of a recent Delaware court decision, corporate directors named in these lawsuits could be in for a surprise when they ask their corporations for advances on their legal expenses. These directors could discover that the right to advances that they thought was enshrined in the corporation's by-laws does not, in fact, exist. All corporate directors, therefore, would be well advised to review their corporate indemnification and advancement rights to ensure they are adequately protected and that their rights cannot be stripped away unilaterally by the corporation.

The source of this caution is the Delaware Chancery Court's decision in *Schoon v. Troy Corp.* In this particular case, Troy Corporation amended its by-laws to remove the requirement to advance legal expenses to former directors who were sued for actions or omissions that occurred while carrying out their duties as directors. The court held that the corporation was not required to advance expenses to a former director who left office prior to the amendment.

Troy Corporation develops and manufactures specialty chemicals used by manufacturers and processors around the world. During the time that William Bohnen served on its board of directors, the corporation's by-laws provided for advancement of legal expenses to current and former directors. Bohnen resigned from his position in February, 2005. In November, 2005,

BLANEYS ON BUSINESS

"...directors should take steps to protect themselves from potential adverse effects of the Schoon decision in the U.S. and other jurisdictions where the reasoning in Schoon could be adopted."

the directors of the Corporation approved amendments to its by-laws to eliminate advancement of legal fees to former directors, including Bohnen.

In February, 2006, the corporation brought an action against Bohnen (and his successor director, Richard W. Schoon) for breach of fiduciary duties. When Bohnen sought advancement of his attorney's fees, the corporation refused, arguing that it was no longer subject to mandatory advancement of expenses to former directors because of the by-law amendment.

The issue addressed by the court was when did Bohnen's right to advancement of legal fees "vest," or take effect? Bohnen argued that he was entitled to the advancement rights that were contained in the by-laws at the time he served as director and that they could not be unilaterally altered by the corporation. The court disagreed and held that the right to advancement took effect when the Corporation triggered its obligations, which occurred when the Corporation filed its action against him.

The court reasoned that since the by-laws were amended before the corporation filed its action against Bohnen, and since there was no evidence that the corporation was even contemplating action against him when it changed its by-laws, Bohnen could not rely on the by-laws and rights that were in existence at the time he served as a director. Therefore, he was not entitled to advancement of expenses from the corporation.

This finding opposes conventional thinking and the assumption of many directors that their rights cannot be altered unilaterally after they leave the board of directors. It should alert corporate directors that mandatory indemnification and advancement rights contained in corporate by-laws may not be as protective as they believe.

Since corporate by-laws may be amended by a simple vote of the board of directors, the indemnification and advancement clauses can be changed or eliminated without the consent of the former director, whose interests these clauses were intended to protect.

The fact that the by-laws provided the indemnification and advancement of expenses to former directors at the time the director was in office is irrelevant. The Court determined that the relevant time to consider the corporation's responsibilities under the by-laws is when the obligations become due.

It should be noted that the *Schoon* decision was not appealed by the directors and the time to do so has since expired. Thus, unless and until a Delaware court rules otherwise in a similar case, the *Schoon* decision stands as an important precedent in determining the circumstances under which advancement rights are triggered.

In this context, directors should take steps to protect themselves from potential adverse effects of the *Schoon* decision in the U.S. and other jurisdictions where the reasoning in *Schoon* could be adopted. One way of protecting directors would be to explicitly provide in the by-laws that (a) advancement and indemnification rights take effect when the director joins the board or that (b) indemnification and advancement provisions cannot be amended to the detriment of a director without that director's consent. However, the difficulty with these solutions is that they are simply by-law provisions, and as such, could potentially be amended by the board of directors, resulting in a situation similar to the *Schoon* decision.

The preferred solution is to obtain a written indemnification agreement between the director and the corporation, specifically providing for advancement of expenses. This form of bilateral agreement cannot be amended or terminated without the director's consent. ■

Blaney McMurtry LLP is pleased to announce

Peter F. Kappel, C.S.

Certified Specialist in Intellectual Property Law (Patent, Trademark and Copyright)

has joined the firm's Intellectual Property Group.

Peter practices exclusively in the field of intellectual property law with a principal focus on intellectual property litigation. Peter has appeared as counsel in numerous actions involving patents, trademarks, copyright, unfair competition, judicial review applications, trade secrets and related employment and commercial litigation in the Federal Court, Federal Court of Appeal, and all levels of Ontario Courts.

Peter was called to the Bar of Ontario in 1984 and is a Registered Canadian and U.S. Patent and Trademark Agent.

He can be contacted by telephone at 416.593.3936 or by e-mail to pkappel@blaney.com.

EXPECT THE BEST

Blaney McMurtry
BARRISTERS & SOLICITORS LLP

2 Queen St. East, Suite 1500
Toronto, Canada M5C 3G5
416.593.1221 TEL
416.593.5437 FAX
www.blaney.com

Blaneys on Business is a publication of the Corporate/Commercial Group of Blaney McMurtry LLP. The information contained in this newsletter is intended to provide information and comment, in a general fashion, about recent cases and related practice points of interest. The information and views expressed are not intended to provide legal advice. For specific legal advice, please contact us.

We welcome your comments. Address changes, mailing instructions or requests for additional copies should be directed to Chris Jones at 416 593.7221 ext. 3030 or by email to cjones@blaney.com. Legal questions should be addressed to the specified author.