FINANCING ISSUES

OVERVIEW OF SECTION 80

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OVERVIEW OF SECTION 80

These notes are intended to promote an understanding of the rationale for, and mechanics of, section 80. They are purposely general in nature and do not contain a detailed description of all the factual and legal issues which must be considered when dealing with a section 80 issue.

PURPOSE

Section 80 applies where an obligation of a taxpayer is settled without any payment or by the payment of an amount less than the principal amount thereof. The resultant gain is applied to reduce losses or the cost base to the taxpayer of property.

The reason for section 80 is straightforward. Borrowings in respect of which interest is deductible may only have been used, directly or indirectly, to acquire property or to pay expenses. Although, for example, interest on money borrowed to pay dividends is, under certain circumstances, deductible, this is only the case where such borrowings can be considered to be replacing other funds which were used to acquire property or pay expenses.

When the taxpayer is relieved of the obligation to repay such a debt, the taxpayer should be required to reduce either the losses created by the expenses funded by the debt, or the cost of the property acquired with the debt, since the taxpayer will not have suffered the loss or borne the cost of the capital expenditure. The inclusion of any forgiven amount in income, to the extent that it exceeds losses and the cost of most property, can be seen as a policing rule designed to ensure that a debtor with a forgiven amount transfers the tax consequences to all related entities. The theory behind this aspect of the rule is that if the debtor does not have the losses or the assets, it is because the debtor has used the borrowed funds to invest in other entities which have the losses or
assets. In broad terms, section 80 attempts to force taxpayers to choose between a reduction of the tax attributes of a related entity and an income inclusion.

The policy behind section 80 differs from the alternative, and relatively straightforward policy accepted in the United States; that any gain realized from the settlement of debt is generally included in the income of the debtor. The policy of the Department of Finance has resulted in a very complex set of technical rules that have become the subject of criticism because of just that, their complexity.

Special provisions governing mortgage foreclosures and conditional sales repossessions are to be found in sections 79 and 79.1, while subsection 39(3) governs the purchase in the open market by a taxpayer of bonds, debentures or similar obligations issued by the taxpayer.

**OLD RULE**

The "old rule" was introduced in 1972, presumably as a result of the acceptance by Canadian courts of certain U.K. caselaw that suggested that gains resulting from the forgiveness of debt is capital in nature, and therefore does not give rise to an income inclusion. However, the Canadian courts began to distinguish between trade debts resulting from a vendor-purchaser relationship, and capital debts resulting from a borrower-lender relationship, with gains resulting from the extinguishment of trade debts considered to be profit under section 9. The old section 80 rules applied with respect to the settlement of all debt, but specifically did not apply where any resulting gain was otherwise included in income under section 9 (i.e., where the debt was a trade debt). The new section 80 rules, as discussed below, maintain this distinction.

Under the "old rule", when a taxpayer was relieved of the obligation to pay a debt, the forgiven amount was applied to reduce, in order, the taxpayer's:
non-capital losses
- capital losses
- capital cost of depreciable property
- adjusted cost base of capital property, other than depreciable property.

If the taxpayer did not have sufficient basis in capital property to absorb the forgiven amount, any excess simply disappeared and there were no adverse consequences to the taxpayer.

However, as noted above, where the debt was not a capital debt, the forgiven amount may have been included in the income of the taxpayer pursuant to section 9, and thereby excluded from the application of the section 80 rules. The Canada Revenue Agency has had mixed results pursuing the application of section 9 to gains arising from the settlement of debt before the Courts. They were successful in *Alco Dispensing Canada Ltd. v. The Queen*, [1997] 3 CTC 145 (FCA), [1996] 1 CTC 2662 (TCC), dealing with the reversal of management bonuses. But see also *Queenswood Land Associates Ltd. v. The Queen*, [2000] 1 CTC 352 (FCA), [1997] 2 CTC 2688 (TCC), where funds were borrowed to acquire inventory and *Molstad Development Co. Ltd. v. The Queen*, [1997] 2 CTC 2360 (TCC) where money borrowed to finance assets, including inventory, was held to be a capital transaction and therefore a partial forgiveness of the debt did not give rise to an income inclusion under section 9. In *Denthor Developments Ltd. v. The Queen*, [1997] 1 CTC 2075 (TCC) section 9 did not apply where money had been borrowed to acquire real estate for resale. The Court determined that no business profit could arise prior to the disposition of the real estate, and that section 9 would only apply to include a forgiven amount in income where the forgiveness was in respect of an expense that was deductible in computing income for the year of the forgiveness. For a situation where a forgiven amount...
gave rise to a benefit from employment and was therefore not subject to section 80 see *John M. McIlhargey v. The Queen*, [1991] 2 CTC 52 (FCTD).

In determining whether a forgiveness of indebtedness gives rise to ordinary income under section 9, the above-referenced cases appear to look to the use of the borrowed funds. That is, the cases appear to be decided based on whether the borrowed funds are used to acquire working capital (or to fund current expenses), or to acquire a capital asset. The decision of the Supreme Court of Canada in *Thomas Gifford v The Queen* (March 4, 2004) casts doubt on the appropriateness of this distinction. In *Gifford*, the Court held that in determining whether a loan is on account of capital it is only necessary to consider what the proceeds of the loan are to the borrower when they are received, and an examination of what those loan proceeds are spent on is not required. Furthermore the Court commented that ordinarily a loan to a trading company, whatever the purpose for which it is intended to be used, will constitute an addition to that company’s capital. It could be argued that *Gifford* suggests that only in the case of money lenders will a forgiveness of indebtedness give rise to ordinary income under section 9 of the Act.

**OLD PLANNING OPPORTUNITIES**

Four factors made planning around the old rules relatively easy. First, in most cases, the adjusted cost base to a parent in the shares of its subsidiary, or the adjusted cost base in an interest in a partnership, is not particularly meaningful. In the case of a wholly-owned subsidiary, any basis in the shares is generally irrelevant when the subsidiary is wound-up into, or amalgamated with, its parent. Second, the debt forgiveness rules could generally be avoided by having the debt acquired at a discount by a related entity (a technique known as "debt parking"). Third, any unapplied portion of a forgiven amount had no adverse implications. Fourth, where shares were issued in repayment of debt, in
general, the amount agreed upon and added to stated capital was conclusive of the amount paid by the debtor to repay the debt. See King Rentals Limited v. The Queen, [1995] 2 CTC 2612 (TCC).

Taxpayers were generally willing to spend a considerable amount of time planning around the old rules. Absent total financial collapse, it is always better not to throw away losses or basis. In addition, in most cases where losses are being sold or otherwise transferred, such losses have been funded with debt that is being settled and a method must be devised to defeat the application of section 80 for the transaction to be economically viable.

Where there was a desire to preserve cost base in assets, most of the basic planning techniques involved transferring the assets of the debtor corporation to a subsidiary, prior to the application of section 80. When section 80 applied, the debtor would have no assets, other than the shares of the subsidiary, which would be ground down with no detrimental effect.

Where there was also a desire to preserve losses, the planning techniques generally included some form of "debt parking". Rather than having the debtor settle its debt for, say, 20¢ on the $1, a corporation affiliated with the debtor would acquire the debt from the creditor for the same 20¢ on the $1. The purchaser would then hold the debt indefinitely and the parties would take the position that section 80 never applied because the debt remained outstanding between the two affiliated corporations. The Courts supported this position. See Wigmar Holdings Ltd. (sub nom. Diversified Holdings Ltd.) v. The Queen, [1997] 2 CTC 263 (FCA), [1994] 2 CTC 2369 (TCC). However, as illustrated in Central City Financial Services Ltd. v. The Queen, [1997] 3 CTC 2949 (TCC), the assignment must not be preceded by a settlement between the debtor and the creditor.

In Jabin Investments Ltd., [2003] 2 CTC 25 (FCA) the Court held that the general anti-avoidance rule did not apply to a blatant debt parking arrangement.
The Court held that where the application of section 80 is avoided, the section cannot be said to have been misused as any provision of the Act which is not used cannot be misused. In addition, the Court concluded that there was no clear and unambiguous policy in the Act that debts that are not legally extinguished are to be treated as if they were.

Any attempt to park debt generally ran into hurdles, emanating from the fact that if the debt is acquired by a related corporation, it generally has to be amended to become non-interest bearing. Otherwise the related corporation may be in a position of having to pay tax on the interest while the debtor is unable to utilize the deduction of same. However, amending the debt to provide that it was not interest bearing might have triggered the application of section 80, with the debtor being regarded as having issued a new non-interest bearing debt in repayment of the old interest bearing debt, resulting in a novation of the debt. It is the Department's stated position that a change from interest-bearing to interest-free status will almost invariably precipitate a disposition. However, the jurisprudence does not support the Canada Revenue Agency's views. See Wigmar Holdings Ltd. (sub nom. Diversified Holdings Ltd.) v. The Queen, [1997] 2 CTC 263 (FCA), [1994] 2 CTC 2369 (TCC), where it was held that removal of security in the form of a mortgage did not create a new debt. However, see also General Electric Capital Equipment Finance Inc. v. The Queen, 2001 FCA 392 where the Court held changes can give rise to a new obligation without necessarily causing a novation.

Any debt which is non-interest bearing is caught by paragraph 7000(1)(a) of the Income Tax Regulations since it is a "debt obligation in respect of which no interest is stipulated to be payable". If such debt is acquired at a discount, paragraph 7000(2)(a) could then apply to cause the taxpayer to include in its income the difference between the face amount of the debt and the cost to it. In
at least one technical interpretation, the Canada Revenue Agency has confirmed this perhaps unexpected result.

Placing the debt offshore was not an easy solution. First, it raised serious fapi issues. Second, the debt still had to be amended (raising the novation issue) because section 78 does not allow the interest to remain unpaid.

Where a debtor retired debt by issuing shares, the Canada Revenue Agency's position was that the "amount paid" was equal to the fair market value of the shares. However, there was no judicial support for the Agency’s position. On the contrary, the old jurisprudence strongly suggested that the "amount paid", for purposes of section 80, was equal to the stated capital of the shares issued in settlement of the debt obligation. This position was endorsed by the Tax Court of Canada in King Rentals Limited v. The Queen, [1995] 2 CTC 2612 (TCC).

There are three separate but very much intertwined rationales which lead to the conclusion that the "amount paid" by a taxpayer in issuing its shares in settlement of a debt obligation is based on the subscription price for the issued shares and that the fair market value of such shares is irrelevant. First, there is a line of cases which suggest that the "amount paid" in such a situation is equivalent to the amount of cash which the taxpayer was entitled to receive on the shares subscription but gave up in return for a settlement of the debt obligation. Second, there is judicial support for the proposition that, as long as there is a reasonable basis for the addition to stated capital, the amount agreed

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2 Osborne v. Steel Barrel Co. Ltd., [1942] 1 All E.R. 632 (CA); Craddock V. Zevo Finance Co. Ltd. (1946), 27 TC 267 (HL); Tuxedo Holding Co. Ltd. v. MNR, [1959] CTC 172 (Ex).
between the lender and the borrower is conclusive of the amount paid by the borrower to retire the debt.\(^3\) Third, no matter what the fair market value of the debt, from the borrower's perspective, it has received an amount equal to the principal amount of the debt - since it has been relieved of the obligation to pay that amount.

The later statement is supported by the relevant corporate law. For example, under the Canada Business Corporations Act, "a share shall not be issued until the consideration for the share is fully paid in money or in property or past services that are 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."\(^4\) The CBCA also provides that "a corporation shall add to the appropriate stated capital account the full amount of any consideration it receives for any shares it issues."\(^5\) Where the principal amount of the debt is added to the stated capital account, it appears clear that, as a matter of general law, the corporation has received an amount equal to the principal amount of the debt in return for the issue of shares. The fact that the debtor may have paid an amount equal to the face amount of a debt when it issues shares does not mean that the creditor has received the same amount. From the creditor's perspective "it is the real or actual value of the shares which must be considered rather than the par value even if the issuing corporation has agreed to issue them at their par value as fully paid."\(^6\)

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OFFICIAL REACTION TO OLD OPPORTUNITIES

The response from the Department of Finance to the perceived problems with the old rules is all too apparent. Rather than relying on GAAR and a substance over form approach to statutory interpretation, Finance chose to create a set of supposedly tight rules, which are so complex that it is difficult to imagine how they can ever be properly administered.

Meanwhile, the Canada Revenue Agency has pursued, with a fair amount of enthusiasm, the techniques designed to avoid the old rules. This pursuit has not always resulted in success before the courts. The Canada Revenue Agency's reasonably standard list of arguments include GAAR, ineffective transactions and novation. On the issue of novation, the Canada Revenue Agency's general position has been that if there are any significant amendments to the loan documentation, a new loan has been created. In effect, they argue that there has been a barter transaction with a new debt instrument being swapped for the old debt instrument. Under the old rules, it follows that the old debt instrument is settled or extinguished for an amount less than its principal amount, to the extent that the fair market value of the new debt is less than such principal amount. This could arise, for example, where an arrangement has been made with a creditor to settle certain indebtedness, and as part of these arrangements it is planned that the debtor drop assets down into a subsidiary so as to avoid the impact of section 80. However, the creditor has security against such assets and, therefore, must release such security in order for the assets to be transferred down to the subsidiary. The Canada Revenue Agency has taken the position in some cases that the release of such security so fundamentally alters the nature of the debt that novation has occurred. As illustrated by King Rentals Limited v. The Queen, [1995] 2 CTC 2612 (TCC), the Canada Revenue Agency's position has not been supported by the Courts.
THE BASIC RULE

Section 80 applies where a commercial obligation of a debtor is settled and there is a forgiven amount.

Commercial Obligation

First, there must be an obligation. An obligation is a broader concept than simply borrowed money. Under subsection 248(26), an obligation is considered to have arisen whenever a debtor becomes liable to repay money borrowed or becomes liable to pay an amount (other than interest) as consideration for any property acquired or services rendered or that is deductible in computing the debtor's income. Thus the concept of an obligation embraces balances of sale or amounts owing for services rendered and includes any amount payable in respect of an amount that is deductible in computing the debtor's income. Further, this subsection provides that any such obligation will be treated as having a principal amount equal to the amount of the liability at the time it comes into existence. Interest is excluded from the definition of an obligation because it is specifically addressed by paragraph 80(2)(b) which provides that any amount of interest payable on an obligation is itself deemed to be an obligation that has a principal amount, and was issued for an amount, equal to the portion of such interest that was deductible in computing the taxpayer's income. See paragraph 80(2)(b) and the definitions of "commercial debt obligation" and "commercial obligation" in subsection 80(1).

In general terms, a commercial obligation is either (a) an obligation upon which interest is, or if chargeable would be, deductible in computing income, or (b) a distressed preferred share.
Debtor

A debtor includes a partnership. For the purposes of these rules, either a partnership or a trust is treated as though it is a corporation with 100 issued shares and each partner or beneficiary is considered to own the proportion of shares equal to the proportion of the value of its interest compared to the value of all interests. In general terms, a beneficiary's interest in a discretionary trust is deemed to be 100%. See the definition of "debtor" in subsection 80(1) and paragraph 80(2)(j).

Forgiven Amount

The forgiven amount, as defined in subsection 80(1), is, essentially, the excess of the amount of the debt over the amount paid to settle the debt, less:

- any amount included in income as an employee or shareholder benefit,
- an amount deductible under paragraph 18(9.3)(f) as prepaid interest in respect of a future period,
- any gain realized under subsection 39(3) from an obligation repurchased in the open market,
- amounts previously renounced under the resource rules in respect of the obligation,
- amounts included under section 79 upon seizure of property for unpaid debts,
- previously parked or statute-barred amounts,
- the portion of the principal amount arising from section 80.4 inclusions in income in respect of employee or shareholder loans,
- the entire debt if the taxpayer is bankrupt,
- the portion of the debt which is an excluded obligation,
- the entire debt if owed by a partnership to an active partner, and
any amount paid to another to assume the debt.

Excluded Obligation

An excluded obligation is defined in subsection 80(1) as an obligation where:

- the proceeds were included in income,
- the proceeds reduced deductible expenses or the cost of property,
- it relates to an unpaid amount that is only deductible when and if paid,
- section 78 applies to the debt, and
- without the provisions of sections 79 and 80, the forgiven amount would nonetheless be included in income.

This last exclusion maintains the distinction between a trade debt and a capital debt for the purpose of these rules. See the discussion above under "Old Rule" regarding the relationship between sections 9 and 80.

Settled

An obligation is considered to have been settled where it has been settled or extinguished, otherwise than by bequest or inheritance or upon the issuance of distress preferred shares.\(^7\) An obligation is deemed to be settled upon a winding-up or an amalgamation involving the debtor, or where the obligation becomes a parked obligation (discussed below), or becomes statute-barred. For a discussion of the meaning of settlement, see Central City Financial Services Ltd. v. The Queen, [1997] 3 CTC 2949 (TCC) and Carma Developers Ltd. v. The Queen, [1996] 3 CTC 2029 (TCC).

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\(^7\) See generally paragraph 80(2)(a), subsections 80.01(3), (4), (5), (8), (9), paragraphs 80(2)(g), (g.1) (h), (k), and (l).
In addition, special rules provide that where shares are issued in settlement of an obligation, an amount equal to the aggregate of (a) the fair market value of the issued shares, and (b) the increase in the value of any other shares owned by the creditor, is considered to have been paid by the debtor to settle the debt. The (b) portion of this calculation applies even if no shares are issued. Thus, if a creditor who is also a shareholder settles a debt, in addition to any other consideration that may be paid by the debtor, the debtor will be considered to have paid an amount equal to the amount by which the value of the creditor's shares increased as a result of the settlement. As this rule only applies for purposes of section 80, it would not appear to apply for purposes of determining the amount received by the creditor. See Praxair Canada Inc. (sub. nom, Union Carbide Canada Limited) v. The Queen, [1993] 1 CTC 130 (FCTD) and Saskatchewan Co-operative Credit Society Ltd. v. The Queen, [1986] 1 CTC 53 (FCA).

Where one debt is substituted for another, the principal amount of the new debt is the amount that is deemed to be paid by the debtor, again for purposes of section 80 only. In this case it would appear reasonably clear that the creditor would be treated as having received an amount equal to the fair market value of the new debt.

If an obligation was issued in a foreign currency, it will nonetheless be treated as having been issued in Canadian currency based on the appropriate exchange rate at the time of issuance. Any gain or loss will be determined under subsection 39(2).

Where an obligation is paid on behalf of a debtor by a person with subrogation rights (such as a guarantor), a new obligation is deemed to have been issued as between the debtor and the guarantor as at the same time and in the same circumstances as the original obligation.
Parked Obligation

Where a commercial debt obligation (that is, a commercial obligation, other than a distress preferred share) becomes a parked obligation and the cost at that time to the holder is less than 80% of the principal amount of the obligation, the obligation is deemed to have been settled at that time for a payment equal to the cost of the obligation to the holder. In general terms, a parked obligation is a specified obligation which is owned by a significant shareholder, or a person who does not deal at arm's length with the debtor. A significant shareholder is defined as a person who, if the debtor is a corporation, together with another person with whom the person does not deal at arm's length, owns 25% or more in votes or in value of the shares of the debtor. A specified obligation includes an obligation (a) which is acquired by the holder from a person unrelated to the holder, or (b) if, at any previous time, a person who owned the obligation either dealt at arm's length with the debtor, or if the debtor is a corporation, did not hold a significant interest in the debtor.

The purpose of this rule is, of course, to prevent the debtor from avoiding a settlement of debt by having its debt acquired at less than its principal amount from the original lender by a non-arm's length party to the debtor. However, the concept of non-arm's length has been expanded to include, amongst others, any shareholder who holds more than 25% in votes or value of the shares of the debtor. This rule may well be triggered in reorganization scenarios where a financial institution acquires 25% in value of the shares of a debtor, and also acquires debt from other financial institutions at a discount of more than 20%.

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8 See subsections 80.01(2)(b), (6), (7), (8), (10).
The rule has been drafted so that the order of either becoming a specified shareholder or acquiring a specified obligation does not matter. As soon as both conditions are met, the debt parking rule will apply.

Relief is available, in the form of a deduction in computing income, where a debt that has been parked, or has become statute barred, is subsequently repaid.

**THE MECHANICS OF SECTION 80**

Where a *commercial obligation* is settled, the *forgiven amount* is, in general terms, applied to reduce, in order:

- non-capital loss carryforwards,
- capital loss carryforwards,
- capital cost of depreciable property,
- cumulative eligible capital,
- resource pool balances,
- adjusted cost bases of capital properties (other than shares and debts of corporations in which the debtor is a *specified shareholder* and interests in partnerships which are related to the debtor),
- adjusted cost bases of shares and debts of corporations in which the debtor is a specified shareholder (other than shares and debts of corporations which are related to the debtor),
- adjusted cost bases of capital properties that are interests in, or debts of, related persons.

A specified shareholder is defined in section 248 as a shareholder who, alone or together with other non-arm's length parties, owns not less than 10% of the issued shares of any class of the corporation. See paragraph 80(2)(c), subsections 80(3), (4), (5), (7), (8), (9), (10), (11), and the definition of "specified shareholder" in subsection 248(1).
Non-Capital Loss Carryforwards

Non-capital losses are reduced to the extent that they would be deductible during the year in which the settlement occurs, without regard to the streaming rules triggered by an acquisition of control. Thus, in the first instance, streamed losses are available to absorb forgiven amounts. However, the definition of relevant loss balance then carves out of the amount available, losses incurred prior to an acquisition of control, except were the obligation being settled was issued prior to the acquisition of control or in substitution for such an obligation. To the extent that obligations which are now being settled, directly or indirectly funded losses which are streamed, such streamed losses should be available to offset the effects of having a forgiven amount. See subsection 80(3), and the definition of "relevant loss balance" in subsection 80(1).

Farm losses and restricted farm losses are reduced by this provision, but allowable business investment losses are excluded from non-capital loss carryforwards. Since such losses are equal to 50% of certain capital losses they are dealt with in the same manner as net capital losses and thereby benefit from the 2X gross-up back to the amount of the capital loss.

Capital Loss Carryforwards

Following the erosion of non-capital losses, any remaining unapplied portion of a forgiven amount reduces the debtor's allowable business investment losses and net capital losses for prior years. In both cases the allowable losses are grossed-up to the original loss amount, based on the capital gains inclusion rate for the year of the loss. See paragraphs 80(2)(d) and (e), subsection 80(4), and the definition of "relevant loss balance" in subsection 80(1).
Capital Cost of Depreciable Property

The third category of tax attributes which absorbs a forgiven amount is the capital cost of depreciable property, to the extent of the undepreciated capital cost of the pool to which the asset belongs. In the case of depreciable assets which do not belong to a prescribed class the reduction is limited to the undepreciated cost of the asset itself. The debtor may designate the manner by which the forgiven amount is to be applied. See subsections 80(5) and (6).

Cumulative Eligible Capital

Forgiven amounts are then applied against cumulative eligible capital. As cumulative eligible capital is increased by 3/4 of eligible capital expenditures, for each $4 of unapplied forgiven amount, cumulative eligible capital is reduced by $3. The debtor may designate the extent to which the forgiven amount is to be applied. See paragraph 80(2)(f), and subsection 80(7).

Resource Pools

Resource pools no longer escape section 80. With respect to successored pools, a rule similar to the rule with respect to streamed non-capital losses applies. If the obligation being settled was issued prior to the event which triggered the successoring, or was issued in substitution for such an obligation, then the successored pools are available to offset a forgiven amount. The debtor may again designate the extent to which the forgiven amount is to be applied. See subsection 80(8).

Capital Properties

It is generally less detrimental to a debtor to reduce the cost base of an interest in other entities, than to reduce losses or the cost base of depreciable or otherwise deductible balances. In fact, in the absence of special rules, in many
cases, reducing the cost of an interest in other entities could avoid any negative effects of having a forgiven amount. For this reason, the rules that allow for the erosion of the cost base of capital properties have three special characteristics. First, they are divided into the following three ordered categories:

- the adjusted cost bases of capital properties (other shares or debts of corporations of which the debtor holds 10% of the shares of any class, or interests in partnerships that are related to the debtor) (Category I),
- the adjusted cost bases of shares of, or debts owing by, corporations of which the debtor holds 10% of the shares of any class, but which corporations are not related to the debtor (Category II), and
- the adjusted cost bases of the shares of, and debt issued by, related corporations, and interests in partnerships which are related to the debtor (Category III).

Second, the tax bases in any one category is only available, if the tax attributes of all prior categories have been reduced to the fullest extent permissible. Third, there is no advantage to reducing the adjusted cost bases of the shares in, or debts of, a related corporation, or an interest in a related partnership, unless such entities have first used the transfer of a portion of the forgiven amount to eliminate their tax attributes (see discussion below). See subsections 80(9), (10), and (11).

In all cases, a partnership which is a debtor cannot reduce the adjusted cost bases to it of capital property below the fair market value of such property. This rule is designed to prevent a partnership from hiding tax attributes in another entity in which it has an interest. See subsection 80(18).

Capital Properties - Category I

A deduction against the adjusted cost base of this category of capital property is available under subsection 80(9), but only if the maximum
permissible deductions have been taken against the cost of depreciable property, cumulative eligible capital, and the resource pools. The reductions against non-capital loss carryforwards and net-capital losses are mandatory. However, the deductions against the next three categories of tax attributes (ucc, cec, and resource pools) shall be applied either in such manner or to the extent designated in a prescribed form.

Under the depreciable property rule, the capital cost of depreciable property could only be reduced to the extent of the undepreciated capital cost of the pool to which the asset belonged. In some cases, the capital cost of a depreciable asset for capital gains purposes, is greater than the amount added to undepreciated capital cost when the asset is acquired. This situation arises, for example, where a depreciable asset is transferred at a gain between non-arm's length parties and paragraph 13(7)(e) applies to reduce the addition to the transferee's undepreciated capital cost to an amount equal to the taxable capital gain realized by the transferor. To the extent that the debtor remains with a capital cost to it of depreciable property of a prescribed class because of the prior application of one of these reduced ucc rules, such capital cost is available under this section 80 rule to absorb a forgiven amount.

Capital Properties - Category II

At this stage, the unapplied forgiven amount may be applied against the adjusted cost bases of capital properties that are the shares of, or debts owing by, corporations in which the taxpayer holds 10% of the shares of any class, but not to which the debtor is related. The theory would appear to be that it is easier to hide tax attributes in a corporation in which the debtor has a significant interest than in a corporation in which it has a lesser interest. On the other hand, it is not practical to force a debtor to transfer forgiven amounts to an unrelated corporation. Reductions are allowed against Category II capital properties under
subsection 80(10), but only after the maximum permissible deductions have been claimed against Category I properties.

Capital Properties - Category III

The debtor may now reduce the adjusted cost bases of the shares of, and debts issued by, related corporations and interests in related partnerships. However, this reduction will only be efficient if the debtor has first transferred all unapplied forgiven amounts, to the fullest extent possible, to related entities. See subsection 80(11) and section 80.04.

Current Year Capital Losses

The rule contained in subsection 80(12) applies between Category I and Category II capital property reductions. This provision allows a debtor to use current year capital losses to absorb a forgiven amount. This is accomplished by deeming the debtor to have a capital gain equal to the amount of such capital loss (thereby offsetting the capital loss so that it will not create a net capital loss carryforward) and by considering the debtor to have applied the forgiven amount to the extent of such capital gain.

Such a rule is not necessary for current year non-capital losses since they will be available to offset any income inclusion resulting from the application of section 80.

Transfer of Unapplied Forgiven Amounts

Under section 80.04, a debtor may by agreement with the transferee, transfer a remaining unapplied forgiven amount to an eligible transferee. An eligible transferee is either a directed person of the debtor, or a directed person of a taxable Canadian corporation or a partnership that is related to the debtor. A directed person is a taxable Canadian corporation or an eligible Canadian
partnership that controls the debtor, or that is controlled by the debtor, either alone or together with other related entities, or that is controlled by the same person, or group of persons, which controls the debtor. No benefit is considered to have been conferred on the debtor as a consequence of the transfer.

This transfer is only available to a debtor where it has reduced all of its tax attributes (except the adjusted cost bases of the shares in, or debts issued by, related corporations, or the adjusted cost bases of interests in related partnerships) to the maximum extent permitted. To the extent of any amount specified in the transfer agreement, the transferee will be deemed to have issued a commercial debt obligation that was settled for no payment. The transferee will then be required to apply the forgiven amount so created against its tax attributes in the manner described above, with a few stated exceptions. One such exception is that the transferee will not be entitled to reduce the adjusted cost bases to it of the shares in, or debt of, a related corporation or an interest in a related partnership. This is not a hardship because there is no need for an original debtor to transfer an amount in excess of the other tax attributes of the transferee. Another exception is that the reserve generally available in respect of an income inclusion does not apply to the transferee. See section 80.4 and the definition of "directed person" in subsection 80(1).

In non-wholly owned situations, it is quite possible that the debtor will have to compensate a transferee for entering into an a transfer agreement. Subsection 80.04(5) provides that the debtor will not be entitled to a deduction in respect of any such compensating payment and the transferee will not have to include an amount in income in respect of the receipt of such amount.
Income Inclusion

Any remaining unapplied amount is included in the income of the debtor under subsection 80(13), subject to some significant adjustments. The calculation of the amount to be included in income (the "Inclusion") commences with a determination of the unapplied amount remaining after all reductions (ignoring, at this preliminary stage any transferred amounts) under section 80.4. The Inclusion is then increased by the lesser of (a) amounts applied against the acb of interests in related entities, and (b) the residual balance. The residual balance in respect of the settlement is equal to the total of the income tax attributes of directed persons before any amounts transferred to such directed persons. In other words, if the debtor reduces the adjusted cost bases of the shares in, or debt of, a related corporation, or of an interest in a related partnership, then the Inclusion will be increased to the extent that there are tax attributes in directed entities.

The Inclusion is then reduced by all amounts transferred to directed persons. Thus, if a debtor does not reduce the acb of interests in related entities and transfers an amount equal to the unapplied forgiven amount to directed persons, the debtor will not have an income inclusion. Only after the tax attributes of all directed persons have been eliminated by transfer agreements can the debtor reduce the acb of interests in related entities without increasing the positive side of the income calculation in subsection 80(13). Accordingly, in most cases, a taxpayer should not reduce the acb of interests in related entities, unless there are no remaining tax attributes in directed persons.

Lastly, the Inclusion is reduced by unrecognized losses. Unrecognized losses are losses of the debtor which were denied because of subparagraph

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9 See subsections 80(13), (14), and (14.1) and the definition of "unrecognized loss" in subsection 80(1).
40(2)(g)(ii), which denies a loss on the disposition of a debt or other right to receive an amount that was not acquired by the taxpayer for the purpose of gaining or producing income. Losses incurred by a debtor in respect of loans which it previously made to related entities, but which were denied by subparagraph 40(2)(g)(ii), may be used to reduce the amount otherwise required to be included in the income of the debtor.

An amount equal to 50% of the remaining amount is included in income, unless the debtor is a partnership in which case the inclusion rate is 100%. For corporate debt, the 50% inclusion rate recognizes that unapplied forgiven amounts can be offset against capital properties where the effect is to increase a subsequent gain, only 50% of which would be included in computing taxable income. This, again, recognizes a distinction between trade debt and capital debt. In the case of a partnership, the full income inclusion is warranted for two reasons. First, all prior losses of the partnership will have become losses available to the partners. Second, as discussed below, the partners will be able to offset this income inclusion with their own tax attributes.

**Partnerships**

Since partnerships flow losses out to their partners, special rules are required to deal with forgiven amounts of partnerships. Under subsection 80(18), partnerships may not reduce the adjusted cost bases of capital property below the fair market value of such property. As discussed above, this is intended to prevent a partnership from hiding tax attributes in entities in which it has an interest.

Partnerships can, in effect, convert an income inclusion into a forgiven amount at the partner level. In accordance with subsection 80(15), a partner may deduct in computing its income, an amount not exceeding the amount that would be its share of income arising from a forgiven amount at the partnership
level, on the assumption that the partnership reduced its tax attributes to the maximum extent permissible. For this purpose, it is the gross amount of such income which forms the basis for the deduction. The amount so deducted is then treated as a forgiven amount in respect of an obligation settled by the partner.

Reserves and Deductions in Respect of Income Inclusions

Three different types of reserves are available when an unapplied forgiven amount results in an income inclusion. One for corporations and trusts, another for individuals, and a third for insolvent corporations. There is no reserve allowed for partnerships because of the special rules in subsection 80(15).

Reserve for Corporations, Trusts and Non-Resident Persons

Corporations, trusts and non-resident persons that carry on business through a fixed place of business in Canada, are allowed to claim a discretionary reserve in respect of an income inclusion. The maximum reserve entitlement is designed to ensure that a minimum of 20% of the inclusion is taxable in the first year and in each of the following four years. See sections 61.4 and 56.3.

The authority of the Minister under subsection 80(16) to adjust the reduction of tax attributes does not apply when a reserve is claimed under this rule.

Reserve for Resident Individuals (Other than Trusts)

The reserve mechanism for individuals, in sections 61.2 and 56.2, means that the amount that an individual must pay tax on in any one year as a consequence of a forgiven amount does not exceed an amount equal to 20% of the taxpayer's income, determined without regard to any forgiven amount, in excess of $40,000. For example, if an individual has income of $70,000, prior to any income inclusion because of section 80, the maximum amount that the
individual needs to pay tax on in the year because of a section 80 unapplied forgiven amount is $6,000 (20% of $70,000 - $40,000).

A reserve claimed in one year is added back into income in the subsequent year, subject to the same reserve calculation. The process repeats itself indefinitely until the full amount has been included in income or the individual dies. In the year of death, any reserve effectively becomes a deduction because there is no requirement to include the reserve amount in the income of the individual's estate or beneficiaries.

The Minister has the authority under subsection 80(16) to increase the erosion of a debtor's tax attributes, and thereby reduce the income inclusion amount, where the debtor claims a reserve under this rule. In addition, this reserve is only available in respect of section 80 inclusions and does not apply to any amount included in computing the income of an individual as an employee or shareholder benefit resulting from the settlement of an obligation.

Deduction for Insolvent Corporations

Under section 61.3, corporations are allowed a deduction which has the effect of limiting their net income inclusion to an amount equal to two times their net asset value. The deduction is not a "reserve", as it is not required to be later included in income. Assuming a tax rate of no more than 50%, the application of the section 80 income inclusion rule should not, in and by itself, result in the corporation becoming insolvent, and if insolvent, the corporation is not required to recognize income under subsection 80(13). In addition, recall that paragraph (i) of the definition of "forgiven amount" in subsection 80(1) effectively excludes from the section 80 rules, obligations of a bankrupt.

In computing net asset value, there is a claw-back of amounts paid out in the 12 month period preceding the year end of the corporation by way of cash
dividends; reductions of paid-up capital; on the redemption, acquisition, or cancellation of shares; or as any distribution or appropriation of property to a shareholder. Distress preferred shares are treated as liabilities for the purpose of the calculation.

As in the case of the reserve for resident individuals, the Minister has the authority under subsection 80(16) to increase the erosion of a debtor's tax attributes, and thereby reduce the income inclusion amount, where the debtor claims a reserve under this rule.

**Gains on Subsequent Dispositions**

Subsection 80.03(2) applies where there is a surrender of a capital property, the acb in which has been subject to erosion because of the application of a forgiven amount. A surrender occurs where the property is a share which disappears on a winding-up or amalgamation, a capital interest in a trust in respect of which there is a roll-out of property, or an interest in a partnership in respect of which there has been a roll-out of property. Where such a surrender occurs, the debtor is generally treated as having a capital gain from the disposition of another property equal to the amount of the reduction in basis. The debtor can elect under subsection 80.03(7) to treat such gain as a forgiven amount in respect of a debt obligation, subject to the basic section 80 rules.

**Distress Preferred Shares**

A commercial obligation generally includes distress preferred shares issued after February 21, 1994. For purposes of the section 80 rules, such a distress preferred share is treated as debt with a principal amount equal to the amount for which the share was issued. When a dps is issued in settlement of an obligation, the amount paid is considered to be equal to the principal amount of the obligation, provided that the debtor adds a comparable amount to the paid-
up capital of the distress preferred shares. Similar rules apply where a commercial debt obligation replaces a distress preferred share, or where one dps is replaced by another dps. See section 80.02.

**ORDERING OF UNPAID AND FORGIVEN DEBT RULES**

The rules in the Act dealing with unpaid and forgiven amounts apply in the following order:

- unpaid amounts under section 78,
- employee benefits under subsections 6(1) and (15),
- shareholder benefits under subsections 15(1) and (1.2),
- ordinary income under section 9,
- seizures under section 79, and
- general debt forgiveness under section 80.

Forgiveness of debt which gives rise to a benefit from employment, which constitutes a shareholder benefit, which arises on the seizure of property, or which results in profit, at least in the first instance, is dealt with under sections 6, 9, 15 or 79, as the case may be, and not section 80. See the definitions of "excluded obligation" and "forgiven amount" in subsection 80(1).

**Employee and Shareholder Benefits**

In accordance with subsection 6(15) or 15(1.2), the forgiven amount, as modified, is included in income if the obligation arose in connection with employment, or as a consequence of the debtor being a shareholder, as the case may be. For these purposes, forgiven amount is given the modified meaning contained in subsection 6(15.1) or 15(1.21). In particular, for these purposes, the forgiven amount does not include any interest on the original obligation. Any such interest remains subject to the rules in section 80.
However, section 80 only applies in respect of a commercial debt obligation, which is an obligation upon which interest is, or if charged would be, deductible. Accordingly, interest on housing loans and other loans where the proceeds are not used for the purpose of gaining or producing income will not give rise to a section 80 problem, if forgiven. Similarly, the deemed settlement rules for debt parking and statute barred debt, found in subsections 80.01(8) and (9), only apply in respect of commercial debt obligations.

Under paragraph 80(2)(b), any interest payable by a debtor on an obligation is deemed to constitute a separate debt instrument with a principal amount equal to the portion of such interest that was deductible\textsuperscript{10} in computing the debtor’s income. However, where any such interest payable can reasonably be considered to have been included in computing income under section 80.4, paragraph (h) of the definition of "forgiven amount" in subsection 80(1) provides that such amount is excluded from the definition of forgiven amount. This latter rule would apply even if the taxpayer also received a deduction under section 80.5 equal to the amount of the 80.4 inclusion.

**Profit**

Where the gain resulting from the forgiveness of debt can be considered profit to the debtor, through a combination of paragraph (d) of the definition of "excluded obligation" and paragraph (j) of the definition of "forgiven amount" in subsection 80(1), the section 80 rules do not apply to that gain. The Courts have distinguished between a gain resulting from the settlement of a trade debt and a capital debt in determining whether such a gain is on income or capital account. A number of cases deal with this distinction in the context of the old section 80 rules, and more, particularly, in the context of the settlement of working capital

\textsuperscript{10} Under the application rules contained in 1995, c. 21, s. 27, "was deductible" is replaced by "was deducted" with respect to interest accruing prior to July 14, 1990.
loans from third party financial institutions. The analysis in these cases will remain relevant under the new section 80 rules. See the discussion above under "Old Rule".

Repossessions and Other Seizures of Property

Sections 79 and 79.1 govern the tax consequences to a debtor or a creditor, respectively, where property is acquired by a creditor from a debtor as a consequence of the debtor's failure to pay a debt owed to the creditor. In very general terms, section 79 deems the debtor to have proceeds of disposition of the property equal to the aggregate of the unpaid principal amount and the unpaid accrued interest on such debt. Any subsequent payment by the debtor on such debt will, where the property was capital property, be treated as a repayment of assistance thereby triggering a capital loss under subsection 39(13). Comparable relief is provided were the property was an eligible capital expenditure, a resource expenditure, or other property. As with section 80, foreign exchange gains are excluded from section 79 and are therefore subject to the provisions of subsection 39(2).

The cost of the property to the creditor is, in general terms, the cost of the debt to the creditor, less the inclusions in such cost base which are reversed as a consequence of the acquisition of the property. Such latter adjustment applies to the extent of a reserve claimed in the immediately prior year under paragraph 20(1)(n) for inventory sales, under subparagraphs 40(1)(a)(iii) for sales of capital properties, or 44(1)(e)(iii) for replacement properties. By eliminating these reserves without an income inclusion, section 79.1 is reversing the income or gain recognized on the original sale which gave rise to the debt in question, and to this extent it is appropriate to reduce the creditor's cost of the debt and, ultimately, the acquired property. A comparable rule applies to reverse the consequences of the sale of capital property which is now being seized and
which was sold earlier in the same taxation year. In general terms, the creditor is deemed to have disposed of the debt at the time of the seizure for an amount equal to its adjusted cost base or cost amount, as the case may be.
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