The Joint Committee on Taxation of
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and The Canadian Institute of
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January 27, 2006

Mr. Brian E. Ernewein
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Tax Policy Branch
Department of Finance
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Dear Mr. Ernewein:

November 17, 2005 NWMM – Proposed Section 143.3

We are pleased to provide the enclosed submission for your consideration. The submission sets out the concerns and suggestions of the Joint Committee with respect to proposed section 143.3 of the *Income Tax Act* (Canada), as it applies to corporations. This provision is contained in a Notice of Ways and Means Motion tabled by the Minister of Finance on November 17, 2005.

The Joint Committee understands the concern that has given rise to proposed section 143.3. However, we do not think that the need for a rule of broad application has been demonstrated. Unless this can be done, we recommend that section 143.3 be restricted to the SR&ED investment tax credit rules.

The submission identifies a number of aspects of section 143.3 that are of concern to us. Principal among these are the use of paid-up capital in determining the amount by which expenditures are reduced, and the lack of any tax recognition when a corporation pays for property or services by issuing options to acquire its shares.

Our consideration of section 143.3 has caused us to also focus on problems with the determination of the cost of property in other circumstances, specifically where property is acquired by a corporation by way of contribution of capital or where it is distributed by a corporation on a reduction of capital. These problems are also discussed in the submission.

We trust you will find our comments and recommendations helpful. We believe that it would be fruitful to get together with you and other officials involved in this matter to discuss it further. Accordingly, we will contact you shortly to request a meeting.

Yours truly,

Paul B. Hickey, CA
Chair, Taxation Committee
Canadian Institute of Chartered Accountants

William R. Holmes
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cc: Kerry Harnish, Department of Finance
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Submission of the
CICA-CBA Joint Committee on Taxation
Regarding Proposed Section 143.3

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Submission of the CICA-CBA Joint Committee on Taxation Regarding Proposed Section 143.3

A. Introduction

This submission sets out the concerns and suggestions of the Joint Committee with respect to proposed section 143.3, as it applies to corporations. Section 143.3 is contained in a Notice of Ways and Means Motion (the "**NWMM**") tabled in the House of Commons on November 17, 2005. Our consideration of the proposed legislation has led us to also consider the cost of property that is contributed to a corporation as surplus, or that is distributed by a corporation on a reduction of capital. Accordingly, we have included comments and suggestions with respect to the determination of cost in those circumstances.

Statutory references in this submission are to the *Income Tax Act* (Canada) (the "Act), except as otherwise indicated. References to section 143.3 and its subsections, paragraphs, etc. are to the proposed provisions contained in the NWMM.

B. Finance's Concerns

The Minister of Finance has indicated that section 143.3 is being introduced in response to the Tax Court's decision in *Alcatel Canada Inc. v. The Queen*[1]. The issue in that case was whether stock option benefits conferred on employees qualified as expenditures for purposes of the scientific research and experimental development ("**SR&ED**") investment tax credit. Specifically, the Court was called upon to determine whether the amount by which the fair market value of shares issued under an employee stock option plan exceeded the price payable for the shares on the exercise of the option was an expenditure. The Court's conclusion was that such an excess amount did constitute an expenditure. In a Backgrounder to the Press Release announcing the new provision, the Minister stated that this result was not intended.

We understand that the Department of Finance ("**Finance**") is concerned not only with the specific result in *Alcatel*, but also with the Court's broad interpretation of the term "expenditure". Finance believes that other amounts also may be inappropriately regarded as expenditures for the purposes of the SR&ED investment tax credit. An example that has been given in discussions is the amount of a corporation's expenditure when property is acquired by the corporation on a subsection 85(1) rollover basis, where the corporation provides consideration equal to the fair market value of the property. The concern in that case is that the corporation may be considered to have made an expenditure equal to the fair market value of the property, rather than the agreed amount for the purpose of the subsection 85(1) election. We also understand that Finance's concern as a result of the *Alcatel* decision is not

[1] 2005 DTC 387 (TCC).

limited to the SR&ED investment tax credit rules. Finance believes there is a risk that other references in the Act to the term “expenditure”, and to analogous terms, also may be interpreted more broadly than intended. We understand that it is for these reasons that section 143.3 is broadly framed and is not limited to the SR&ED investment tax credit rules.

We note that the need for a broad-brush rule has not been demonstrated. In particular, Finance has not identified provisions, apart from the SR&ED investment tax credit rules, for which the interpretation risk exists. We suggest that Finance consider this further. If such other provisions cannot be identified, then we recommend that section 143.3 be restricted to the SR&ED investment tax credit rules so as to avoid the risk of unforeseen and unintended consequences.

C. Issuance of Shares for Property

1. Introduction

This part of the submission raises several concerns with subsection 143.3(3) as it applies where a corporation receives property as consideration for the issuance of shares and the shares are not issued as a result of the exercise of an option. We also have a concern with the exclusion rule in subsection 143.3(5).

Subsection 143.3(3) provides for a reduction in each “expenditure” (as defined in subsection 143.3(1)) of a corporation where the expenditure includes an amount because of the corporation (or a non-arm’s length corporation) having issued shares. The amount of the reduction is equal to the excess of the fair market value of the shares over the net increase in the paid-up capital of the class of shares (as determined for purposes of the Act) resulting from the receipt of the consideration for the shares. Pursuant to subsection 143.3(5), the reduction applies only if the expenditure includes an amount determined to be an excess under subsection 143.3(3).

Our principal concern is with the use of paid-up capital in determining the amount of the reduction under subsection 143.3(3). We understand that, in response to comments it has already received on this issue, Finance is considering certain modifications. Accordingly, we have included comments on the modifications that we believe are under contemplation.

We also have the following concerns, which are elaborated on below:

- The use of the fair market value of shares in determining the amount of a reduction could produce a reduction that is too large (or too small) in particular cases.

- It is unclear when subsection 143.3(5) applies.

- It is unclear when, if at all, subsection 143.3(3) would apply when shares are issued by a corporation that deals at non-arm’s length with the corporation that has made or incurred an expenditure.

Before describing our concerns in detail, we think it is useful to highlight three aspects of subsection 143.3(3).

First, subsection 143.3(3) is a provision that reduces the amount of an expenditure, rather than deeming it to be a specific amount. We assume that this approach has been adopted because an expenditure may reflect consideration in addition to the issued shares, or it may include acquisition costs. For example, if a corporation acquires land which it pays for by a combination of money and shares, the cost of the land will include the amount of money paid and also the legal fees, transfer taxes and any other costs of acquisition.

Second, technically subsection 143.3(3) is a series of rules, one for each type of amount referred to in the definition of "expenditure" in subsection 143.3(1), i.e., expense, expenditure, outlay, cost, and capital cost. More than one of these types of amounts may be relevant with respect to a property of a corporation. For example, where a corporation has acquired depreciable capital property, the "capital cost" of the property is used in the capital cost allowance rules, whereas the SR&ED rules refer to the "expenditure" of the corporation in respect of the property. In this example, the "capital cost" of the property may not include the excess referred to in subsection 143.3(3) (e.g., where subsection 85(1) has applied to the acquisition of the property), but the corporation's "expenditure" to acquire the property may include the excess. In this case, the subsection 143.3(3) reduction would apply with respect to the "expenditure" but not the "capital cost" of the property.

Third, subsection 143.3(3) applies to non-resident corporations, as well as corporations resident in Canada. The application of the provision to a non-resident corporation could have Canadian tax consequences if the property is taxable Canadian property that is not treaty exempt. The provision also may affect the determination of foreign accrual property income (FAPI) and amounts added to surplus accounts.

2. Use of Paid-Up Capital in Determining Amount of Reduction

(a) Concern

Subsection 143.3(3) appears to be based on the view that, if a corporation issues shares as full or partial consideration for property, the portion of the cost or capital cost of the property (as well as the corporation's expenditure or outlay to acquire the property) attributable to this form of consideration should not exceed the increase in the corporation's paid-up capital as determined for the purposes of the Act ("**tax PUC**"). Several people already have discussed with Finance officials the inappropriate results that can ensue from using tax PUC in this way. As they have noted, the fundamental purpose of tax PUC is to provide a basis for determining the extent to which certain corporate distributions should be considered a return of capital and hence should not be subject to deemed dividend treatment. That being the case, there is no apparent tax policy reason why tax PUC should be used in determining the cost of property acquired by a corporation. We understand that this concern has been acknowledged by Finance. Accordingly, we will not elaborate on it, but simply will note two of the examples that have been given:

- The transfer of property to an arm's length corporation ("Purchaseco") for low par value shares of the corporation.[2] Assume that (i) the parties agree on a purchase and sale price of $1 million, (ii) the transferred property has a fair market value of $1 million, and (iii) the consideration for the property consists of 1,000 shares of Purchaseco having a par value of $0.01 each and a fair market value of $1,000 each. The increase in Purchaseco's paid-up capital as determined for corporate law purposes ("**corporate PUC**") is $10, which also is the increase in its tax PUC. Pursuant to subsection 143.3(3), the cost of the property to Purchaseco would, therefore, be reduced from the agreed price of$1 million to $10.[3]

- The transfer of low-tax PUC shares of a corporation ("Aco") to another corporation ("Purchaseco") in circumstances where section 84.1 applies. Assume that the tax PUC and adjusted cost base ("**ACB**") of the Aco shares is $1, and that their fair market value is $200,000. The only consideration received by the transferor is common shares of Purchaseco, and no election is made under subsection 85(1) in respect of the transfer. The agreed purchase price for the shares is $200,000, and this amount is added to the corporate PUC of the Purchaseco common shares. In this situation, the tax PUC of the Purchaseco common shares would increase by $1. Thus, pursuant to subsection 143.3(3), the cost of the Aco shares to Purchaseco would be reduced to $1.

(b) Modifications Contemplated by Finance

We understand that, to address the concern with the use of tax PUC, Finance is considering the following modifications to section 143.3:

- As a general rule, the reduction in the amount of an "expenditure" (as defined) would be determined by reference to the amount that the corporation recognizes in its financial accounts as the value transferred to it for the issuance of the shares. The financial accounts for this purpose would include both stated capital (corporate PUC) and contributed surplus.

- Where accounting principles restrict the amount that is added to the financial accounts on the transfer of property within a corporate group, the reduction would be determined as if the restriction did not apply.

- If a specific provision of the Act, such as subsection 85(1) or 87(4), applies to establish the cost of a property, that cost will be used for each other type of "expenditure" (as defined) in respect of the property.

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[2] Jurisdictions that have par value shares include British Columbia and the state of Delaware.

[3] In the absence of subsection 143.3(3), the cost of the property to Purchaseco would be the $1 million purchase price, based on the Federal Court of Appeal's decision in *Teleglobe Inc. v. The Queen*, 2002 DTC 7517 (FCA). It appears that the CRA would agree that *Teleglobe* applies to produce this result: Document No. 2003-0048585, December 2, 2003.

Assuming that our understanding of the contemplated modifications is correct, we are concerned with the proposed reliance on corporate and accounting amounts to determine the maximum amount that may be included in an expenditure when shares are issued as consideration. From a tax policy perspective, we submit that any adjustment of expenditures should be based on the application of an appropriate principle, rather than on the amounts recorded in the financial records of a corporation (or amounts that would have been recorded if a non-arm's length transaction had been an arm's-length transaction). While the use of such amounts may, in many cases, produce an appropriate result, this would be because the amounts are determined in a manner that is also appropriate for the determination of expenditures.

To make this more concrete, assume that a corporation governed by the *Canada Business Corporations Act* ("CBCA") acquires property in an arm's length transaction and issues shares of a particular class as consideration for the property. Subsection 26(2) of the CBCA requires the corporation to add to the stated capital account for that class the "full amount" of the consideration received for the shares. For this purpose, the full amount of the consideration is generally thought to be the amount determined by the issuing corporation as the fair market value of the property acquired by it in consideration for the shares. Thus, the operative principle is that the fair market value of property acquired by a CBCA corporation is to be added to the corporation's stated capital account. If this is also the appropriate principle for determining the maximum amount to be included in a corporation's expenditure in respect of property when it issues shares as consideration for the property, then the rule in the Act should, we submit, specifically refer to the fair market value of the property. With such a rule, the amount recorded in a CBCA corporation's stated capital account when it acquires property would provide evidence of the fair market value, but would not be determinative of this amount.

Before a decision is made to use corporate and accounting amounts (or hypothetical accounting amounts, in the case of a non-arm's length transfer), it would seem to us that a review would have to be conducted of how these amounts are determined, to ensure that they are determined in a manner that makes them appropriate for use in limiting expenditures. Such a review would encounter some major hurdles. One is that the proposed limitation on expenditures is intended to apply not only to resident corporations, but also to non-resident corporations. Thus, the review would have to extend to a large number of jurisdictions in addition to Canada and its provinces. Another hurdle is that contributed surplus, as an accounting concept, may generally not be well-defined. Thus, it may not always be clear how much would be added to contributed surplus in particular situations. Moreover, the rules for determining corporate or accounting amounts in various jurisdictions may change from time to time. Hence, a rule based on such amounts would automatically track the changes, whether or not the result is still appropriate. Given these issues, we do not see how Finance could possibly satisfy itself that the use of corporate and accounting amounts is always appropriate. Furthermore, in assessing the suitableness of corporate and accounting amounts, Finance would have to have some standard in mind. That standard, we submit, should form the basis for the limitation of expenditures (assuming that the standard itself is appropriate).

With respect to the last modification listed above, we agree that where the cost of property to a corporation is established by a specific rule in the Act, such as subsection 85(1), that cost is the appropriate amount to use to limit the corporation's outlay, expenditure (in the ordinary sense of the term) or expense in respect of the property.

(c) Alternative to Finance's Modifications

In reflecting on what to suggest in place of the use of corporate PUC and contributed surplus, we have considered when it could happen that the cost of property determined under general principles (i.e., when a specific rule in the Act does not apply) would be excessive. It is not evident to us that this will ever be the case. Where the consideration for property acquired by a corporation consists solely of shares of the corporation, the cost of the property will be determined in accordance with the principle laid down by the Federal Court of Appeal in *Teleglobe*. The principle in that case is that the cost is to be determined by reference to the agreement of the parties to the transaction. If the parties do not deal at arm's length, paragraph 69(1)(a) will ensure that the cost does not exceed the fair market value of the property. Finance should not have any concern about the cost of property determined in this manner. Furthermore, where there is consideration for the property in addition to the shares, or where the corporation incurs transaction costs in acquiring the property, the reflection of these items in the cost of the property should not give rise to any issue.

The only situation we could think of that might potentially be of concern to Finance is where a period of time elapses between entering into a purchase and sale agreement and the issuance of the shares, and the shares increase in value during the period. However, in view of the *Teleglobe* decision, we think it is clear that the increase in value of the shares would not be reflected in the cost of the property.

We therefore question the need for subsection 143.3(3) to provide for a reduction in the cost of property where the cost is determined under general principles. Moreover, since the other amounts referred to in the definition of "expenditure" would almost certainly be determined in the same manner as the cost of property, we question the need for subsection 143.3(3) to reduce those amounts.

There is a further consideration that supports our view. Where the cost of property to a corporation is determined under general principles, it normally would be expected that the vendor's proceeds of disposition of the property would equal the cost to the corporation (before taking into account transaction costs). Thus, a reduction in the cost to the corporation, without a concomitant reduction in the proceeds to the vendor, would result in asymmetrical treatment that is clearly not appropriate from a tax policy perspective. For example, assume that a corporation acquires a capital property for a cost of $100, and that the cost is reduced to $80 under subsection 143.3(3). The vendor will have computed its capital gain using proceeds of $100. If the corporation later sells the property, and must compute its capital gain using a cost of $80, the result is that the value of the property between $80 and $100 will have been taxed twice (in the hands of two different taxpayers). We can see no justification for such a result.

If Finance continues to be of the view that there are circumstances where the cost of property (and the other amounts referred to in the definition of "expenditure") should be reduced when the cost is determined under general principles, then we suggest that the provision be limited to those circumstances. If Finance does not agree, and decides to maintain the current subsection 143.3(3) approach, then the base amount for calculating the reduction should be the same as in subsection 143.3(4) (i.e., the "amount of the consideration" that the corporation has received for issuing the shares). We can see no tax policy rationale for using a different base amount for corporations than is used for partnerships and trusts. Furthermore, if a cost reduction rule applies, there also should be a reduction in the vendor's proceeds of disposition.

3. Use of Fair Market Value of Shares in Determining Amount of Reduction

A further issue regarding subsection 143.3(3) relates to the use of the fair market value of shares in computing the amount of the reduction in an expenditure. Assuming that Finance introduces a different approach for adjusting expenditures where cost is determined under specific rules (as described above), the fair market value of shares will be used in computing reductions only when the cost of property is determined under general principles. The assumption underlying the use of fair market value seems to be that whenever an expenditure in respect of property is excessive, it is because the fair market value of the shares issued as consideration for the property (determined at the time of issue of the shares) has been included in the amount of the expenditure. Given the difficulty in identifying situations where the cost or other expenditure amounts determined under general principles may be excessive, we do not think it can be assumed that if there are any such situations, the excess amount of expenditure will exist because the expenditure includes the fair market value of the shares on the date of issue. Thus, in our view, subsection 143.3(3) potentially could reduce an expenditure by too much (or too little).

This issue would be avoided if the amount of the reduction were determined using, in place of the fair market value of shares, the amount actually included in an expenditure because of the corporation having issued shares.

4. Subsection 143.3(5) Exclusion

Subsection 143.3(5) provides that subsection 143.3(3) does not apply to reduce an expenditure if the expenditure does not include an amount determined under subsection 143.3(3) to be an excess. It is unclear how this exclusion is to be interpreted. Specifically, we do not know what is meant by the reference to an expenditure including an amount determined to be an excess. Will this be the case only if the amount included in the expenditure because of the issuance of the shares is equal to the fair market value of the shares at their date of issue? (If so, then the issue raised above regarding the magnitude of the reduction being inappropriate in some cases would not arise.) Alternatively, is it intended that an expenditure be considered to include an excess if the amount included in the expenditure because of the issuance of the shares exceeds the amount used as the base for determining the excess under subsection 143.3(3) (i.e., the amount in subparagraph 143.3(3)(a)(ii))? For example, assume that (i) the fair market value of shares issued as consideration for a property is $1,000, (ii) the amount used as the base amount to compute the excess under subsection 143.3(3) is $600, and (iii) the amount of the expenditure is $900. The excess is equal to $400 ($1,000 - $600). Is the exclusion intended to apply to this expenditure?

A further comment with respect to subsection 143.3(5) concerns the use of the words "for greater certainty" in the provision. We think it is unlikely that subsection 143.3(3) would be interpreted such that it applies to an expenditure only if the expenditure satisfies a condition in addition to the condition expressly stated in the subsection. In order to conclude that some expenditures are implicitly excluded from the application of subsection 143.3(3), a purposive approach would have to be applied to the interpretation of the subsection. However, as is well known, the courts generally apply a literal, textual approach to the interpretation of the Act. That being the case, we think that, as subsection 143.3(3) is currently drafted, subsection 143.3(5) is required in order to preclude its application where it should not apply. Thus, we submit that subsection 143.3(5) is not a "for greater certainty" provision.

Subsection 143.3(5) would not be required if the reduction in subsection 143.3(3) were determined in such a way that it equals the actual excess amount included in an expenditure.

5. Shares Issued by Non-Arm's Length Corporation

Subsection 143.3(3) applies when an expenditure of a corporation includes an amount because of the corporation, or a non-arm's length corporation, having issued shares. It is not apparent to us what situations Finance has in mind with the reference to shares issued by a non-arm's length corporation. If shares are issued by one corporation, when would another corporation be considered to have made or incurred an expenditure as a result?

It has been suggested by some practitioners that the non-arm's length part of the rule might be considered to apply in a situation such as the following.[4] Assume that Opco's issued share capital consists solely of common shares, all of which are owned by Holdco, and which have the following attributes: ACB of $1 million, fair market value of $3 million, and tax PUC of $100. As a preliminary step to a key employee acquiring shares of Opco, a freeze is implemented. In exchange for its common shares of Opco, Holdco receives preferred shares of Opco with a redemption amount of $3 million. Pursuant to paragraph 86(1)(b), the cost of the preferred shares to Holdco is $1 million (before the application of section 143.3(3)). The tax PUC of the preferred shares is $100. If subsection 143.3(3) applies as a result of the issuance of the preferred shares by Opco (which deals at non-arm's length with Holdco), the excess determined under paragraph 143.3(3)(a) would equal $2,999,900 (FMV of $3 million less tax PUC of the issued shares of $100). Consequently, the cost of the preferred shares to Holdco would be reduced to nil.

While we do not agree that subsection 143.3(3) would apply in this example – since we do not think it can be said that the cost of the preferred shares to Holdco includes an amount

[4] This example is based on section 143.3 as contained in the NWMM, i.e., it does not take into account the modifications that are being considered by Finance.

because of Opco having issued the shares – we think that the rules need to be clarified to remove any ambiguity.

D. Issuance of Shares for Services

Subsection 143.3(3) does not distinguish between the issuance of shares as consideration for property and the issuance of shares as consideration for services. We agree that the same principles should apply to the determination of the corporation's expenditures in either case. Thus, the comments and suggestions made above with respect to expenditures for property also apply with respect to expenditures for services (except to the extent that the comments and suggestions relate to cost, which only is relevant for property).

E. Options to Acquire Shares

Section 143.3 contains two rules that can apply where a corporation grants options for the acquisition of its shares. Pursuant to subsection 143.3(2), an expenditure of a corporation does not include any amount that would otherwise be included because of the corporation having granted an option. Subsection 143.3(3) applies if a corporation has issued shares as a result of the exercise of an option. It reduces any expenditure of the corporation that includes an amount because of the issuance of the shares. The amount of the reduction, determined under paragraph 143.3(3)(b), is equal to the excess of the fair market value of the shares over the net increase in the tax PUC of the class of shares resulting from the receipt of the option exercise price. Pursuant to subsection 143.3(5), the reduction applies only if the expenditure includes an amount determined to be an excess under subsection 143.3(3).

1. Subsection 143.3(2)

For simplicity, the following discussion refers to the situation where property is provided to a corporation as consideration for the granting of an option, and the only expenditure amount we refer to is the cost of the property to the corporation. However, the general point that is made also applies where the consideration for an option takes another form such as the provision of services, and where the expenditure amount is an amount other than cost.

As a consequence of subsection 143.3(2), a corporation will not have any cost for the property it receives as consideration for granting an option to acquire its shares. We submit that this is not appropriate from a tax policy perspective, since it results in the asymmetrical treatment of taxpayers. Where one taxpayer acquires property from another, the cost of the property to the acquiring taxpayer generally should equal the proceeds of disposition to the disposing taxpayer. The person who disposes of property to a corporation for an option will have proceeds from the disposition of the property equal to the fair market value of the option. The corporation should, therefore, have a cost equal to this amount, not a cost of nil.

The inappropriateness also can be seen in another way. If the optionholder exercises the option, the consideration paid for the option can be regarded, in substance, as forming part of the consideration paid for the shares. This is the principle that underlies paragraph 49(3)(b), which includes, in the cost of property acquired on the exercise of an option, the ACB of the option. Hence, the corporation should have a cost for the property as if the property had formed part of the consideration for the issuance of the shares. On the other hand, if the option is not exercised, the corporation will realize a capital gain by virtue of subsection 49(2) equal to the proceeds (i.e., the property) received by it for granting the option. This gain in respect of the property should be matched by a cost for the property.

Furthermore, it would be incongruous for property to have no cost to a corporation when the corporation provides consideration for the property, whereas if the property had been given to the corporation as a gift the property would have a cost equal to its fair market value. The fact that the corporation gives consideration (in the form of an option) should not result in an unfavourable tax result.

2. Paragraph 143.3(3)(b) Reduction

The reduction that is determined under paragraph 143.3(3)(b) where shares are issued as a result of the exercise of an option potentially is applicable with respect to both the consideration provided for the option and the consideration paid on the exercise of the option (the exercise price).   With respect to the consideration for the option, we can see the rationale for ensuring that the corporation's expenditure to acquire this consideration does not include any amount in respect of an increase in the value of the shares to which the option relates. For example, if a corporation receives land as consideration for granting an option to acquire its shares, and the shares increase in value before the option is exercised, we agree that the cost of the land should not include any amount attributable to the increase in the value of the shares. The acquisition of the land, and the subsequent exercise of the option, should be treated as independent transactions for the purpose of determining the cost of the land.

We have a concern, however, with the determination of the amount of the reduction under paragraph 143.3(3)(b). The same principle seems to underlie this reduction as underlies subsection 143.3(2), namely, that a corporation should not be allowed to recognize any expenditure in respect of the consideration it receives for granting an option. For the reasons stated above, we maintain that this principle is not appropriate from a tax policy perspective. If it is accepted that a corporation should be permitted to recognize an expenditure for the consideration provided to it for granting an option, a different approach needs to be used to ensure that the expenditure is not excessive. This could be achieved, for example, by a rule providing that, in determining an expenditure in respect of the granting of an option, there shall not be included any amount because of the issuance of shares as a consequence of the exercise of the option.

As it applies with respect to the consideration received on the exercise of an option, the reduction under paragraph 143.3(3)(b) essentially is the same as the reduction determined under paragraph 143.3(3)(a) where no option is involved. The only difference between the two paragraphs is a technical one: paragraph (a) refers to the consideration for issuing the shares, whereas paragraph (b) refers to the amount paid pursuant to the option for issuing the shares. In substance, the same amount is determined under both paragraphs. Thus, the concerns expressed above with respect to subsection 143.3(3) are equally applicable where the subsection applies with respect to the consideration received as a result of the exercise of an option.

F. Further Issues re Cost of Property

In the course of considering section 143.3, we have identified issues relating to the cost of property acquired by a corporation or distributed as a reduction of capital. We would urge Finance to introduce legislative changes to address these issues in conjunction with a revised version of section 143.3.

1. Par Value Shares

In *Tuxedo Holding Co. Ltd. v. MNR*,[5] the Exchequer Court held that the cost of land to a corporation was equal to the par value of the shares issued as consideration for the land. This resulted in a cost that was substantially less than the appraised value of the land. We think that the Federal Court of Appeal decision in *Teleglobe* has superseded *Tuxedo Holding* in situations where a corporation issues shares as consideration for the acquisition of property and the parties have agreed to a price for the property. However, where the parties have not agreed to a price, the principle in *Tuxedo Holding* may continue to apply

From a tax policy point of view, we do not think that the use of par value to establish cost is appropriate. We submit that it should not make any difference to the determination of the cost of property whether or not the shares issued as consideration are par value shares. For this reason, we request that a provision be introduced to override *Tuxedo Holding*. It could provide, for example, that the cost to a corporation of property acquired in consideration for shares of the corporation is to be determined without regard to whether the shares are par value shares.

2. Contributions and Reductions of Capital

The question of the appropriate cost to a corporation of property also arises where property is contributed to a corporation with no shares being issued. The CRA has taken the position that property contributed by a shareholder does not have a cost to the corporation (Document No. 2001-0103315, dated January 22, 2002, and Document No. 922723A, dated December 7, 1992). In particular, in those technical interpretations the CRA rejected the view that the contribution of capital should be regarded as a gift and so paragraph 69(1)(c) should apply. The CRA did not regard the contribution as a gift, since it increased the value of the shareholder's shares.

We submit that this result is not appropriate from a tax policy perspective. In most cases, the contributor will be a person who does not deal at arm's length with the corporation, and so will be deemed to have received proceeds of disposition equal to the fair market value of the property. We think it is a basic principle of taxation that there should be symmetrical treatment of the transferor and transferee. There can be no tax policy reason for the property to have a nil cost to the corporation.

[5] 59 DTC 1102 (Ex. Ct.)

The Act contains deeming rules applicable to property distributed by a corporation on its winding-up. Subsection 69(5) deems the corporation to have disposed of the property for fair market value proceeds, and the recipient shareholder to have acquired the property at a cost equal to this amount. We submit that a similar rule should apply when property moves in the opposite direction, namely from a shareholder (or other taxpayer) into a corporation. Thus, we recommend that such a rule be added to the Act.

The distribution of property by a corporation on a reduction of its capital is another situation where this cost issue exists. Subsection 69(4) generally will deem the corporation to have disposed of the property for fair market value proceeds. However, there is no rule that gives cost to the recipient of the property. While the CRA has ruled a number of times that the cost of property distributed on a reduction of capital equals the fair market value of the property, we recommend that a rule be added for certainty and to eliminate the need to obtain advance tax rulings on the point.

G. Money

In theory, the cost issues discussed above arise even when the property that is transferred to, or distributed by, a corporation consists of money. In this regard, we are not aware of any rule or principle that would exclude money from the application of the general capital gains rules. In particular, the Act defines property to include money, unless a contrary intention is evident. The only indication we have found in the capital gains rules that they are not intended to apply to money is the fact that the cost rule for dividends in subsection 52(2) is limited to dividends in kind. It is hard to conclude from this fact alone that there is an evident contrary intention that, for capital gains purposes, property does not include money.

We should clarify that by "money" we mean the various forms of property that money can take. This includes cheques and other instruments used as a means of payment, as well as amounts owed by financial institutions that are regarded as money, e.g., the balance in a chequing account. Where, for example, a monetary contribution of capital is made, the property received by the corporation may consist of a cheque, or it may be the increased balance in its chequing account (if the contributor has given instructions directly to a financial institution to transfer an amount to the corporation's account).

We suggest that a rule be added to the Act clarifying that the capital gains rules do not apply to money, with the exception of the foreign currency gain or loss rule in subsection 39(2).