

Taxation of a Group of Companies

Consolidated tax returns for groups of related companies are not permitted in Canada. As a result, losses incurred by an individual corporation within a corporate group (that is, within a family of a group of companies under common ownership and control) cannot be offset against the profits of other corporations of the same group (there are exceptions in the case of corporate reorganization – liquidation of a subsidiary into a parent company or an amalgamation of corporations). Losses incurred by a corporation within a group can only be offset against prior or subsequent profits of the corporation. For some corporations, losses may never be utilized.

The Conference Board of Canada in its report “Barriers to Rebuilding: Structural Irritants for Reorganization Transactions” stated: “the lack of consolidated tax returns, even the lack of rules, for consolidating corporate tax losses within a related group of companies means that corporate groups have to undertake significant internal reorganizations in order to calculate and put a dollar figure on the tax losses available within their group. Not only that, but moving non-capital losses within a related group of corporations is a very complex procedure and involves transaction costs: for instance, the absence of provisions for loss transfers in the *Income Tax Act* requires companies to use losses through indirect means such as intercompany loans or internal reorganizations to move assets around.”

The fact that Canada’s tax system taxes corporations on a separate entity basis may stifle innovation, the very activities the government is trying to stimulate. In many cases, Canadian companies are compelled to structure their business into a number of subsidiary holdings for reasons of legal liability, financing, to minimize risk and to maximize flexibility and creativity. Canada’s separate entity taxation system renders Canadian companies less competitive than their foreign counterparts.

More than two-thirds of OECD member-countries now offer group taxation. Canada is the only country within the G-7 with no tax consolidation regime.

Since the tax system in Canada does not expressly permit loss consolidation in a corporate group, various techniques have been used to transfer losses within a group of affiliated corporations. For example, a company in a loss position can lend money at interest to a profitable affiliate which, in turn, invests in preferred shares of the loss company. The profitable affiliate uses the interest expense on the borrowing to reduce its taxable income under paragraph 20(1)(c) of the *Income Tax Act*. Canada Revenue Agency (CRA) has confirmed that this type of planning is acceptable. CRA, however, draws a distinction between “in-house loss utilization” (shifting and utilizing net operating losses where effected through the use of inter-company loans within affiliated corporate groups) which is acceptable, and “external loss transfers” which CRA has stated that it will use “every available tool” to challenge. While CRA’s policy of accepting certain forms of loss consolidation within a related group of companies works in many situations, it has high administrative costs, business risks and creates timing issues.

The Technical Committee on Business Taxation in its December 1997 Report recommended that the government undertake a thorough review of loss transferability and restrictions on loss carry-over to see if the rules could be changed to reduce administration and compliance costs. In particular, the Committee concluded that the

tax system should provide a more straightforward means of transferring losses within a group of companies with common ownership.

The Technical Committee on Business Taxation also recommended that the federal government review the Department of Finance's 1985 Discussion Paper (*A Corporate Loss Transfer System in Canada*) which acknowledged that there are problems with current loss utilization techniques (specifically, legal and accounting costs, administration and compliance costs, and uncertainly associated with the utilization of tax planning techniques) and argued that a group reporting system would:

- Improve the equity and neutrality of the income tax system as between economic entities;
- Enhance the response of business to tax incentives provided by the federal government; and
- Increase the freedom of managers of business organizations to structure business operations in the most desirable way from a business point of view with less concern about adverse or uncertain income tax consequences.

In summary, the ability to transfer losses to other corporations within the group would reduce administrative and compliance costs, increase cash flow within the corporate group, simplify Canada's corporate tax system and make Canadian business more competitive. However, because tax consolidation raises provincial tax issues and impacts provincial government revenues, the Advisory Panel on Canada's System of International Taxation recommended that the federal government work with provincial/territorial governments to consider how a tax consolidation system could operate in Canada.

Recommendations

That the federal government, in consultation with the provinces and territories:

1. Develop a formal system (including the possibility of consolidated tax returns) for transferring losses between members of the same corporate group with a defined common ownership.
2. That under this formal system:
 - Loss transfer is available for non-capital losses, capital losses, unused annual deductions and available tax credits.
 - Losses are offset against all forms of corporate income and across different lines of business.
 - Losses, deductions and credits not utilized in a given year are available in future years subject to similar limitations as presently exist in the Income Tax Act.