Tax Notes

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INCOME TAX LEGISLATION

Two Bills Receive Royal Assent

The House of Commons has adjourned for the holidays until January 28, 2013. The Senate has also adjourned and will return on February 5, 2013. On December 14, 2012, the following Bills amending the *Income Tax Act* received Royal Assent:

- Bill C-45, the *Jobs and Growth Act, 2012*, is law as S.C. 2012, c. 31. It implements 2012 Budget proposals and measures related to pooled registered pension plans (CCH *Special Report* No. 067H).
- Bill C-44, the *Helping Families in Need Act*, is law as S.C. 2012, c. 27. It amends the *Labour Code* and the *Employment Insurance Act* and makes consequential amendments to the *Income Tax Act* and Regulations.

Bill C-377

On December 12, 2012, Bill C-377, *An Act To Amend the Income Tax Act (requirements for labour organizations)*, was passed by the House of Commons and on December 13, 2012, received first reading in the Senate. This Private Member's Bill would add new section 149.01 to the *Income Tax Act*. This requires every labour organization and labour trust to file with the Minister of National Revenue an information return that contains financial statements (including a balance sheet and an income statement) and numerous other statements detailing transactions and investments. The contents contained in the information return would be made available to the public on the Canada Revenue Agency's website.

Other Income Tax Legislation Not Enacted

The other federal income tax legislation that is outstanding is listed below.

- Bill C-48, *Technical Tax Amendments Act, 2012* (first reading in the House of Commons on November 21, 2012), implements numerous technical amendments, certain 2010 Budget proposals, and other measures (CCH *Special Report* No. 068H);
- July 25, 2012 — Draft legislation regarding stapled securities; the instalment rules for SIFT trusts and SIFT partnerships; and withholding tax on amounts that are payable from a Canadian-resident trust to a non-resident beneficiary, which are paid after the trust ceases to be a Canadian resident;
- June 8, 2012 — Draft legislation regarding changes required to improve the caseload management of the Tax Court of Canada;

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- November 9, 2006 — The amendments from former Bill C-10, Part 2, relating to the Canadian Video Production Tax Credit; not included in the July 16, 2010 draft legislation, but the Department of Finance announced that they would be reintroduced at a later date (CCH *Special Report* No. 021H); and
- October 31, 2003 — Draft legislation concerning the deductibility of interest and other expenses related to a source (CCH *Special Report* No. 006H).

INDEXED AMOUNTS FOR 2013

On December 12, 2012, the Canada Revenue Agency (the "CRA") released a Fact Sheet setting out the federal 2013 personal tax bracket thresholds and amounts and thresholds pertaining to personal tax credits. The Fact Sheet stated that the federal indexation factor for 2013 is 2%. This figure was reported in *Tax Notes* No. 599, along with the indexing factors for the provinces as set out in the CRA guide T4127-JAN, Payroll Deductions Formulas for Computer Programs — 96th Edition — Effective January 1, 2013.

The following chart lists the federal indexed amounts for 2012 and 2013. Generally, the increased amounts take effect as of January 1. However, increases to the Canada Child Tax Benefit (including the National Child Benefit Supplement and the Child Disability Benefit) and the Goods and Services Tax Credit take effect as of July 1. The Fact Sheet does not list the indexed amounts relating to the Working Income Tax Benefit in subsections 122.7(2) and (3).

	2013 ($)	2012 ($)
Tax bracket thresholds		
Taxable income above which the 22% bracket begins	43,561	42,707
Taxable income above which the 26% bracket begins	87,123	85,414
Taxable income above which the 29% bracket begins	135,054	132,406
Amounts relating to non-refundable tax credits		
Basic personal amount	11,038	10,822
Age amount	6,854	6,720
Net income threshold	34,562	33,884
Spouse or common-law partner amount (maximum)	11,038	10,822
Spouse or common-law partner amount (maximum if eligible for the family caregiver amount)	13,078	12,822
Amount for an eligible dependant (maximum)	11,038	10,822
Amount for an eligible dependant (maximum if dependant eligible for the family caregiver amount)	13,078	12,822
Amount for children under age 18 (maximum per child)	2,234	2,191
Amount for children under age 18 (maximum per child eligible for the family caregiver amount)	4,274	4,191
Canada employment amount (maximum)	1,117	1,095
Infirm dependant amount (maximum per dependant)	6,530	6,402
Net income threshold	6,548	6,420
Caregiver amount (maximum per dependant)	4,490	4,402
Caregiver amount (maximum per dependant eligible for the family caregiver amount)	6,530	6,402
Net income threshold	15,334	15,033
Disability amount	7,697	7,546
Supplement for children with disabilities (maximum)	4,490	4,402
Threshold relating to allowable child care and attendant care expenses	2,630	2,578
Adoption expenses (maximum per adoption)	11,669	11,440
Medical expense tax credit — 3% of net income ceiling	2,152	2,109

Refundable medical expense supplement		
Maximum supplement	1,142	1,119
Minimum earnings threshold	3,333	3,268
Family net income threshold	25,278	24,783
Old age security repayment threshold	70,954	69,562
Certain board and lodging allowances paid to players on sports teams or members of recreation programs		
Income exclusion (maximum per month)	335	329
Tradesperson's tools deduction		
Threshold amount relating to cost of eligible tools	1,117	1,095
Goods and services tax/harmonized sales tax credit		
Adult maximum	265	260
Child maximum	139	137
Single supplement	139	137
Phase-in threshold for the single supplement	8,608	8,439
Family net income at which credit begins to phase out	34,561	33,884
Canada child tax benefit		
Base benefit	1,433	1,405
Additional benefit for third child	100	98
Family net income at which base benefit begins to phase out	43,561	42,707
National child benefit (NCB) supplement		
First child	2,221	2,177
Second child	1,964	1,926
Third child	1,869	1,832
Family net income at which NCB supplement begins to phase out	25,356	24,863
Family net income at which NCB supplement phase-out is complete	43,561	42,707
Canada disability benefit (CDB)		
Maximum benefit	2,626	2,575
Family net income at which CDB supplement begins to phase out	43,561	42,707
Children's special allowances (CSA)		
CSA Base Amount	3,654	3,582
Tax-Free Savings Account (the indexed amount has been rounded to the nearest $500)		
Annual TFSA dollar limit	5,500	5,000

FOCUS ON CURRENT CASES

This is a regular monthly feature examining recent cases of special interest, coordinated by *John C. Yuan* and *Christopher L.T. Falk* of McCarthy Tétrault LLP. The contributors to this feature are from McCarthy Tétrault LLP, Montreal, Toronto, Calgary, and Vancouver.

Facts and Assumptions To Be Pleaded by the Minister

***O'Dwyer v. The Queen*, 2012 DTC 1215 (Tax Court of Canada)**

The *O'Dwyer* decision provides a helpful reminder: facts and assumptions, rather than arguments, evidence, and conclusions of law, are the elements to be pleaded by the parties in their pleadings. In this case, the Court struck the Minister's Reply in its entirety because of the failure of the Minister to plead the facts and assumptions necessary to establish the elements supporting the assessment.

In this case, the Minister had assessed the taxpayer and imposed a tax shelter penalty pursuant to subsection 237.1(7.4) of the *Income Tax Act* (the "Act"). The taxpayer appealed the assessment to the Tax Court. Following the taxpayer's Notice of Appeal, the Minister filed a Reply, following which the taxpayer brought a motion to strike the Minister's Reply pursuant to paragraph 58(1)(*b*) of the *Tax Court Rules*. In the alternative, the taxpayer asked the Court to strike out certain portions of the Reply as an abuse of process in accordance with paragraph 53(*c*) of the Rules. The particular portions of the Reply in issue for these purposes included the following:

(a) paragraph 11(r), which stated that:

SRLP made statements or representations that would cause an investor to believe that the loss that would be deductible in respect of their [*sic*] partnership interest would exceed the cost to the investor of the partnership interest less the value of the investor's promissory note;

(b) paragraph 18, which stated that:

The Appellant is liable for a penalty because he acted as a principal or agent to sell, issue or accept consideration in respect of the SRLP tax shelter before the Minister issued a tax shelter identification number, pursuant to subsection 237.1(7.4) of the Act.

As a final alternative, the taxpayer sought an order of the Court requiring that the Minister provide particulars in respect of paragraph 11(r) as to each statement or representation that the Minister assumed was made.

The Court considered first the request to strike the Reply *in toto*, since its outcome would determine the need to address any of the alternative relief sought.

Based upon the Federal Court of Appeal's decision in *Baxter v. The Queen*, 2007 DTC 5199 (FCA), Mr. Justice Bocock indicated that a tax shelter exists where:

(1) property is offered for sale to prospective purchasers (the "Property Element");

(2) statements or representations have been made or proposed in connection with the property describing the loss in excess of the cost (the "Statement Element"); and

(3) in respect of the Statement Element, it may be reasonably considered that the loss will exceed the cost within four years, all in accordance with the formula contained in subsection 237.1(1) (the "Calculation Element").

The Court also noted that once each individual tax shelter element is established, a tax shelter penalty may be imposed against the assessed party if the party "as a principal or as an agent sells, issues or accepts consideration in respect of a tax shelter before the Minister has issued an identification number" (the "Role Element").

Bocock J noted that the Minister referred in the Reply to a limited partnership ("LP") as being the tax shelter in question in this case. In respect of this position, the Court referred to *Madsen v. The Queen,* 2001 DTC 5093 (FCA), as setting out the legal character of a partnership within the context of the Act. Based upon *Madsen*, the Court found that it was clear that a partnership was not property for the purposes of the Act. Therefore, with respect to the Property Element, the Court concluded that an LP could not be a tax shelter within the definition of the Act since it is not a property. In respect of this issue, the Court noted that the Minister had not, although the matter was drawn to counsel's attention, requested leave to amend the pleadings in order to instead refer to the LP units as the "property" rather than the LP itself.

In addition, the Court found that "the Minister's Reply pleadings in respect of the Statement Element and Calculation Element of the Penalty are lacking in a level of factual specificity and disclosure" necessary to allow the taxpayer to meet his case.

Similarly, paragraphs 11(r) and 18 did not, according to Bocock J, disclose sufficient material facts to establish the Role Element which the taxpayer could reasonably identify and point out in the Minister's pleadings in order for the taxpayer to be able to properly attempt to demolish the facts establishing the legal elements of the penalty.

The Court noted that authorities like *Johnston v. Minister of National Revenue,* (1948) 3 DLR 1182 (SCC), *Continental Bank of Canada v. The Queen,* 98 DTC 6501 (SCC), *Anchor Pointe Energy Ltd. v. The Queen,* 2003 DTC 5512 (FCA), and *Loewen v. The Queen,* 2004 DTC 6321 (FCA), provide direction to the Crown that "Reply pleadings must provide the Appellant with a clear and unequivocal map to the sequence, detail, depth and chronology of the facts assumed by the Crown".

In summary, the Court came to the conclusion that the Minister had failed to plead sufficient facts and assumptions which would otherwise comprise the legal elements necessary to establish the penalty. Specifically, Bocock J concluded that:

> (1) an LP could never legally be "property" within the definition of a tax shelter;
>
> (2) the Reply did not contain specific, precise, or clear factual allegations and/or assumptions needed to establish statements and representations made by the taxpayer in respect of the property offered for sale;
>
> (3) the Reply did not contain direct or inferred facts or allegations concerning the sufficiency of the calculations and quantum of the losses in excess of the cost within the threshold formulae described in subsection 237.1(1) of the Act; and
>
> (4) the Reply failed to factually assert facts relating to the capacity or acts of the taxpayer in the sale, issuance, or acceptance of consideration in respect of the alleged tax shelter.

The *O'Dwyer* decision is a reminder that the ability of the Minister to make "assumptions" that the taxpayer must disprove, failing which the assumptions will be treated as fact, gives rise to a significant advantage to the Minister which could be abused. However, as confirmed by the Court, the Minister's assumptions must be pleaded, unlike evidence or conclusions of law. As this decision is under appeal, it will be interesting to see the Federal Court of Appeal's comments on this issue.

— *David Roulx*

Alberta Court of Appeal Upholds Crown Prerogative to Priority of Payment Among Claims of Equal Degree under the Civil Enforcement Act

***Liberty Mortgage Services Ltd. v. The Queen*, 2012 DTC 5134 (Alberta Court of Appeal)**

The Alberta Court of Appeal in *Liberty Mortgage Services* found that a writ filed by the federal Crown for unpaid taxes under the *Income Tax Act* (the "Act") had priority over the claims of other creditors of equal degree. Generally, section 99 of the Alberta *Civil Enforcement Act* ("CEA") sets out a priority scheme for the distribution of a debtor's assets, including amounts outstanding on all writs in force against a debtor. Paragraph 99(3)(*e*) provides that, where the amount of all claims against the debtor exceeds the assets available for distribution, priority will be given over general creditors to "eligible claims that by virtue of any other enactment or law in force in Alberta *are entitled to priority over the eligible claims of enforcement creditors generally*" (emphasis added). In the absence of any such priority, paragraph 99(3)(*g*) provides that equally situated creditors must share in the distributable assets *pro rata*. The essential question in this case was whether, after registering a writ under the CEA, the federal Crown's common law prerogative to priority of payment among equally ranked claims is preserved by paragraph 99(3)(*e*), or rather whether the federal Crown would be required to share *pro rata* under paragraph 99(3)(*g*).

The decision involved a debtor who had defaulted on his mortgage. His defaulted lands were sold in a foreclosure action. Less costs of the action, a balance of approximately $64,000 was paid into court for distribution to the debtor's creditors. The applicant, the federal Crown, had registered a writ against the mortgaged lands for unpaid taxes under the Act. The respondents, Liberty Mortgage Services Ltd. and DJ Will Holdings Limited ("Respondents") had registered writs in respect of amounts owed to them. The balance of $64,000 was insufficient to satisfy both the Crown's and the Respondents' claims in full.

The Crown applied to the Court of Queen's Bench for an order granting it priority to the funds paid into court in reliance on the "Crown prerogative to priority of payment among claims of equal degree", a common law entitlement that has been recognized by a number of Canadian courts, including the Supreme Court of Canada in its 1979 decision in *Household Realty Corp. v. Canada (Attorney General)*, [1980] 1 S.C.R. 423. The Respondents contested the application and argued that the Crown was required to share with them *pro rata*.

The Crown's application was dismissed by a Master in reasons reported at *Royal Bank of Canada v. Samra*, 2010 ABQB 699. An appeal by the Crown to the Court of Queen's Bench was also dismissed in reasons reported at 2011 ABQB 556. The Master and the Court of Queen's Bench agreed that the federal Crown may waive its general immunity from the application of provincial legislation (such as the CEA) if it seeks to rely upon the benefits of such legislation. The test for establishing such a waiver is called the "benefit/burden test". If it is established that the federal Crown is seeking the benefit of relying on a particular provincial statute, it must also accept the burden of complying with its provisions. In this case, both the Master and the Court of Queen's Bench found that, in filing writs of execution

pursuant to the CEA, the federal Crown became bound by the requirement to share *pro rata* under paragraph 99(3)(*g*) of the CEA. The Crown appealed further to the Alberta Court of Appeal.

The Crown argued that the Master and the Court of Queen's Bench had misinterpreted the CEA and misapplied the benefit/burden test. It argued that its common law priority was preserved by virtue of paragraph 99(3)(*e*) of the CEA (which the lower court did not refer to in its reasons), which granted priority to "eligible claims that [have priority] by virtue of any other enactment or law in force in Alberta". Its common law priority, the Crown argued, is a "law in force in Alberta" that had not been expressly overruled by validly enacted legislation.

The Respondents argued that the appeal should be dismissed. They relied on the Alberta Court of Appeal's 1988 decision in *Royal Bank v. Black & White Developments Ltd.*, 88 A.R. 340. In *Black & White*, the Court of Appeal had found that the provincial Crown (the Crown in right of Alberta) had waived its common law prerogative to priority by filing a writ of execution pursuant to the *Execution Creditors Act*, the predecessor statute to the CEA.

Madam Justice Paperny, writing for a unanimous court (Justices Slatter and O'Ferrall concurring), reversed the decisions of the lower court and found in favour of the Crown.

The Court found that the Crown's prerogative to be paid before other creditors of equal degree is a common law entitlement "in force in Alberta". As such, it is preserved by the wording of paragraph 99(3)(*e*) of the CEA *vis-à-vis* creditors of equal degree. Since the Respondents' claims were equally situated to the Crown's, paragraph 99(3)(*e*) provided a full answer, and there was no need for the Court to consider the lower court's application of the benefit/burden test for the purposes of granting the appeal.

In response to the Respondents' reliance on the *Black & White* case, the Court suggested that the conclusions reached in that decision were no longer appropriate. In this regard, it relied on decisions reaching opposite conclusions in Ontario (*Re Marten* (1981), 34 O.R. (2d) 399 (Ont. Div. Ct.)) and Saskatchewan (*Farley v. Bradley* (1991), 87 D.L.R. (4th) 178 (Sask. C.A.)).

More importantly, the Court found that its decision in *Black & White* was rendered moot through the repeal of the *Execution Creditors Act* under which it was decided and the subsequent enactment of the CEA in 1994. The Court relied on the 1991 report of the Alberta Law Reform Institute, the recommendations in which led to the drafting and ultimate passage of the CEA. The Institute had turned its attention to the issue of the Crown's prerogative to priority and concluded that statutory priority schemes requiring *pro rata* distribution should bind the Crown only where the Crown debt does not have priority "by virtue of statute or crown prerogative". The Court found that the Legislature intended to give effect to the Institute's recommendations in paragraph 99(3)(*e*) of the CEA.

In the result, the federal Crown's claim for unpaid taxes under the Act was found to have statutory priority over equally ranked claims of the Respondents.

While the decision is binding only in Alberta, it should be noted by creditors across the country. The Court of Appeal's interpretation of the CEA as preserving the Crown's prerogative to priority suggests that direct and clear wording to the contrary in a statutory distribution scheme would be required to displace the Crown's common law entitlement. While in some ways the *Liberty Mortgage Services* decision simply brings Alberta jurisprudence into line with that of Ontario and Saskatchewan, creditors may nevertheless wish to review the sufficiency of their security in light of the Court's confirmation of the Crown's "prerogative".

— *Mark Firman*

Deductibility of Luxury Goods Purchased by a Parent for Her Children in Lieu of Cash Wages

***Bruno v. The Queen*, 2012 DTC 1260 (Tax Court of Canada — Informal Procedure)**

In *Bruno*, the Tax Court allowed the value of "luxury items" purchased by the taxpayer for her two children (in lieu of cash wages) to be deducted in computing her income from a business. The central question in this case was whether the deduction should be disallowed because of paragraph 18(1)(*h*) of the *Income Tax Act*, which precludes deductions for "personal or living expenses of the taxpayer . . .".

The appeal concerned the 2007 and 2008 tax years. During this time, the taxpayer operated a window business called "Shades N Shutters". Her two children worked for the business on certain weekends and holidays for wages payable at a rate of between $10 and $12 per hour. While the taxpayer tracked the wages owed to her children, Shades N Shutters never issued any paycheques. Instead, the taxpayer paid for some of the children's personal

expenditures, which the taxpayer characterized as "luxury items", in an amount equal to the wages that they had earned. These expenditures totalled $18,000 for 2007 and $7,000 for 2008. The taxpayer testified that although she had the power to veto any of her children's purchases, she usually approved them.

The Minister disallowed the deductions in their entirety.

The Crown argued before the Tax Court that the expenditures were not deductible because they were "personal or living expenditures" of the taxpayer and the children, which are not deductible pursuant to paragraph 18(1)(*h*). Furthermore, the Crown argued that the expenditures were not deductible because the children did not have sufficient discretion over what purchases they could make. In this regard, the Crown relied on the Tax Court's decision in *Bradley* (2006 DTC 3535), in which the Court ruled that, in order for wages payable to a parent's child to be deductible, "payment must be made and deposited as it would be to a stranger. The payee must receive and control the alleged payment in his or her name and be able to use it for his or her benefit without any further control by the payer". Importantly, the Crown in *Bruno* never disputed that the amount of the wages earned by the children was reasonable.

The taxpayer testified that the expenditures for luxury items were not personal because she would not have purchased such items unless the children had "earned" the money to pay for them. The taxpayer also stated that she had relied on the advice of her accountant, who had told her that she could not deduct expenditures for the children's "basic needs", but could deduct expenditures for "luxury items" beyond these needs.

The Tax Court (per Woods J) allowed the appeal, but reduced the amount of the deduction by 50%.

The Court's reasons were short. It rejected the Crown's argument that the expenditures were not deductible because the taxpayer could control what the children purchased. The Court did not consider itself bound by the *Bradley* decision on which the Crown relied, since *Bradley* was decided under the Informal Procedure.

Therefore, the sole remaining question was whether the expenditures in issue were for "personal or living expenses". The Court found that the items purchased had both business and personal elements. However, the Court relied on the Supreme Court of Canada's decision in *Symes v. The Queen* (94 DTC 6001) and concluded that the mixed nature of the expenditures did not by itself preclude deductibility. In *Symes*, the majority found that expenditures with both business and personal elements could still be deductible as long as they were incurred "for the purpose of gaining or producing income from a business".

Nevertheless, despite this favourable finding on the deductibility of the value of luxury items, the Court did not fully allow the taxpayer's appeal. Instead, it found the taxpayer's evidence of the character of the specific purchases claimed to be self-serving and deficient. Given this unreliability, the Court concluded that it could accept that only some of the items in issue were in fact "luxury items" for the children's benefit. Accordingly, relying on the relaxed rules of evidence under the Informal Procedure, the Court held that it was appropriate in these circumstances to make a rough estimate and reduced the available deduction to 50% of the expenditures claimed. It is unclear from the Court's reasons whether there was a specific basis for the 50% figure or whether it was arbitrary.

The decision underscores the importance of maintaining sufficient records to support deductions, particularly in the case of dependants who also work as employees of a family business.

— *Mark Firman*

CONTRIBUTION LIMIT FOR TAX-FREE SAVINGS ACCOUNTS INCREASED FOR 2013

On November 26, 2012, the Department of Finance and the Canada Revenue Agency announced that for 2013, the limit for contributions to a tax-free savings account ("TFSA") has been increased to $5,500 from $5,000 for previous years. The TFSA contribution limit was set at $5,000 when the program was introduced in 2009. As set out in the definition of "TFSA dollar limit" in subsection 207.01(1) of the *Income Tax Act*, the 2009 amount is subject to indexing in increments rounded to $500. 2013 is the first year that the indexation since 2009 has reached the first $500 increment.

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