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Tax Notes

August 2007
Number 535

Mr. Flaherty, Tear Down These Rules

July 30, 2007

Mr. James Flaherty
Department of Finance
Ottawa, Canada

Dear Mr. Flaherty:

Re: FIE Proposals

I am writing to you from Maui, where I spend a good chunk of the summer. I work in the mornings and then take advantage of the six-hour time difference from Toronto to spend most afternoons windsurfing. This regimen has a way of putting things in perspective, including – believe it or not – our country's international tax policy. Actually, that's why I'm writing. I would like to invite you to come to my windsurfing beach – maybe you might pick up some pointers.

I'm sure you're wondering what in the world windsurfing has to do with international tax policy? You see, Mr. Flaherty (may I call you Jim?), most people on my windsurfing beach are barely aware that Canada exists. There are only a few of us here, dwarfed by legions of Japanese, Europeans, and of course Americans. Worse still, I'm in constant peril of being bumped into by one of the Japanese windsurfers – they're very competitive and aggressive. So here's my point: Just like on my windsurfing beach, international business can be tough competition for Canadian business people – they need all the help they can get! A smallish country like Canada should be structuring its international tax laws to encourage Canadian competition abroad.

Inside

Jim, I'd like to bend your ear about one pretty flagrant example: the foreign investment entity ("FIE") proposals in Bill C-33, which passed through the House of Commons last month with only minor changes. My impression is that not many tax advisors have had an opportunity to go into the proposals in detail, so you probably haven't received many letters on them. But I have seen enough of them to realize that they are a morass of complexity that may seriously hamper international investment by Canadian businesses.

After numerous rounds of revisions, the FIE proposals are top-heavy with complexity, often bordering on the nonsensical. Here's an irony: a major rationale for the rules was to deal with offshore mutual funds and the like. As the original legislation featured a hard-to-enforce test as to whether there was a tax-avoidance motivation for making the investment, the complex new rules were introduced. Several rounds of revisions later, we found that similar motivation tests were reinstated for many or most of these sorts of investments – along with page after page of fine print, having nothing to do with offshore funds and everything to do with legitimate international investment.

The rules are structured so that unless an investment in a foreign entity fits specifically into an exemption, it's a FIE, with the typical result that there is deemed income based on prescribed interest rates as applied to the "designated cost" of the FIE. While a major exemption is available for controlled foreign affiliates,[1] (in most cases) anything else – most "co-ventures", for example – must be scrutinized carefully, even if it is active-business-related, and therefore might fit into the major exemptions offered for this type of investment.[2] In this respect, I believe there may be major issues where there are layers of FIEs. Look-through rules are limited by accounting practice: consolidated financial statements in accordance with Canadian or similar GAAP may be required.[3] With the possible exception of a controlled foreign affiliate, any substantial foreign investment, even if business-related, should be reviewed to make sure it is not caught by the rules. The more complex the structure, the more likely it is that issues may arise.

The various revisions to the FIE proposals have spawned virtual sub-regimes where special knowledge is required. Somewhere along the way it became apparent that the rules could adversely affect Canadian beneficiaries of non-resident estates and trusts – in situations where the non-resident trust proposals themselves do not apply. The latest revisions make it pretty clear that unless the estate or trust is completely discretionary (no default clauses allowed), the rules are in play.

Let me say it in plain words. If you are a beneficiary of a non-resident estate or trust, the general rule is that you must pay tax based on the interest factor applied to the entire trust's/estate's assets, even though you may receive only pennies. This makes sense? Here's another example: A person who has immigrated to Canada with a foreign life insurance policy will ultimately have to revalue the policy every year and pay tax on the increase.[4] C'mon, Jim. Some poor schmuck comes into Canada and he has to do this? How does he even go about it?

Let me be honest. I doubt that you're going to hop on a plane to Hawaii. So is there any chance that you might make some changes to these proposals? I know, I know – they've gone all the way through the House of Commons, not to mention your own Department. But you have to admit it – a lot of this legislation is off-the-wall. Instead of helping Canadian businesses compete abroad, the FIE rules and other elements of our international tax policy are structured as if we were a superpower.[5]

Actually, this brings me to one last point. Having gone through some examples, let me give you my overview, straight from the middle of the Pacific. I honestly think that there is something terribly wrong going on here, not only with the legislation itself, but with the legislative process in your own Department – and I think you should fix it. These are not technical glitches I am talking about, they are stinkers. And by the way, while the biggest stinkers lie in the international area, there are other stinkers too (the restrictive covenant proposals spring to mind).

I know what you're thinking. If I'm carping about competitiveness, why haven't I carped about the double dip/tower proposals, which (speaking of harming competitiveness) replaced the restricted interest proposals in the March 2007 federal Budget. You're probably getting so

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many letters from my colleagues down the street at King and Bay, I don't see the point.

Aloha!

– David Louis, B.Com., J.D., C.A., tax partner Minden Gross LLP, a member of MERITAS Law Firms Worldwide.

Notes:

[1] However, where the CFA holds an interest in a FIE, the income related thereto will be included in the CFA's FAPI, per proposed paragraph 95(2)(*g*.3).

[2] A participating interest in a non-resident entity will not be a FIE if either the "carrying value" of "investment property" (as defined in proposed subsection 94.1(1)) is not greater than 50% of all property held by the non-resident entity, or the principal undertaking of the non-resident entity is carrying on a business other than an "investment business" (as defined in proposed subsection 94.1(1)). See the definition of "foreign investment entity" in proposed subsection 94.1(1). In addition, a "qualifying entity" may be an "exempt interest". However, there is an "all or substantially all" test in respect to qualifying carrying values. Practitioners who are familiar with the capital gains exemption generally agree that relying on this test can be dangerous.

[3] Proposed paragraph 94.1(2)(*a*) provides that, in determining whether the particular non-resident entity is a foreign investment entity, if the "financial statements" of an entity reflect property, indebtedness, income, or losses of a lower entity, the business and non-business activities, net accounting income (and so on) are deemed to be carried on by, owned (and so on) by the upper entity. As a general rule, "financial statements" must be consolidated, prepared in accordance with GAAP per the Accounting Standards Board of Canada or substantially similar GAAP. (See the definition of "financial statements" in proposed subsection 94.1(1); per proposed paragraph 94.1(2)(*b*), GAAP of the Financial Accounting Standards Board of the United States or the International Accounting Standards Board is "substantially similar".) Other look-through rules require notification to the Minister; for example, proposed paragraph 94.1(2)(*j*) provides formulae to look through to the financial positions of a downstream entity, provided that the taxpayer has a "significant interest" in the entity (for corporations, 25% or more of votes and value).

[4] For further discussion of these issues, see "Clear and Present Danger – The Saga Continues" in the June edition of TAX NOTES. I have had several comments about an anomalous provision in the proposed legislation relating to interests in non-resident trusts and estates which I did not mention in the article, so I thought I would mention it now. As stated above, the FIE "interest factor" is applied to the trust's assets. Per proposed clause 94.1(2)(c)(ii)(B), the designated cost of an interest in a trust or estate is based on the "cost amount" of the interest in the trust, per subsection 108(1), but a special "adjustment" ignores the normal reduction for debt owing by the trust. I am mystified by the rationale for this. In addition, the cost amount is based on the entire asset base of the trust. However, this amount is divided by the number of Canadian resident beneficiaries who are identified by the beneficiary in prescribed form, so that Canadian beneficiaries appear to get no relief where there are also non-resident beneficiaries.

[5] The FIE proposals are reminiscent of the U.S. PFIC rules.

CRA Q&A Re Pension Income Splitting

Reproduced below is a CRA Q&A, released July 18, 2007, regarding the pension income splitting initiative introduced in the 2007 federal Budget and implemented by Bill C-52 (S.C. 2007, c. 29, Royal Assent June 22, 2007).

1. What is pension income splitting?

Beginning with 2007 income tax returns, Canadian residents will generally be able to allocate up to one-half of their income that qualifies for the existing pension income tax credit to their resident spouse (or common-law partner) for income tax purposes.

The amount allocated is deducted in determining the net income of the person who actually received the pension income, and it is included in computing the net income of the spouse or common-law partner. Pension splitting affects the calculation of income and tax payable for both persons, so they must both agree to the allocation in their tax returns for the year in question.

2. Is it necessary to contact the payer of the pension?

Splitting eligible pension income does not have any effect on how or to whom the pension income is paid, so it does not involve the payer of the pension. Information slips will be prepared and sent to the recipient of the pension income in the same manner as previous years.

3. Who qualifies for pension income splitting?

A pension recipient (pensioner) and his or her spouse or common-law partner can elect to split the pensioner's "eligible pension income" received in the year if:

- they are married or in a common-law partnership with each other in the year and are not, because of a breakdown in their marriage or common-law partnership, living separate and apart from each other at the end of the year and for a period of 90 days commencing in the year;[1] and
- they are both resident in Canada on December 31; or
  - if deceased in the year, resident in Canada on the date of death; or
  - if bankrupt in the year, resident in Canada on December 31 of the calendar year in which the tax year (pre- or post-bankruptcy) ends.

4. What is "eligible pension income"?

Eligible pension income is generally the total of the following amounts received by the pensioner in the year (these amounts also qualify for the pension income amount):

- the taxable part of annuity payments from a superannuation or pension fund or plan; and
- if received as a result of the death of a spouse or common-law partner, or if the pensioner is age 65 or older at the end of the year:
  - annuity and registered retirement income fund (including life income fund) payments; and
  - Registered Retirement Savings Plan annuity payments.

Note: Old Age Security and Canada or Quebec Pension Plan payments do not qualify.

5. How do individuals elect to split eligible pension income?

The pensioner and spouse or common-law partner have to make a joint election in prescribed form with their income tax returns for the year on or before their filing due date (generally April 30 of the year following the tax year, or June 15 if self-employed). The new Form T1032, Joint Election to Split Pension Income, will be available by January 2008. The 2007 income tax return will include a new line for the pensioner to deduct the amount of pension allocated to the spouse or common-law partner. A new line will also be added for the spouse or common-law partner to report the allocated pension income.

6. Who will claim the tax withheld at source from the eligible pension income?

The income tax that is withheld at source from the eligible pension income will have to be allocated from the pensioner to the spouse or common-law partner in the same proportion as the pension income is allocated.

7. Will pension income splitting affect the pension income amount?

The pensioner will be able to claim whichever amount is less: $2,000 or the amount of his or her eligible pension income after excluding amounts allocated to his or her spouse or common-law partner.

The spouse or common-law partner will be able to claim whichever amount is less: $2,000 **or** the amount of his or her pension income that is eligible for the pension income amount, including the allocated pension income.

Note: A pension that qualifies for the pension income amount in the hands of the pensioner does not necessarily qualify for the pension income amount in the spouse or common-law partner's hands because eligibility can depend on age (see question 4).

8. Does pension splitting affect the Goods and Services Tax/Harmonized Sales Tax (GST/HST) credit, Canada Child Tax Benefit (CCTB), and other federal or provincial benefits and tax credits?

Allocating pension income to a spouse or common-law partner reduces the pensioner's net income and increases the spouse or common-law partner's net income. As a result, benefits and tax credits that are calculated based on the total of the net incomes of both spouses or common-law partners – such as the GST/HST credit, CCTB, and related provincial or territorial benefits – will not change as a result of pension splitting.

However, pension splitting will affect any tax credits and benefits that are calculated using one individual's net income, such as the age amount, the spouse or common-law partner amount, and the repayment of Old Age Security benefits.

9. If pensioners intend to split pension income when filing their returns, can they ask for a reduction of tax being withheld from the eligible pension income during the year?

The CRA cannot approve a reduction of tax withheld at source based on an election to split pension income.

10. If pensioners intend to make this election when filing their 2007 returns, can they reduce their instalment payments?

Many individuals, including pensioners, are required to pay tax by instalments, and the CRA issues instalment reminders to them indicating the amounts to be paid by each instalment due date. However, as an alternative to paying the amounts shown on the reminders, instalment payments can instead be made based on either the individual's prior-year net tax owing and CPP payable, or his or her estimated current-year net tax owing and CPP payable.

Under the current-year option, an individual can estimate his or her current-year net tax owing for 2007 based on the intention to split pension income. However, if the instalment payments are insufficient, instalment interest may be charged. More information about instalment payments and instalment interest charges is available in Pamphlet P110, *Paying Your Income Tax by Instalments*.

Notes:

[1] A pensioner and his or her spouse or common-law partner will still be eligible to split pension income if living apart at the end of the year for medical, educational, or business reasons (rather than a breakdown in the marriage or common-law partnership).

CRA's Update on Eligible Dividends

Reproduced below is a CRA release, dated July 10, 2007, describing issues concerning the administration of the rules relating to eligible dividends, contained in Bill C-28, which received Royal Assent on February 21, 2007.

The Canada Revenue Agency (CRA) would like to provide an update on two issues.

(1) Subsection 89(11) of the *Income Tax Act* (the "Act") permits a Canadian Controlled Private Corporation (CCPC) to elect not to be a CCPC by using the Form T2002 – *Election or Revocation of an election not to be a Canadian-controlled private corporation (2006 and later tax years)*. The election is effective for that year and subsequent years, beginning in the 2006 fiscal year. As the measure was not passed into law until February 2007, some private corporations whose fiscal year ended early in 2006 and who may have wished to make this election were required to file their T2 returns before that date and before the prescribed form was made available. For that reason, the election under subsection 89(11) for the 2006 taxation year will be considered to have been filed on time if filed on, or before, December 31, 2007.

(2) The CRA has recently determined that a former version of T2 Schedule 53 – *General Rate Income Pool (GRIP) Calculation (2006 and Later Tax Years)*, a form used to calculate the GRIP pursuant to subsection 89(7) of the Act, did in some situations, for the 2006 taxation year, produce an excessive balance. Unfortunately, this fault in the form was also built into software packages sold by commercial vendors. The CRA posted a revised T2 Schedule 53 on its website on June 13, 2007, and is working with software companies to correct this problem. If any corporation has paid out a dividend in excess of its eligible GRIP amount due to reliance on the CRA's T2 Schedule 53, its representative should send details to Mr. Wayne Adams, Director General of Income Tax Rulings (see contact information below) as soon as possible after the revised form is available. Corporations that paid an excessive dividend as a result of the error in the form will not be subject to the penalty tax set out in Part lll.1 of the Act, provided they contact Mr. Adams before December 31, 2007, to identify steps to restore the proper balance.

CRA Contact:

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All or *Nunn*: Taxpayer Forced To Include Value of RRSP Investment in Income After Participation in Dubious Tax Scheme

The Queen v. Nunn, 2007 DTC 5111 (Federal Court of Appeal)

This case provides another example of an individual taxpayer who sought the assistance of the Tax Court after becoming the victim of a dubious tax scheme and a consequential adverse tax assessment. In this case the facts are fairly straightforward. The taxpayer was the annuitant of an RRSP which had a value of $29,000. Upon encountering financial difficulties and illness, the taxpayer agreed to participate in a scheme which purportedly offered him the opportunity to continue investing funds in his RRSP, while obtaining immediate access to a substantial part of his RRSP via a loan secured by the RRSP.

Under the scheme, the taxpayer's RRSP purchased shares of a corporation owned by the promoter, which in turn "invested" the taxpayer's funds in the shares of another corporation controlled by the promoter. The facts showed that the promoter had convinced a number of other individuals to transfer funds from their RRSPs in a similar fashion; other investors had in fact received a portion of their invested funds back in the form of loans from one of the corporations. However, the taxpayer did not receive any funds in such a manner since a provincial regulator had commenced an investigation into the promoter and its activities, apparently stopping the scheme in its tracks. The evidence given by the CRA in the Tax Court of Canada (which was not contested by the taxpayer) showed that none of the corporations ever had any business activity other than circulating funds between related corporations, and that the accounting records of the corporations had been falsified to create an impression of business activity.

The Minister reassessed the taxpayer for the taxation year in which the transaction took place, including the amount of the investment in the taxpayer's income on the basis that the taxpayer's RRSP had acquired a "non-qualified investment". In the Minister's view, the investment by the RRSP in shares of the corporation operated by the promoter was not a "qualified investment", and as such the investment was subject to the income inclusion mandated by subsection 146(10). The taxpayer appealed to the Tax Court of Canada under the informal procedure.

In the Tax Court of Canada, Madam Justice Campbell summarized the sole issue to be decided on the taxpayer's appeal as whether the purchase by the taxpayer's RRSP of shares in the promoter's corporation was the purchase of a non-qualified investment, giving rise to an inclusion of the amount of the investment in the taxpayer's income. Based on a detailed summary of the facts regarding the promoter and its investment structure, the Court quickly concluded that the taxpayer had become the victim of a scam, and that the shares purchased by his RRSP did not fall within any of the definitions of qualified investments in the Act or Regulations. However, the Court did not conclude that the taxpayer's RRSP had made a non-qualified investment, in spite of the Court's initial conclusion that the shares did not fall within any of the definitions of qualified investment. Rather, in allowing the taxpayer's appeal, the Court held that the taxpayer's RRSP had not acquired a non-qualified investment, since the taxpayer was an unwitting participant in a sham, and as a consequence never acquired a non-qualified investment due to the operation of the sham. Further, the Court concluded that since the taxpayer had never received any funds on the purported loan scheme due to the untimely intervention of provincial regulators, he should not face the punitive consequences of subsection 146(10); rather, any actual withdrawals from his RRSP would be included in his income under subsection 146(8). Madam Justice Campbell cited another informal procedure case, *St-Hilaire* (2006 DTC 3294) (see also *Lalancette* (2006 DTC 2020) which, along with *St.-Hilaire*, was decided by Mr. Justice Archambault), which dealt with another taxpayer who had participated in the same scheme as the taxpayer in the present case, as support for her conclusions in the case at bar. Neither the Crown nor the taxpayer had raised or been invited by the Court to speak to the issue of sham on which the Tax Court had based its conclusion.

The Federal Court of Appeal, hearing the Crown's appeal of the Tax Court's decision, disagreed with the decision. In allowing the Crown's appeal, the Federal Court of Appeal agreed that the Tax Court had erred in its application of the doctrine of sham as articulated by the Supreme Court of Canada in *Stubart Investments* (84 DTC 6305). The doctrine of sham is premised on parties to a transaction misrepresenting to a third party such as the Minister what the actual state of affairs is in order to secure an advantage. That was not what had happened in the case at bar. No sham existed since the taxpayer was a willing participant in a scheme to purchase shares under which, but for the intervention of the provincial authorities, the taxpayer would have received a portion of his funds in cash. As the Federal Court of Appeal noted, at best the taxpayer could have claimed that he was defrauded, but that would not have assisted him on the issue to be decided.

The Federal Court of Appeal also agreed with the Crown's second argument, that the Tax Court had breached the principles of natural justice in reaching a conclusion that was outside the scope of the pleadings and in respect of which neither party had had the opportunity to make submissions. The Federal Court of Appeal held that it was not open to the Tax Court to rule on issues not raised by either party where the parties had not been given the opportunity to address the issues. The Court cited the decision of the Federal Court of Appeal in *Pedwell* (2000 DTC 6405) as authority for this proposition. Finally, the Federal Court of Appeal held that the Tax Court had not ascertained the fair market value of the non-qualified investment and therefore remitted the case back to the Tax Court solely to determine that value.

– *Aaron Chai, McCarthy Tétrault LLP*

Recent Cases

Deemed dividends properly included in taxpayers' incomes

Both of the taxpayers, Marcel and Yvonnette, held 500 non-voting non-participating Class B preferred shares of the Centre d'Hébergement St-Joseph (the "Centre"). The taxpayers acquired these Class B shares from the Centre during 1994 and 1995 in exchange for their Class A voting common shares of the Centre. The taxpayers and Bertrand Wall ("Wall") were also the trustees of a family trust established on March 30, 1998 (the "Family Trust"). On March 18, 1998, a numbered corporation ("9061") was incorporated. At all relevant times, Marcel was 9061's only director, and Yvonnette was its president from 1999 to 2002. The Family Trust held 100% of 9061's outstanding voting common shares. Wall took no part in the decisions made by the Family Trust; however, he knew Marcel and Yvonnette, and he prepared tax returns for 1998 to 2002 for the Family Trust, the Centre, 9061, and Marcel and Yvonnette. On March 30, 1998, Marcel and Yvonnette each sold 50 of their Class B shares of the Centre to 9061 for $50,000. On April 10, 1998, Marcel and Yvonnette each sold their remaining 450 Class B shares of the Centre to 9061 for $450,000. Assuming that the sales of the Class B shares were not at arm's length, the Minister included in Marcel and Yvonnette's incomes for 1998, $593,065 and $600,539 respectively, under the deeming and grossing-up provisions of sections 82 and 84.1 of the Act. The taxpayers appealed to the Tax Court of Canada.

The taxpayers' appeals were dismissed. The Family Trust had the power to elect 9061's board of directors. Therefore, it had *de jure* control over 9061. However, under the terms of the governing trust agreement, only the three trustees of the Family Trust, acting unanimously, could make decisions binding the Family Trust. Marcel and Yvonnette could not do this alone, so they did not control 9061 *de jure*. Conversely, Wall's role as a trustee of the Family Trust was entirely passive, and he never had any real decision-making power. Hence, Marcel and Yvonnette had *de facto* control over 9061. Accordingly, when they sold their Class B shares of the Centre to 9061, they were the same guiding minds behind 9061's decision to agree to that sale. As a result, Marcel and Yvonnette and 9061 were not at arm's length. Also, immediately after the sale, 9061 and the Centre were "connected" within the meaning of subsection 186(4) of the Act, since 9061 owned more than 10% of the common shares of the Centre. Therefore, all of the conditions for the application of section 84.1 were met. As well, the taxpayers' argument that they never "acquired" the Class B shares of the Centre, although they did subscribe for them, was totally untenable. The Minister's assessments were affirmed accordingly.

Côté-Létourneau et al., 2007 DTC 768

Taxpayer not entitled to child tax benefits

The Minister assessed the taxpayer for recovery of the Canada Child Tax Benefits ("CCTBs") paid to her for her daughter from September 2005 to January 2006. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was dismissed. On a balance of probabilities, the taxpayer was not the parent primarily responsible for the care and upbringing of her daughter. Paragraph (*f*) of the definition of "eligible individual" in section 122.6 of the Act was not applicable to the taxpayer, since more than one notice had been filed with the Minister under section 122.62 of the Act. Therefore, the taxpayer was not entitled to the CCTBs that she received. It was not relevant to this finding that the father of the taxpayer's daughter had been ordered on July 11, 2006 by the Supreme Court of Newfoundland and Labrador to assign his rights to the CCTBs in dispute to the taxpayer. Also, debts owing by the Crown cannot be assigned by virtue of section 67 of the *Financial Administration Act*.

Walsh, 2007 DTC 826

Recreational activities not child care expenses

The Minister reduced the taxpayer's child care expense claims from $7,901 to $2,161 for 2002, and from $7,904 to $924 for 2003. The Minister's position was that the disallowed portion of the child care expenses claimed was either not incurred or was incurred for activities that were recreational in nature, and was not incurred to enable the taxpayer to earn income from her employment. The taxpayer appealed to the Tax Court of Canada.

The taxpayer's appeal was dismissed. In *Jones v. The Queen*, 2006 DTC 3531, the Tax Court concluded that expenses incurred for recreational activities are "child care expenses"; however, in *Levine v. The Queen*, 96 DTC 3250 (T.C.C.), it was determined that expenses incurred for children's recreational activities are not "child care expenses", as defined in subsection 63(3), because they are not incurred to provide true child care. The Minister's assessments were affirmed accordingly.

Malecek, 2007 DTC 833

Taxpayer not entitled to deduct cost of purchased shares

The taxpayer was the sole proprietor of a small business. In 2002, he spent $42,195 to purchase shares of public corporations (the "Shares") in order to protect his business from "contingencies" due to an anticipated drop in business revenues during 2003 and 2004. In 2003 and 2004, he sold a portion of the Shares to pay his ongoing business expenses. In assessing the taxpayer for 2002, the Minister disallowed the deduction of the cost of the Shares. The Tax Court of Canada dismissed the taxpayer's appeal (2006 DTC 3220) on the ground that the $42,195 was a non-deductible capital outlay. On his appeal to the Federal Court of Appeal, the taxpayer argued that (a) the proceeds of sale of the Shares were used during 2003 and 2004 to pay business expenses that were deductible, so the Tax Court's decision was unreasonable, and (b) tax laws put sole proprietors at a disadvantage with corporations in the same type of business, because of the difference in tax rates.

The taxpayer's appeal was dismissed. Both of the taxpayers' arguments were untenable. The Minister's assessments were affirmed accordingly.

Aktary, 2007 DTC 5264

Taxpayer grossly negligent in failing to correct tax filing error

The taxpayer had a total income of $3,154,851 for 2000. His accountant prepared his 2000 return, showing interest of $985, when the actual total interest income was $276,420. In reassessing the taxpayer for 2000, the Minister added the unreported interest of $275,435 to his income, and imposed penalties for gross negligence. The taxpayer appealed to the Tax Court of Canada for the penalties imposed.

The taxpayer's appeal was dismissed. The taxpayer knew the size of his bank account and the amount of the interest that it generated. A quick review of his return would have revealed to him that the reported interest amount was understated. Also, his failure to detect the underreported interest amount was more than mere carelessness. It amounted to indifference to complying with the Act. The Minister's reassessment was affirmed accordingly.

Hougassian, 2007 DTC 823

FMV of dividends should not have been reduced

The Minister assessed the taxpayers vicariously for tax owing by their corporation when it paid dividends to them. In allowing the taxpayers' appeals in part (2005 DTC 1579), the Tax Court of Canada concluded that (a) the dividends received by the taxpayers constituted a "transfer" of property without consideration, within the meaning of paragraph 160(1)(*a*) of the Act, but (b) for subsection 160(1) purposes, the fair market value of the dividends received by the taxpayers should be reduced by the tax payable by them. The Crown appealed to the Federal Court of Appeal, and the taxpayers cross-appealed.

The Crown's appeal was allowed and the taxpayers' cross-appeals were dismissed. The Tax Court judge was correct in finding that the dividends constituted a "transfer" of property without consideration. She was merely following an established line of Supreme Court and Federal Court of Appeal decisions. However, the Tax Court judge erred in reducing the fair market value of the dividends by the tax payable. The tax consequences to the taxpayers upon receipt of the dividends were not remotely relevant to the determination of the fair market value of those dividends for purposes of a subsection 160(1) vicarious liability assessment. The Minister's assessments were affirmed accordingly.

Gilbert, 2007 DTC 5270

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